SURREY COUNTY COUNCIL

SURREY PENSION FUND COMMITTEE

DATE: **18 SEPTEMBER 2015**

LEAD OFFICER: **SHEILA LITTLE, DIRECTOR OF FINANCE**

SUBJECT: **UNITISATION OF ASSETS**

SUMMARY OF ISSUE:

The report explains the need for an alternative, more sophisticated, robust allocation of fund assets to scheme employers.

RECOMMENDATIONS:

It is recommended that the Pension Fund Committee:

1. consider the benefits that asset unitisation would bring to the Fund in order to support a focused employer funding and investment strategy;

2. approve in principle the future implementation of asset unitisation and request officers to work with the Fund's actuary towards its implementation with effect from 1 April 2016 (the effective date of the next actuarial valuation), and subject to the actuary's final report being approved by the Committee.

REASON FOR RECOMMENDATIONS:

The Pension Fund Committee must be aware of the need and requirement for more refined methods of allocating assets to scheme employers based on employers' unique maturity status, funding position, investment time horizon and covenant strength.

DETAILS:

Background

1 The Local Government Pension Scheme (LGPS) has changed and continues to change. The number of employers and variability of employers bears no resemblance to the LGPS from, say, ten years ago. The administering of employers participating in the Fund (often with more diverse characteristics) now requires far more information and advice. Benefits are now becoming increasingly complicated to administer, requiring additional reporting and scrutiny, with the bar raised in relation to governance, audit and transparency.

2 Thus, the requirements and responsibilities are fast becoming ever more onerous and complicated, and therefore there is a need for more robust processes and greater transparency for stakeholders. The current method for asset tracking is becoming increasingly limited and outdated.

3 Currently, employers participating in each fund within the LGPS are allocated assets at each formal valuation. The fund actuary carries out this valuation once every three years. The standard approach across all actuarial firms advising LGPS funds when allocating assets for a multi-employer fund is to use an "analysis of surplus" approach, which involves complicated actuarial techniques.

4 The current method relies heavily on using averages, which works best when employers have similar characteristics (e.g. funding level, cash flow, membership profile, investment time horizon and covenant strength). This also applies to the use of market and return data, which have recently been far more volatile than in the past. The current approach (use of averages) necessarily shares the Fund's experience proportionately across all employers in the Fund. It allows for employer specific experience, where the relevant data exists over the inter-valuation period, to determine the assets for each employer in the Fund.

5 This methodology has worked well in the past. However, given the changing LGPS environment and, in particular, the ever increasing number and varying profiles of employers, the traditional approach can result in an element of partial cross-subsidy across employers. A form of unitisation could be regarded as a better solution to the allocation of assets in a multi-employer scheme.

6 Unitisation supports a more focused employer funding and investment strategy based on unique employer maturity, membership profile and covenant strength characteristics which, in turn, promotes more effective employer risk management, better outcomes for employers and better protection for the Fund.

Analysis of Surplus Approach

7 Rather than the analysis of surplus approach being used as a method of asset allocation, it is better employed as an independent review of the calculations. In particular, the approach has the following limitations:

- Assets are linked to the value placed on the liabilities. The attribution of assets therefore relies on fully accurate membership data. Whilst the quality of the Surrey membership data is considered exemplary, 100% accuracy is very difficult to achieve.

- Any changes to one employer's assets, due to an update on the analysis of surplus calculations, impacts on the assets allocated to all other employers, as the Fund's employers are sharing the total value of assets of the Fund.

- It is not possible to analyse accurately at employer level all items which will have resulted in a profit or loss to employers which are required to carry out a complete analysis of surplus. The data is not available at a sufficiently granular level, and so some cross-subsidies occur, e.g., for the salary increase analysis. The actuary can only analyse members who were active at both the previous and current valuation, so any member who joined or left between the valuation dates is excluded from the analysis. Under an asset unitisation approach, the assets do not depend on (in this example) the salary analysis.

- The analysis of surplus approach uses fund averages for some experience items as sufficient data is not available to do this at employer level, which again leads to cross-subsidies.

- Manual intervention is required to ensure that the asset allocation is adjusted for any transfers of employers which do not occur on a fully funded basis.

- Differences in approach between formal triennial valuations and inter-valuation employer calculations are not captured, e.g., employer cessations.

- Individual movements of members from one employer to another may not be reflected accurately.

- The analysis of surplus approach requires actuarial expertise and experience and the process cannot be fully automated. This results in a cost increase.

- The analysis of surplus approach is not transparent or easy to understand for employers.

Unitisation as an Alternative Approach

8 Unitisation provides an efficient way of accurately apportioning assets to individual employers. It allows for employer cash flows and investment returns achieved by the Fund in the same way as a bank account or investment fund operates. It is a pragmatic process that meets the needs of LGPS funds.

9 Unitisation processes are commonly used where assets are invested for the mutual benefit of several parties. Examples of this include unit trusts, where each investment or disinvestment of monies involves the purchase or selling of units in the trust. The same principles can be extended to the LGPS, where the stakeholders in this case are the different employers who each have an interest in the LGPS fund. By sub-dividing the fund's assets into units, the fund can more easily and accurately track each individual employer's assets. Changes in the value of the underlying assets are allowed through changes in the unit price.

10 By moving to unitisation and an asset tracking approach, there will be particular benefits to the Fund:

- Assets allocated to employers would be readily auditable and more accurately reflect the employer's assets through a reduction in the level of cross-subsidies across participating employers (and so reduce the risk of the potential challenge by employers).

- Allow the Administering Authority to give investment flexibility to employers as appropriate and offer bespoke investment strategies to meet the needs of particular employers.

- Improve the record keeping, financial accounting and administration of the Fund with precisely calculated monthly asset valuations, as opposed to averages over a three-year time period.

- Have a system for allocating assets that is robust and more accurate than the current approach, while retaining a level of pragmatism proportionate to the needs of the Fund.

- Benefit from efficiencies in the longer term, resulting in lower future costs on formal valuation and other actuarial work.

- Benefit from increased engagement from employers as the approach would be easier to understand and more transparent.

- Conversely, there will be a degree of complexity in the record keeping and administration of the sharing of employers' assets within the Fund.

11 Concerning the offering of more than one bespoke investment strategy, one potential concern would be the degree to which the Fund would be likely to allow bespoke strategies to be applied. Clearly, there is a benefit of moving away from one size fits all, but too much complexity may be equally undesirable. Initial consideration would be given to a growth asset pool and a risk aligned pool, with possibly a default allocation between the two. Alternatively, consideration could be given to something more granular, for example, 'Equities', 'Liquid Alternatives', 'Real Assets' and 'Liability Aligned'.

12 A further consideration is the current lack of optionality when seeking to switch away from riskier assets (equities) to less risky assets (traditionally, fixed income gilts and corporate bonds). The current risk characteristics inherent within gilts and corporate bonds make the traditional move away from equities more problematic and challenging.

Reduced Costs Resulting from Unitisation

13 Unitisation will result in lower formal valuation costs as asset calculation will be automated, rather than relying on actuarial expertise and experience using the analysis of surplus approach. There will be potential for further benefits of efficiency, reduced costs and better quality service to stakeholders.

14 In the longer term, it is expected that the actuarial process will be faster and cheaper by linking asset unitisation with other actuarial data and calculation systems. There will be a reduction in cyclical workloads for the Administering Authority as there is no need to supply bulk cash flow data for accounting and formal valuation exercises.

Bespoke Investment Strategies for Employers

15 Unitisation will provide a platform to allow numerous bespoke investment strategies for employers with special circumstances, for example, employers that are extremely mature or, alternatively, employers with a very high proportion of active membership. This will allow transparency, in terms of their individual investment strategies and the corresponding risk inherent within those strategies. It will also allow flexibility in terms of an employer's ability to align its specific investment and funding strategy with its objectives.

16 Unitisation will also allow the ability to deal more accurately with investment returns achieved on employer cash flows by pricing assets on a monthly rather than three-yearly basis, which will reduce cross-subsidy across those employers that are cash flow positive and those that are cash flow negative.

Risk Management

17 Unitisation will allow more accurate allocation of assets and less cross-subsidy between employers. It will result in more accountability and ability to audit assets, which will avoid challenge by employers or auditors.

18 Any inaccurate data for an employer or revised data for a new employer would be less problematic as this would no longer affect the allocation of assets to all other employers. Transparency, ease of understanding by employers and less challenge by employers, will result in growing employer confidence, which should reduce queries from employers and reduce the risk to the Fund.

Improved Means of Asset Apportionment

19 Given the immediate access to accurate asset and pricing data, unitisation will result in a more efficient and faster automated financial accounting system for record keeping and administration. Employer asset values would be available for all actuarial calculations on a monthly basis. Currently, the employers' asset share is reset once every three years at the formal valuation, resulting in a discontinuity in employers' asset values.

20 Regular communication of the asset position will increase engagement and awareness by employers. This would be beneficial to ongoing risk monitoring of employers within the Fund and could be further enhanced by regular reporting of their liabilities.

21 Employers will easily understand and verify their assets. This may encourage better funding behaviours as employers see a more immediate and tangible benefit of paying contributions to their own share of the Fund's assets. Employers can also be alerted to negative cashflow concerns. Employers would also better understand their obligations to the Fund.

Focused Funding and Investment Strategy Framework

22 A standard funding and investment approach has become increasingly inappropriate as the cohort of employers in the Fund with unique characteristics has mushroomed.

23 A standard funding and investment approach may expose well funded and short duration employers to a high level of risk while, for less well funded employers, this may not offer the growth bias required.

24 A focused funding and investment approach need not include a complex myriad of investment strategies unique to each employer. Instead, employers with similar risk characteristics such as covenant, maturity, funding position and investment time horizon could be grouped together for the purposes of then identifying suitable contribution strategies and compatible high level investment strategies that may more closely reflect the objectives of each group.

25 A comprehensive framework will be established in order to categorise employers. However, an initial example of the possible classification of differing employer investment strategy groups is illustrated as follows:

Group 1 Large secure employers: main fund approach with dynamic growth and de-risking triggers;

Group 2 Other well funded employers: reduced risk strategy;

Group 3 Poorly funded employers: short term maintenance of growth weighting with transition to lower risk if conditions allow.

26 A comparison of the current standard approach and the approach that could be adopted with a focused funding and investment strategy framework is set out in the table below.

Current standard approach	
One strategy	
70%	30%
Growth assets (Growth)	Lower risk (Low risk assets)

Focused funding and investment strategy framework		
Notionally separate		
Group 1	70%	30%
	Growth assets	Lower risk assets
Example: reasonably well funded or secure (e.g. councils, colleges)		
Group 2	20%	80%
	Growth assets	Lower risk assets
Example: well funded employer with no guarantor (e.g. admitted bodies)		
Group 3	50%	50%
	Growth assets	Lower risk assets
Example: poorly funded employers (e.g. charities, housing associations)		

27 The benefits of setting out a focused funding and investment strategy approach include:

- Transparency: any interested body in the Fund can understand how each employer has been categorised in accordance with clearly defined criteria with the opportunity for employers to take appropriate remedial action, for example, offering increased security;

- Risk mitigation: it allows the classifications to be periodically reviewed in line with the risks, including covenant strength;

- Appropriateness: a focused funding and investment strategy allows the Fund to meet unique employer funding objectives more effectively and accurately.

28 Although it is possible to implement a multi-strategy approach without unitisation through the creation of notional sub funds, unitisation does make a multi-strategy approach far easier to administer. The unitisation of assets in the Fund also enables the possibility of further sophisticated approaches to be adopted in the future.

CONSULTATION:

29 The Chairman of the Pension Fund Committee has been consulted on the report.

RISK MANAGEMENT AND IMPLICATIONS:

30 Risk related issues are contained within the report, most notably the single investment strategy currently being implemented for a very diverse set of employer organisation with different circumstances.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

31 The costs of unitisation and the adoption of a focused employer funding and investment strategy will be investigated and reported in a future Committee report.

DIRECTOR OF FINANCE COMMENTARY

32 The Director of Finance will ensure that all material, financial and business issues and possibility of risks will be considered when a final report is presented to the Committee.

LEGAL IMPLICATIONS – MONITORING OFFICER

33 Legal implications or legislative requirements associated with this initiative will be addressed in future Committee reports.

EQUALITIES AND DIVERSITY

34 There are no equalities or diversity implications associated with this report.

OTHER IMPLICATIONS

35 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

36 The following next steps are planned:

- Further investigations and a further report presented at a future Committee meeting following the actuarial valuation 2016.

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Contact Officer:
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Consulted:
Pension Fund Committee Chairman

Annexes:
None

Sources/background papers:
None