Pension Panel	
24 July 2019	**Part I**
Funding Strategy Statement	
Report by Director of Finance and Support Services	

Summary

The Pension Fund has commenced its triennial valuation. However there are a number of factors which may impact the outcome or the period that rates need to be set (eg. the McCloud case, HM Treasury's cost control mechanism and the Scheme Advisory Board's (SAB) cost control mechanism and the outcome of several consultations or Government decisions, including a consultation on the frequency of the Local Government Pension Scheme valuation cycles).

Since the Pension Panel last met, the Government's request for an appeal against the December 2018 the Court of Appeal judgement relating to transitional protections has been denied by the Supreme Court. This means that the Court of Appeal's decision will be upheld and the case will be returned to an employment tribunal for a detailed decision. The court will require steps to be taken to compensate employees who were transferred to the new Scheme, potentially requiring retrospective changes (from 1 April 2014) for benefits and member contributions – with the benefit structure becoming more generous.

Notwithstanding the above uncertainty the Pension Fund has drafted its Funding Strategy Statement. The Statement summarise the Administering Authority's approach to funding its liabilities and how employer liabilities are measured and follows the Pension Panel's training on funding strategies. The full Statement and feedback is included within this report.

Recommendation

1. The Panel notes the update on the McCloud judgment

2. The Panel consider the feedback from Employers relating to the draft Funding Strategy Statement.

3. The Panel agree the current version of the Funding Strategy Statement as the approach assumed by the Actuary when calculating employer liabilities and determining the pace at which these liabilities are funded.

4. The Panel agree that further minor changes to the document can be made by the Director of Finance and Support Services in consultation with the Chairman. Any material changes will be brought back to the Pension Panel.

5. The Panel provide comments on the draft response on the changes to the local valuation cycle and management of employer risk and agree that the final response is sent by the Director of Finance and Support Services in consultation with the Chairman.

Background

1. The Fund has commenced its triennial valuation. It is anticipated that this will set employer contributions from 1 April 2020 until 31 March 2023. However there are a number of developments which provides significant uncertainty:

    - **The McCloud case**: Where the Court of Appeal ruled that the 'transitional protection' offered to some members as part of the recent pension reforms amounts to unlawful discrimination – directly on grounds of age and indirectly on other grounds. The Government's request for an appeal has been denied but uncertainty of the resulting benefit changes remains.

    - **The HM Treasury cost control mechanism and the Scheme Advisory Board (SAB) cost control mechanism:** Introduced as part of the recent pension reforms to periodically assess the costs of benefits to ensure that the reforms are affordable and sustainable. The cost control mechanism may trigger changes to LGPS benefits and member contributions, but is currently paused in light of the McCloud case.

    - **The outcome of several consultations or Government decisions**: The implementation of these may affect the Scheme (eg. Fair Deal II, Exit Credits, Guaranteed Minimum Pension Indexation and Equalisation and changes to the local valuation cycle and management of employer risk).

McCloud judgment – leave to appeal denied

2. The Pension Panel have received information previously relating to the Court of Appeal's judgement that transitional protections in place following Scheme changes in 2014.

3. On 27 June 2019 the Supreme Court denied the Government's request for appeal. A summary of the issues is included in Addendum 1.

Local government pension scheme: changes to the local valuation cycle and management of employer risk

4. The Ministry for Housing, Communities and Local Government (MHCLG) launched a consultation on 8 May 2019 covering the following areas:

    - Amendments to the local fund valuations from the current three year (triennial) to a four year (quadrennial) cycle and measures aimed at mitigating the risks of moving from a triennial to a quadrennial cycle

    - Proposals for flexibility on exit payments, further policy changes to exit credits and changes to the employers required to offer local government pension scheme membership

5. It is proposed that the response from the County Council:

- Raises concerns about moving to a four yearly valuation cycle due to the potential impact on management of employer risks and maintaining the objective of stable employer contribution rates.

- Supports the ability for Administering Authorities to have the discretion to do an interim valuation at either whole fund or specific employer level (on an approximate basis or otherwise), with the decision depending on the reasons for undertaking the valuation.

- Requests that safeguards are put in place and clear, considered Guidance is provided to ensure there is a clear framework for requests for interim valuations to avoid short-termism.

6. A full draft response has been attached (Addendum 2) and comments are sought from the Pension Panel. Responses must be provided by 31 July 2019.

Funding Strategy Statement

7. Following the training about funding strategies at the April Pension Panel, and as part of its preparatory work for the 2019 Actuarial Valuation Fund, officers have reviewed and drafting a Funding Strategy Statement for the West Sussex Scheme.

8. The FSS is reviewed in detail at each valuation or between valuations for any minor amendments required reflecting regulatory changes or alterations to the way the Scheme operates. This is in line with CIPFA guidance. The last review was completed as part of the 2016 valuation, and the Statement was agreed by the Pension Panel at their meeting on 30 January 2017.

9. The purpose of the Funding Strategy Statement is to summarise the Administering Authority's approach to funding its liabilities and how employer liabilities are measured (the value of the benefits to be paid to members), the pace at which these liabilities are funded (the balance between investment risk and the level of contributions required) and how employers or pools of employers pay for their own liabilities in order to achieve the Administering Authority's funding aims of:

    - Affordability and stability of employer contributions

    - Prudence in the funding basis

    - Transparency of processes

10. The draft Funding Strategy Statement has been reviewed by the Pension Advisory Board in their role of supporting the Scheme Manager by ensuring compliance with Regulations. The comments from the Board are included in their draft minutes (Agenda Item 5).

11. The draft Funding Strategy Statement has been attached for the Panel's review and approval (Addendum 3).

12. The draft Funding Strategy Statement was shared with employers as part of a consultation exercise (Start date: 19/06/2019 // Deadline: 10/07/2019). Responses received are summarised on the following page:

Employer Type	Comments / Feedback
Academy	• Appears to be good and solid, much as one might expect. • With a fully funded scheme, to do all that we can to minimise costs / reduce employer monthly contribution rates. • With regard to potential pressures (not least of which the McCloud case), there is a preference to await the outcome and deal with it once it becomes a reality, rather than anticipating "bad news" and keeping contributions high "just in case". • Consideration should be made of the impact of providing additional security to the Fund to move an employer through risk categories (eg. medium to lowest).
Parish Council	• Happy with consolation document.
Academy	• Happy to follow the proposed schedule, etc, detailed in the Funding Strategy Statement. • At this point, with the on-going government appeal, it does not seem appropriate to make any recommendation for change even if we thought there was a need.
Admission Body	• Happy to go with the recommendations/majority of feedback.
Scheduled Body	• No comments to add on the draft statement or proposed approach.
Scheduled Body	• Nothing comments
Admission Body	• Correction of typographical errors
Admission Body	• TBC (extension agreed)

13. The Statement may need to be reviewed as and when the outcomes of the above consultations (and resulting legislative changes), decisions and guidance are known. Wider consultation will be undertaken on any material changes in approach as a result of these changes.

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Addendum

- Addendum 2 – Draft response to changes to the local valuation cycle and management of employer risk consultation

Background

- Court of Appeal decision (McCloud) - https://www.judiciary.uk/wp-content/uploads/2018/12/lord-chancellor-v-mcloud-and-ors-judgment.pdf
- Guidance for the 2019 Valuation in respect of cost cap process and the McCloud and Sargeant age discrimination case (McCloud) https://www.lgpsboard.org/images/Other/Advice_from_the_SAB_on_McCloud_May_2019.pdf
- Letter on the Pause to the Cost Management Process - https://www.lgpsboard.org/images/CM/LetterPause.pdf
- MHCLG Consultation on Changes to the Valuation Cycle: https://www.gov.uk/government/consultations/local-government-pension-scheme-changes-to-the-local-valuation-cycle-and-management-of-employer-risk Valuations

Addendum 2

Local Government Pension Scheme: Changes to the Local Valuation Cycle and the Management of Employer Risk
Policy consultation

Quadrennial Cycle

Question 1:
As the Government has brought the LGPS scheme valuation onto thsame quadrennial cycle as the other public service schemes, do you agree that LGPS fund valuations should also move from a triennial to a quadrennial valuation cycle?

The Government brought the LGPS scheme valuation onto the same quadrennial cycle as other public service schemes with an effective date of 31 March 2024.

However we believe that three years remains an appropriate period and do not consider that the case has been made to move the local valuations to quadrennial, nor that it will deliver great stability in employer contribution rates and reduce costs.

It should be noted that:

- Regulation 62 of the LGPS Regulations 2013, CIPFA guidance on Preparing and Maintaining a Funding Strategy Statement and the Pension Fund's own Funding Strategy Statement include mechanisms to delivery stability of employer contribution rates.

- The LGPS is funded and holds assets with values and performance that can fluctuate significantly over time. This volatility needs careful and regular management. A longer cycle may lead to the funding position drifting over a longer period and therefore a sharper correction to contribution rate being required at the end of the period (particularly for shorter term employers such as closed charities).

- Accounting standards and guidance require that employers determine the net defined benefit liability with sufficient regularity so that the amounts recognised in the financial statements do not materially differ from the amounts that would be determined at the end of the reporting period. As IAS19/IAS26 reports are calculated on a roll-forward basis, it is not clear what the views of private sector and public sector auditors are if an inter-valuation period is extended and whether interim valuations are required for accounting purposes, increasing costs.

- Employer circumstances and their financial covenant can change quickly, and lengthening the valuation cycle may expose LGPS funds to greater covenant risk. In this context, interim valuations as considered within the Consultation (whether at a whole of fund level or for individual employers) will also increase costs.

- Moving to a four year cycle, with the use of interim valuations, will also add to the burden of already stretched administration teams. When considering any changes to the current arrangements it is equally important to ensure that administering authorities have the capacity to comply with those changes, at no detriment to their current obligations to scheme members and their dependents.

In the context of the above it is difficult to be certain that moving to a four yearly cycle will save costs given the cost of carrying out interim valuations and any other additional employer work required as a result and not necessarily present value given the more substantive possible costs arising from the funding impacts of a delayed valuation.

Question 2:
Are there any other risks or matters you think need to be considered, in addition to those identified above, before moving funds to a quadrennial cycle?

In addition to points raised above, a formal valuation is not just about number crunching. It provides a governance opportunity to undertake a 'health check' on the Fund's data and risk management policies, and the metrics provided (cash flows, benefit projections, funding positions etc.) are often used for strategic investment reviews. Increasing the cycle may encourage less governance.

There is a risk of a repeat of the current situation where the 2019 valuations are to be carried out without knowing what the benefit structure of the LGPS as at the valuation date will be as a result of the mis-alignment of timing of benefit/member contribution changes following the cost management process and the local valuation calculations.

Question 3:
Do you agree the local fund valuation should be carried out at the same date as the scheme valuation?

We consider that the 'as at' date of the scheme valuation should be ahead of the local fund valuations. This would allow time for:

- The Government Actuary's Department (GAD) to gather the necessary data and do the calculations;

- Discussion to take place on the results with the various national oversight bodies;

- Agreement to be reached over any changes to the benefit structure or employee contribution rates to get the cost of the scheme within the +/- 2% of pay corridor; and

- Software providers to make the necessary changes to systems and for those changes to be fully tested ahead of the effective date.

This should avoid changes to benefits or employee contributions being implemented retrospectively and allow time for administration and valuation systems to be updated to reflect the correct structure for the local valuations.

Question 4:
Do you agree with our preferred approach to transition to a new LGPS valuation cycle?

Notwithstanding the comments above, we agree that approach b) (completion of the 2019 valuation with a three year Rates and Adjustments Certificate followed by another valuation as at 31 March 2022 and a two year Certificate) is preferred to a five year gap between the 2019 valuation and the next.

Dealing with changes in circumstances between valuations

Question 5:
Do you agree that funds should have the power to carry out an interim valuation in addition to the normal valuation cycle?

We are supportive of the introduction of a broader power (outside of Regulation 64) to carry out an interim valuation and believe that this is important to support administering authorities' risk management generally given the diverse range of sponsoring employers - and specifically should local valuations be moved to a quadrennial cycle.

We consider it would be sensible for funds to have the discretion to do an interim valuation at either whole fund or specific employer level (on an approximate basis or otherwise), with the decision depending on the reasons for undertaking the valuation

Question 6:
Do you agree with the safeguards proposed?

We agree with the proposal that the circumstances in which an interim valuation would be carried out should be properly documented and defined within the Funding Strategy Statement. Regulations and statutory Guidance on protections is also welcome to ensure that there is some consistency across funds. It is important that the scope for requesting and agreeing to interim valuations does not become an unwelcome distraction and divert attention from the delivery of administration services to scheme members and their dependants.

We would consider that the Local Pension Board would have an important role in ensuring that the Scheme Manager is then complying with the above guidance.

It would be of benefit to understand the factors that the Secretary of State would take into account before requiring an interim valuation on representation from a scheme employer. We are particularly keen to avoid 'moral hazard' situations where employers lobby for a valuation to take advantage of favourable market conditions, for example.

It will also be important to:

- Define the necessary outcomes if an interim valuation is carried out eg. the adoption of the required rate, or otherwise.
- Consider the administrative burden of providing data for interim valuations, particularly where requested by scheme employers.

Question 7:
Do you agree with the proposed changes to allow a more flexible review of employer contributions between valuations?

We consider the following circumstances as being appropriate for an Administering Authority to change employer contributions (across all employer types):

- If an employer closes the fund to new entrant
- If there is a material transfer of staff to or from an employer, for example caused by a Machinery of Government change or outsourcing a large numbers of staff to another body.
- If there is a change in covenant

We consider that safeguards should be put in place to remove the ability avoid a scheme employers requesting a reassessment driven by short termism which would negate MHCLG's objective of stability of contributions.

Question 8:
Do you agree that Scheme Advisory Board guidance would be helpful and appropriate to provide some consistency of treatment for scheme employers between funds in using these tools?

We consider that there is merit in considered and consulted statutory Guidance being provided. It would make sense that this was an extension of CIPFA's existing Funding Strategy Statement Guidance, or wherever the responsibility for statutory guidance referred to in Regulation 58 resides.

We would caution against the guidance being too prescriptive. It is important to ensure local decision-making and the diversity of funding levels and employers within funds is recognised but as referred above it would be helpful if such guidance were to cover the tests that would need to be met in order for a scheme employer to request an interim valuation itself from the Secretary of State.

Question 9:
Are there other or additional areas on which guidance would be needed? Who do you think is best placed to offer that guidance?

The fact that a valuation is interim rather than full does not take away the need for professional advice. Our assumption therefore is that an interim valuation should not be undertaken without having been signed off by the Fund Actuary and this constitutes "*proportionate level of actuarial advice*". However it would be beneficial if this was clarified.

Whilst employers may request interim valuations for accounting purposes it will be important to be clear that it is the administering authorities and not employers who have the final say on reviewing employer contributions. Guidance on this would be helpful to ensure consistency between Administering Authorities.

Our response to # 8 provides some thoughts on who is best placed to offer guidance.

Question 10
Do you agree that funds should have the flexibility to spread repayments made on a full buy-out basis and do you consider that further protections are required?

It is important to clarify that "exit payments" from the LGPS are not calculated on a full buy-out basis and the Regulations as they currently stand do not subscribe any one basis for valuing exit debts. In practice, these can differentiate materially between different types of employer and between funds.

We believe that additional flexibilities would be helpful in constructively managing the exit of any employer, independent of the basis of the exit valuation.

Whilst there are circumstances when the timing of an exit event and the magnitude of any exit debt may not be known until well after the exit event, Administering Authorities also manage an employer flight path to reduce the likelihood of liabilities on exit being "significantly higher than their ongoing contributions".

We would consider spreading exit payments a risk, even with a legal side agreement being in place. But in appropriate circumstances this additional risks could be managed through:

- The payment arrangement being at the discretion of the Administering Authority (and the guarantor where appropriate), allowing them to make a judgement on the covenant of the underlying employer;
- Locally, there is a maximum period for repayment
- Interest be charged at an appropriate rate
- The Administering Authority should have the ability to request additional security be put in place during the repayment period.

Question 11:
Do you agree with the introduction of deferred employer status into LGPS?

We agree with the introduction of a deferred employer status, subject to further detailed consultation.

However consideration needs to be given as to how we would manage and be aware of the 'relevant events'.

Question 12:
Do you agree with the approach to deferred employer debt arrangements set out above? Are there ways in which it could be improved for the LGPS?

We agree with the introduction of deferred employer debt arrangements, subject to further detailed consultation.

We would consider the following safeguards as being necessary:

- Termination could be triggered on significant deterioration of covenant without an associated insolvency event.

- Either the employer or the fund can trigger termination without agreement of the other party providing that this then leads to an exit valuation being carried out

- A "flight plan" approach whereby the funding and investment strategy are regularly reviewed in light of the longer-term target of being fully funded on a gilts basis may be appropriate, particularly for larger employers.

Question 13:
Do you agree with the above approach to what matters are most appropriate for regulation, which for statutory guidance and which for fund discretion?

The Regulations should be limited to key obligations and entitlements of parties, supplemented by supporting Guidance formed with significant input from LGPS practitioners throughout the drafting and consultation stages.

Question 14:
Do you agree options 2 and 3 should be available as an alternative to current rules on exit payments?

We agree options 2 and 3 should be available as alternatives to the current rules on exit payments.

Question 15:
Do you consider that statutory guidance or Scheme Advisory Board guidance will be needed and which type of guidance would be appropriate for which aspects of the proposals?

We believe that guidance is needed. A balance will need to be struck between compulsion to ensure a consistent interpretation of the Regulations and the ability of funds to manage their own funding and employer risks. We would strongly encourage any guidance to go out for full public consultation.

Exit credits

Question 16:
Do you agree that we should amend the LGPS Regulations 2013 to provide that administering authorities must take into account a scheme employer's exposure to risk in calculating the value of an exit credit?

We believe that exit credits should not be applied retrospectively to any contracts that were in force prior to 14 May 2018, whether on a risk-sharing basis or otherwise. In other words, the exit credit regime should only apply to new contracts that were set up from 14 May 2018 onwards.

However, it is worth noting that there is a very wide range of risk sharing arrangements in place and it is important to avoid circumstances where the onus is on the Administering Authority adjudicating on what is, in many cases, a contractual arrangement between two employers, outside of the admission agreement and exit calculations can vary materially between different types of employer and between funds, based on their own local funding strategy.

Question 17:
Are there other factors that should be taken into account in considering a solution?

It is important to consider the breadth of arrangements in which an employer may bear less pension risk (including "pass through" or cap and collar arrangements, allocation of specific risks (e.g. excessive pay increases), a fixed contribution rate) and the commitment that is often in place for the awarding authority to absorb any assets and liabilities after the contractor exits the fund.

As the contract price and other terms and conditions will have been determined on whatever basis was agreed at the outset, we believe it is important for the Regulations to be amended so that no exit credits are payable for transferee admissions entered into before the date of the Regulatory changes.

Even if a change is agreed to state that the administering authority can determine (as part of its funding strategy) that an exit credit is only due for existing admissions if the contractor is in surplus on a low risk/gilts basis on exit, this would result in a move away from the arrangements intended at the time of the contract being let.

Consideration should also be given of suspension notice cases where there is a potential credit with the grounds for the suspension being consistent with those where a deficit is determined.

Employers required to offer LGPS membership

Question 18:
Do you agree with our proposed approach?

It is a policy decision for MHCLG on which employers must and which can participate in the LGPS but given the changes in this sector it does now appear arguable that HE/FE is not "public sector" and hence should not be required to admit new members.

It is important however to recognise that choosing this approach may not immediately reduce a HE/FE's pension costs, and contributions may increase in the short term, as administering authorities are likely to want to recalculate the employer contribution rate, allowing for the fact the employer is now closed to new entrants and potentially altering the funding basis to reflect the shorter term nature of the participation of the employer.

We would note that closing the scheme to new members via an Admission Agreement is preferable to an employer becoming a designating employer. The Admission Agreement would form a contractual agreement between the fund and the employer which governs the employer's participation.

We would also note that employers that use this proposal would create a two-tier work force in terms of pensions provision. There will be a need to monitor and ensure that promises are kept to those members currently in the LGPS i.e. that they are not induced out of the LGPS. The accompanying legislation should make it clear where that responsibility lies and the possible penalties for non-compliance.