2019 Valuation: Section 13 Overview

Addressee and purpose

This paper has been requested by and is addressed to Surrey County Council ("the Council") in its capacity as Administering Authority to the Surrey Pension Fund ("the Fund"). It has been prepared to

- provide a recap on the purpose and high-level overview of the Section 13 valuation applicable to LGPS funds; and
- discuss the Fund's funding strategy in two areas that will be of focus during the 2019 Section 13 valuation.

It has not been prepared for use for any other purpose and should not be so used.

No liability is accepted under any circumstances by Hymans Robertson LLP for any loss or damage occurring as a result of reliance on any statement, opinion or any error or omission contained herein where the report is used by or disclosed to a third party.

We are happy for this paper to be shared for information purposes with the Government Actuary's Department as part of any engagement with the Fund regarding the 2019 Section 13 valuation.

Background

The 2019 formal valuation of the Fund is nearly complete, and the final report will be signed before 31 March 2020 (as required by the LGPS Regulations). The formal valuation concerns itself with reviewing and amending (where necessary) existing funding plans to ensure there are enough monies to pay members' benefits when they fall due. The main output of the funding valuation is the Rates and Adjustments certificate containing the contribution rates payable by employers from 1 April 2020 to 31 March 2023.

Prior to the Public Sector Pension Scheme reforms, this would be the completion of the valuation process. However, a part of these reforms was a requirement included in the Public Service Pensions Act 2013 to review each LGPS fund's 'local' funding valuation to ensure compliance with four aims:

1. The valuation is in accordance with the LGPS Regulations ("Compliance")
2. The valuation has been carried out in a way which is not inconsistent with other LGPS funds' valuations ("Consistency")
3. Employer contribution rates are set at an appropriate level that ensures solvency of the fund ("Solvency")
4. Employer contribution rates are set such that they are fair between generations ("Long term cost efficiency")

This review is colloquially known as the "Section 13 Valuation" and its primary purpose is to provide a mechanism that allows Central Government to gain comfort that no LGPS fund is setting inappropriate funding plans which increase the likelihood of their being insufficient monies to pay members' benefits when they fall due.

As the responsible authority for the LGPS, the Ministry of Housing, Communities and Local Government ("MHCLG") were required to appoint an appropriately qualified person to carry out the Section 13 Valuation. MHCLG appointed the Government Actuary's Department ("GAD").

The first Section 13 Valuation was carried out after the 2016 round of local valuations and GAD's final report was made publicly available[1] in September 2018. Shortly after its publication, the four actuarial advisors to LGPS

[1] https://www.gov.uk/government/publications/local-government-pension-scheme-review-of-the-actuarial-valuations-of-funds-as-at-31-march-2016

funds issued a joint public letter outlining their thoughts about the report and process. This letter is contained in Appendix A.

The Fund did not raise any flags for concern in the 2016 report.

2019 Section 13 Valuation

GAD have recently been in touch with all LGPS funds to outline their approach for the 2019 Section 13 Valuation. The timetable for GAD's valuation is below:

- March/April 2020: Data collation by Administering Authority and Fund Actuary
- End of April 2020: Submission of data to GAD
- Q4 2020: GAD engage with actuarial firms who advise LGPS funds to discuss initial findings
- Q1 2021: GAD engage with those funds where further information/discussion is needed
- Summer 2021: GAD publish final report

GAD have confirmed that they will continue to review each LGPS fund's local valuation against the four aims of compliance, consistency, solvency and long-term cost efficiency using a similar approach to that taken during the 2016 exercise.

GAD have also confirmed in a draft letter to the England & Wales LGPS Scheme Advisory Board[2] that they intend to focus on two additional areas for the 2019 Section 13 Valuation, these are:

- Allowance for the impact of the McCloud case; and
- Falling contribution rates.

Allowance for the impact of the McCloud case

GAD explicitly state in their draft letter that they plan to review Funding Strategy Statement ("FSS") and final valuation report to check if the approach towards potential additional McCloud costs has been clearly set out. A corollary to that is that GAD will also be checking to see if funds have made provision for the potential of additional costs due to the resolution of the McCloud case.

Surrey Pension Fund's position

The risk associated with the McCloud case is that, although the remedy is expected to increase the cost of LGPS benefits, the format or nature of the remedy is currently unknown. It is therefore difficult to make an explicit allowance for McCloud when setting employer contribution rates.

As such, during the 2019 valuation process we considered and discussed with Officers in depth how to best mitigate the McCloud risk. As detailed in the FSS, the Fund has increased the likelihood of success in nearly all employers' funding plans. By including additional prudence in the funding plans, we expect that all, or a large proportion, of the increased costs due to the McCloud remedy can be absorbed which reduces the need to revisit employer contribution rates. Where an allowance hasn't been made e.g. in the instance of contractors, if cessation occurs, allowance will be made where appropriate.

Given this approach, we would **not anticipate** GAD raising any concerns about the FSS or valuation report for the Fund as far as the McCloud treatment is concerned.

[2] https://www.lgpsboard.org/images/PDF/CMBDAJanuary2020/Item8PaperB_2019Section13Report_ DraftGADletter.pdf

Falling contribution rates

The second area of additional focus for GAD concerns the long-term cost efficiency measure, which is intended to flag funds who are seen to be placing an undue burden on future taxpayers. In their draft letter, GAD state that where funds have reduced overall contribution rates, they will review the FSS and valuation report to check this has not led to an 'adverse impact' on future taxpayers. In these cases, GAD would expect a fund to have:

- kept the same deficit recovery end date, or brought it forward, and
- made an explicit allowance for potential McCloud costs

As well as the specific points about funds who have reduced contributions, GAD also intend to increase their scrutiny of the long-term cost efficiency measure (for example flagging funds with low funding levels and low contributions compared to the LGPS peer group).

Surrey Pension Fund's position

We are supportive of the principles of long-term cost efficiency and intergenerational fairness within the LGPS. However, we do have some concerns with various aspects of GAD's approach to evaluating the long-term cost efficiency measure and have raised them with GAD in the past (see "How deficit recovery periods should be set" in Appendix A for further information).

Specifically, we believe that funding an open pension scheme with a decreasing recovery period (for a fund either in surplus or deficit) leads to volatile contributions and increased potential for intergenerational cross-subsidy. If GAD will carry out their calculations as outlined in their draft letter, we expect that it is likely that the Fund will not be flagged against the long-term cost efficiency measure.

Our understanding is that GAD will continue to only look at the whole fund contribution rate i.e. the aggregate total of employer rates, when they carry out their analysis.

The table below shows the whole Fund contribution rates for the periods 1 April 2017 to 31 March 2020 and 1 April 2020 to 31 March 2023 for comparison.

Period	Primary rate	Secondary rate		
		Year 1	Year 2	Year 3
1 April 2017 to 31 March 2020	15.8% of pay	£43,770,000	£44,044,000	£44,324,000
1 April 2020 to 31 March 2023*	18.2% of pay	£36,262,000	£37,511,000	£38,814,000

* The rates for the period from 1 April 2020 have not yet been finalised for all employers and as such are subject to change

As you can see from the table above, the whole Fund **secondary contribution rates** for 1 April 2020 to 31 March 2023 are expected to be less than those disclosed in the 2016 valuation report for the previous 3 years. However the whole Fund **total rate** when considered in percentage of pay terms has increased from 23.5% of pay in 2019/20 to 24.4% of pay in 2020/21 (based on the 2019 valuation payroll).

Note the above is subject to the contribution rates for employers being agreed as per our proposed rates. We will confirm the whole Fund total rates from 1 April 2020 once the final rates are agreed. On this basis we would not expect there to be a flag.

Further commentary

Whilst we don't believe there will be a flag, it may be helpful for the Fund to have an awareness of their position in relation to the points that GAD intend to focus on, namely deficit recovery period and deficit recovery end date, (although we expect the focus to be on those funds were rates are decreasing).

The Fund's **deficit recovery period** is 20 years as per the 2016 valuation period. This is reasonable in an open pension scheme when new benefits are continued to be accrued and there is no crystallisation or end in the future. However, this means that under GAD's interpretation the **deficit recovery end date** is now three years further in the future, 31 March 2039. **Therefore, GAD will view this as an extension of the deficit recovery timeframe.**

Based on GAD's 2016 Section 13 Valuation, it was known that an extension of the deficit recovery timeframe may result in a flag, this did not sway the funding strategy considerations during the 2019 valuation for the following reasons:

- we believe that GAD's expectation around reducing deficit recovery timeframes is not appropriate for open pension schemes;
- the primary objective during the valuation is to set long term, affordable and robust funding plans that the Fund's Actuary, Officers and Committee believe are appropriate.

As such, the funding plans set at the 2019 valuation are appropriate, risk-aware and aim to achieve inter-generational fairness.

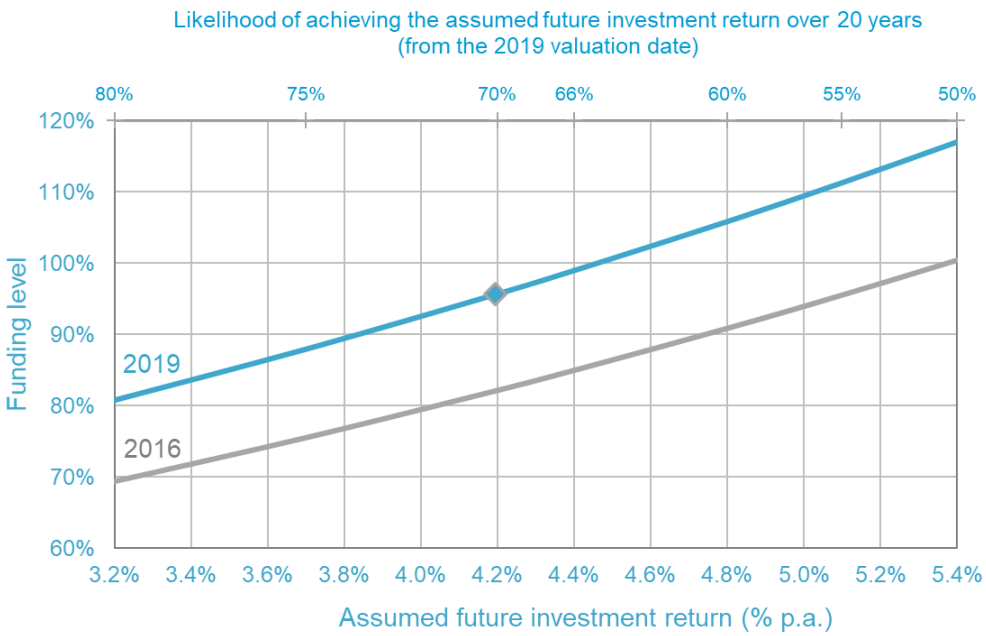
Evidencing intergenerational fairness

To give the Fund comfort we have outlined why we believe the funding plans set at this valuation are appropriate and inter-generationally fair. These can be summarised as:

1. Less reliance on future investment returns;
2. Higher proportion of contribution receipts in relation to funding deficit;
3. Appropriate likelihood of success of the funding plan

Future investment returns

The chart below shows how the past service funding position of the Fund at the 2019 valuation has genuinely improved since 2016. The chart details how the past service funding level varies (vertical axis) with the assumed level of future investment return (horizontal axis) at both the 2016 and 2019 valuation.



Given that the 2019 line is above 2016, this means Fund now needs a lower level of future investment return to have enough monies to pay members' future benefits. For example, to be 100% funded at the valuation date, the Fund would have needed a future investment return of 5.4% p.a. at the 2016 valuation. At the 2019 valuation, the required return has reduced to 4.5% p.a..

Contributions funding deficit

The Fund is receiving more secondary contributions per £ of funding deficit than 2016.

	2016 valuation	2019 valuation
Funding deficit at valuation date (£000)	679,000	196,000
Secondary contribution rate (£000) *	44,324	37,904
Contribution per £ of deficit	6.5%	19.3%

* 2016: 2019/20 whole fund secondary rate, 2019: 2022/23 whole fund secondary rate

Likelihood of success of the funding plan

At the 2016 valuation, a funding plan was agreed for the employers that make up most of the Fund which had a minimum likelihood of 66% of achieving full funding at the end of the funding time horizon. The funding time horizon was 20 years, so the funding plan end date we inspected was 2037 (20 years from introduction of new rates on 1 April 2017).

At the 2019 valuation, the funding time horizon of 20 years has continued to be used. However, when agreeing funding plans, inter-generational fairness was considered by reviewing the likelihood of success at both 2035 and 2038 (as the modelling was carried out as at 31 March 2018). The Fund then agreed a funding plan which had a minimum likelihood of 70% of achieving full funding at the end of 20 years this would be in 2038. The Fund then concluded that the funding plans agreed at 2019 did not place an undue burden on future taxpayers (or were unfair to the current generation of taxpayers).

We are happy for the Fund to use the above information when liaising with GAD during their engagement phase in Q1 2021 to give them comfort that the Fund's funding plans are cost efficient in the long term. We would be happy to provide any further information or support during this engagement phase if necessary.

Next steps

At this stage of the process there is no further action for the Fund to take regarding the Section 13 Valuation and the areas considered in this paper. We will keep the Fund informed as any new information or details emerge regarding the 2019 Section 13 Valuation.

Reliances and limitations

This paper has been prepared to provide an overview of the 2019 Section 13 Valuation. It has not been prepared for any other purpose and should not be used for any other purpose.

The Administering Authority is the only user of this advice. Neither I nor Hymans Robertson LLP accept any liability to any party other than the Administering Authority unless we have expressly accepted such liability in writing. The advice or any part of it must not be disclosed or released in any medium to any other third party without my prior written consent. In circumstances where disclosure is permitted, the advice may only be released or otherwise disclosed in its entirety fully disclosing the basis upon which it has been produced (including any and all limitations, caveats or qualifications).

I am happy for this paper to be shared with the Government Actuary's Department to help support the Administering Authority during any discussions related to the 2019 Section 13 Valuation.

Please note that the comments made in this paper regarding whether the Fund raises any concerns or 'flags' are based on my opinion only and interpretation of the draft approach to be undertaken by GAD which may be subject to change. As we are not carrying out the Section 13 valuation we cannot be certain or guarantee the approach that will be taken.

The results contained in this document are for the Fund as a whole. It does not set out the valuation results for individual employers. We would advise against extrapolating the results contained in this document to predict possible funding positions or contribution rates for employers at this stage.

The following Technical Actuarial Standards[3] are applicable in relation to this report and have been complied with where material given the summary nature of the paper:

- TAS100

Gemma Sefton FFA

For and on behalf of Hymans Robertson LLP

03 March 2020

[3] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work.

Appendix A: Actuarial advisors' reply to 2016 Section 13 Valuation

Dear Sirs

Local Government Pension Scheme 2016 Section 13 Valuation

We are writing to you as the responsible authority for the LGPS and Chair of the Local Government Pension Scheme Advisory Board (England and Wales) on behalf of the four firms who provide actuarial advice to LGPS funds regarding the Section 13 review carried out by the Government Actuary's Department (GAD).

We recognise that the initial headline messages in the report are positive about the overall progress being made by the LGPS, and this has been identified in the initial press reports which have emerged since the report's publication. Clearly this is something which we are pleased to see. However, on reading the detail of the report we have some material concerns over its content. We believe that it is important to highlight these, as we do below, and that it is not in the interests of the LGPS for some of GAD's recommendations to be taken forward.

Our concerns relate to GAD's:

- lack of recognition of the LGPS's updated financial position and outlook;
- approach to engagement during the process;
- interpretation of consistency as applied to LGPS funding plans; and
- understanding of LGPS funding plans and expectation of how deficit recovery plans should be set.

We consider each of these areas in turn.

The LGPS Funding Position and Outlook

We believe that the LGPS's financial position has improved significantly over the last few years and, for most local authorities, we do not currently expect that monetary contributions will need to rise following the 2019 valuations (albeit the valuation date is still six months away so that cannot be guaranteed).

The Section 13 report is based on the position as at 31 March 2016. It does acknowledge the significant improvement in funding since 31 March 2013 (from 79% to 85% on average on prudent local bases and from 92% to 106% on average on GAD's best estimate market basis). However, despite being published 18 months after the 2016 valuations were signed off, the report does not acknowledge that the funding position would have been expected to increase further due to continuation of deficit contributions and due to the funds' strong asset performance since 2016. Instead, the report is largely focussed on highlighting perceived failures by Funds against a series of arguably rather arbitrary actuarial metrics, many of which focus on a single point when in fact there are a number of interrelated issues at play.

Our concerns are that readers (particularly lay readers) may conclude that:

- The LGPS is not being well managed from a funding perspective, with more than 20 amber or red flags being allocated.
- There will be significant employer contribution increases at the 2019 valuation based on GAD's asset liability modelling work (work which we believe goes beyond the remit and requirements of Section 13). Based on current financial conditions, this does not reflect what we expect will happen in reality and seems to emanate from GAD's assumption that contributions are set solely based on prevailing market conditions and gilt yields.

Engagement
We recognise that GAD do not carry out valuations of LGPS funds for funding purposes, so all four firms of actuarial advisers have invested considerable time and effort assisting GAD in their work preparing this report.

Our concerns are that:

- Very little of the extensive feedback that we provided has been reflected in the final approach and published report, and similarly for the feedback which has been provided by those clients consulted directly by GAD. It therefore seems to us that GAD have not taken fully into account how the LGPS is funded and how this differs from private sector schemes.
- The metrics are in our view too simplistic and could lead to incorrect/invalid conclusions. Whilst it is accepted that there is a balance to be struck between simplicity by applying metrics (where there is a risk of applying them rigidly despite them potentially offering limited insight) and a detailed bespoke analysis which would offer a more rounded view, in many cases, in our view, there hasn't been sufficient detailed engagement with the administering authority and Fund Actuary to understand local circumstances or the risk management measures already in place to mitigate the identified risks. Readers of the report will see the metrics used as a valid test (especially with the Red/Amber/Green classification used). This could influence funding behaviours in an effort to avoid a future red or amber flag and lead to lay readers drawing incorrect conclusions about the performance of a fund and its officers and committee. Ultimately this could result in actions being taken which are not in the best interests of the LGPS and/or individual funds.

We believe GAD should recognise more explicitly that these metrics are limited in nature and instead undertake a more holistic review of, and commentary on, funding plans with considerably more engagement with key stakeholders at individual funds.

Interpretation of consistency
We have no objection to GAD's recommendation in relation to presentational consistency (Recommendation 1) as long as any "template" reporting is provided in good time to be implemented and is mandatory (since some administering authorities may otherwise refuse to agree to any changes).

However, we fundamentally disagree with how GAD has approached what they call "evidential consistency": the wording in the Public Service Pensions Act is “not inconsistent” implying a focus on identifying outliers which is entirely logical for a review analysing and comparing local LGPS valuations. GAD has instead interpreted their role as requiring a comparison of individual assumptions (focusing on those used to calculate the past service funding level) and commenting on whether or not they are identical. Our concern is that readers will be given a completely false impression of what we understood to be the intentions of Section 13.

In addition, our concerns are that:

- There is very little commentary on the main output from a local LGPS funding valuation, i.e. the employer contributions payable. Given LGPS funds are open, ongoing and long term statutory schemes, the contributions payable are far more relevant and important than the assessment of the past service funding position (on which GAD has focused). We believe that there is far greater consistency in relation to employer contributions and the report as drafted will give readers a false impression of what is most important in the overall funding plan.
- GAD does not acknowledge that different assumptions and funding mechanisms are valid when setting employer contribution rates nor that this diversity in approach allows administering authorities to adopt the approach which maximises the chance that they meet their objectives in light of their appetite for risk and the specific circumstances of the Fund. Equally important, the Fund Actuary is required to have regard to the Funding Strategy Statement when carrying out the valuation. This is an administering authority document and administering authorities may appoint an adviser on the basis of the funding approach adopted. Our concern is that GAD's assertion that house views are responsible for the assumptions adopted for local valuations is misleading, ignores the administering authorities’ (and employers') key role within the valuation process and does not provide an appropriately balanced view.

In putting forward Recommendation 2, GAD has neither outlined what the benefits for the LGPS and its stakeholders would be, nor has it considered the potential downsides in terms of the reduced input from the administering authority into the funding process and the fundamental change in governance arrangements which would be involved. A change of this nature needs to be considered from a policy point of view with consultation with all stakeholders, rather than being introduced by the back door. We therefore do not agree with Recommendation 2 and believe that the Scheme Advisory Board should consider the feedback we provided to GAD before taking this recommendation forward.

In particular, we believe that a better focus for the Section 13 review would have been:

- consideration of the consistency of output of the valuation, i.e. employer contribution rates rather than focusing on certain individual assumptions used to calculate funding levels;
- commentary and analysis of the overall funding strategy and assumptions, including level of prudence, rather than a focus on individual assumptions in isolation; and

- a comparison of employer contribution rates against funding levels (assessed on a standardised funding basis), which would give a visual representation of the above two points and some insight into relative prudence of the overall funding approach for each fund.

How deficit recovery periods should be set

Deficit recovery periods can form an important part of the funding strategy, particularly where funding levels are low, but in practice are often not key drivers of the contribution plan. Our concern is that the application of a strict "rules-based" approach could potentially inadvertently lead to the wrong conclusions in cases where the funding plan overall is robust and meets the cost-efficiency requirements. In particular:

- A fund wishing to adopt a more prudent actuarial valuation basis may be reluctant to do so if the result is an increased deficit recovery period and hence a risk of triggering on this measure.
- A fund which feels it can sensibly afford to adopt a more risk-averse investment strategy may decide against doing so if it will give rise to a longer deficit recovery period.
- When deficit recovery periods are relatively short, there comes a point where seeking to shorten them further at every actuarial valuation may lead to increased volatility of contributions and therefore come into conflict with cost-efficiency.
- Funds/employers may fall foul of this trigger simply due to seeking to manage their budgets prudently within their financial constraints (e.g. paying increased contributions whilst it can afford them with a view to reducing them in future years when its financial position is tighter).
- GAD has interpreted CIPFA's guidance on deficit recovery periods to mean that these should have a fixed end date. However, as GAD has acknowledged, they were not part of discussions when the guidance was drawn up. During these discussions, we have already confirmed to GAD that a deficit recovery period was used to mean a number of years e.g. 20 years, so the intention was for funds to operate with a rolling recovery period which does not extend in the number of years. We are concerned that because GAD has a different interpretation of CIPFA's guidance, even if funds follow that guidance on our advice, they may still be flagged on this metric.

We think it would make more sense for the deficit recovery period not to be flagged in isolation, but for a more rounded view of the funding plan to be taken in the context of viewing whether a fund meets the cost-efficiency requirement. Rather than Recommendation 5, of the report, we would have preferred to have seen:

- the deficit recovery period at this and the previous valuation being noted; and
- a flag being raised only if it were felt that the cost-efficiency requirement was not being met overall.

We are disappointed that after so many months of discussions we are in a position to have to write this letter to you. However, we feel very strongly that it is important to ensure that the requirements of Section 13 can be met whilst recognising the positive steps taken by local authorities to date so it does not become the driver of LGPS funding plans to the detriment of the vast majority of well-managed LGPS Funds and the public perception of the LGPS. One of the great strengths of the LGPS is that it is

funded, giving it a far greater degree of transparency and accountability particularly when compared with the other public service schemes. We would be more than happy to provide further input and gather further feedback from our administering authority clients if that would assist you in determining how best to respond to GAD's review.

Yours faithfully

Alison Murray FFA
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For and on behalf of Aon

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For and on behalf of Barnett Waddingham

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