

# Agenda Item 8

**Report to:** Pension Committee

**Date of meeting:** 23 September 2019

**By:** Chief Finance Officer

**Title:** Whole of Fund Results, Triennial Valuation 2019

**Purpose:** To provide an update on the progress of the actuarial valuation and to present the Whole of Fund results.

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**RECOMMENDATIONS:** The Pension Committee is recommended to:

1. note the progress of the actuarial valuation;
2. agree the background to measuring the funding level alongside initial whole fund valuation results;
3. agree the policy areas within the Funding Strategy Statement (FSS) that are under review alongside the valuation;
4. agree the next steps in the valuation in relation to setting employer contribution rates.

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## **1. Background**

1.1 The valuation of the Fund on a triennial basis is a regulatory requirement and is used to determine contribution rates payable by participating employers for the period commencing 1 April 2020. The valuation is carried out under Regulation 62 of the Local Government Pension Scheme Regulations 2013 (“the Regulations”). Members may note however that the Ministry of Housing Communities and Local Government (MHCLG) issued a consultation seeking views on proposals to amend the Local Government Pension Scheme (LGPS) valuation cycle in England and Wales from a three-year (triennial) valuation cycle to a four-year (quadrennial) valuation cycle. As a result, it is possible that the contribution rates arising from this valuation will apply for five years and this is reflected in the contribution rate modelling. The process for dealing with this change will be detailed as part of the Funding Strategy Statement review, presented to Committee on the 25 November 2019. The report of the actuary on the valuation process and findings is attached at Appendix A to this report.

## **2. Whole of Fund Results**

2.1 Since the last valuation, the funding position as at 31 March 2019 is favourable and shows a funding surplus. The funding level increased from 92% to 108%. A robust funding plan will be agreed for each employer which considers how the assets and liabilities will evolve over the time horizon in different economic scenarios. It is critical to note that the reported funding level does not directly drive the contributions that will eventually be set. The revised position is shown in Table 1, below with the results of the 31 March 2016 valuation, for comparison.

**Table 1: 2019 Funding Level (with comparison to 2016)**

Valuation Date	31 March 2016	31 March 2019
<b>Past Service Liabilities</b>	<b>(£m)</b>	<b>(£m)</b>
Employees	994	1,035
Deferred Pensioners	604	737
Pensioners	1,414	1,587
<b>Total Liabilities</b>	<b>3,012</b>	<b>3,359</b>
<b>Assets</b>	<b>2,771</b>	<b>3,633</b>
<b>Surplus / (Deficit)</b>	<b>(240)</b>	<b>273</b>
<b>Funding Level</b>	<b>92%</b>	<b>108%</b>

2.2 Based on the data provided, the initial results of the 2019 valuation, at Whole of Fund level, is favourable and shows some scope to reduce employer contribution rates across Council and Academy employers. However, the extent to which this can be applied to small and medium employers has yet to be determined. In addition, the presentational funding level will need to be considered alongside the wider considerations (such as current regulatory risk, strength of employer covenant, external scrutiny, climate change and Environmental, Social and Governance (ESG) risk, etc.). Officers are presently in the process of communicating and discussing these options with each of the employer groups, mentioned above. The outcome of these discussions will be presented to the Pension Committee for approval before the contribution rates come into payment from 1 April 2020.

2.3 The next major step in the valuation process is to calculate the funding positions and set the contribution rates for all employers in the Fund. As set out above, this process is already underway for the Authorities and Academies in the Fund. For the other medium and small employers, this requires the Fund to consider for each employer:

- The employer's funding target (i.e. how much assets to hold to meet liabilities)
- How long the employer has in the Fund to reach the funding target
- An appropriate likelihood of meeting the target (or 'likelihood of success') e.g. 2/3rds, 75%.

2.4 As part of the 2019 valuation of the Fund, a formal framework is being developed jointly by Fund officers and the Fund Actuary, to classify employers into risk categories. The details of this framework, in particular how to establish the above three parameters for each employer, will be set out in the draft Funding Strategy Statement for Committee approval. Under the current valuation timetable, a draft of the updated FSS will be discussed at the 25 November 2019 Committee meeting, and subsequently, circulated to all employers, together with their draft valuation results, for the required consultation. A finalised draft will be presented to the Pension Committee for approval at the February 2020 meeting.

### 3. ESG Considerations

3.1 In arriving at an expected future investment return over the time horizon, it is critical that the Fund considers the impact and risks of ESG investment. ESG considerations are integral to the establishment of asset returns going forward and given that premise, modelling scenarios to take ESG into consideration is advised. In the 2016 valuation, expected future investment return assumptions of 4% per annum (on average) were deemed prudent over the next 20 years. Going forward, ESG and Climate Change risks may marginally dampen the expected future investment return assumptions. The committee should note that adjusting the expected future investment return assumption for ESG considerations does not change the level of employer contributions set.

### 4. Valuation data

4.1 The Fund's Administrator submitted membership data for the purposes of the 2019 valuation, however, although the membership data is currently fit for the purposes of reporting the

initial whole fund valuation results, further data queries have been raised by the actuary. These validations, standard data checks and queries are necessary to ensure the data is suitable to calculate individual employer results and contributions, particularly for medium to small employers. Notably, these standard data checks are replicated across all Hyman's Robertson actuarial services for LGPS funds to ensure consistency of approach.

## **5. Conclusion and reasons for recommendations**

5.1 The draft Whole of Fund results for 2019 are favourable and show a funding surplus. The surplus provides scope for the reduction in employer contributions for the long term employers. The determination of employer contributions for small and medium employers, have not been calculated at this stage. The next steps are to finalise the data queries and proceed to employer level calculations.

### **IAN GUTSELL Chief Finance Officer**

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## 2019 Valuation update summary

This paper has been requested by and is addressed to East Sussex County Council (“the Council”) in its capacity as Administering Authority to the East Sussex Pension Fund (“the Fund”). It has been prepared by Hymans Robertson LLP to provide a summary of the progress of the 2019 actuarial valuation for discussion at the Pensions Committee Meeting on 23 September 2019. 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.

### Background

We are in the process of carrying out the valuation of the Fund as at 31 March 2019. The valuation of the Fund on a triennial basis is a Regulatory requirement and is used to determine contribution rates payable by participating employers for the period commencing 1 April 2020. The valuation is carried out under Regulation 62 of the Local Government Pension Scheme Regulations 2013 (“the Regulations”).

Please, however, note on 8 May 2019 MHCLG issued a consultation seeking views on (among other things) proposals to amend the LGPS valuation cycle in England and Wales from a three-year (triennial) valuation cycle to a four-year (quadrennial) valuation cycle. As a result, it is possible that the contribution rates arising from this valuation will apply for five years and this is reflected in the contribution rate modelling covered in this paper. The process for dealing with this change will be detailed as part of the Funding Strategy Statement review.

### Purpose

The purpose of this document is to update the Committee in relation to:

- a) the progress of the actuarial valuation;
- b) the background to measuring the funding level (which will be presented at the meeting) alongside initial whole fund valuation results;
- c) the policy areas within the Funding Strategy Statement (FSS) that are under review alongside the valuation;
- d) the next steps in the valuation in relation to setting employer contribution rates.

## a) 2019 valuation – progress update

### Valuation data

LGPS data collection is very complex and the most important aspect is to ensure each member receives the benefits they are entitled to. However, in order that (i) appropriate contributions are collected from employers to fund these benefits and (ii) risks can be managed in an informed way, our results rely heavily on the quality of the data provided. We are, however, very mindful of the competing demands on the administrator's time and therefore take a proportionate approach to obtaining data for LGPS valuation purposes. We use a standard set of checks, and a standard online 'Data Portal' tool, to help with the data collection process across the funds we advise.

At the time of writing, the Fund's Administrator has submitted membership data for the purposes of the valuation. This data is currently in the process of being validated. While we believe the membership data is currently fit for the purposes of reporting the initial whole fund valuation results within this paper, further data queries have been raised which should be addressed by the Administrator to ensure the data is suitable to calculate individual employer results and contributions. This will also avoid any further delays or costs later in the valuation process.

As requested, Appendix A sets out a timeline of the data provision process.

### Initial whole Fund results

Based on the data as it currently stands, we have produced initial results of the 2019 valuation, at whole Fund level, for discussion at the Committee meeting on 23 September 2019. The initial results shown below include a current funding level, where the market value of assets is compared against a value of the benefits accrued to date.

### Long-term employers' contributions rates

As part of reviewing the contribution plans for the Major Authorities, Academies and Colleges, we use in-depth asset-liability modelling to project forward assets and liabilities under thousands of different economic scenarios and test different combinations of contribution and investment strategies. The modelling then allows us to understand how likely the contribution strategy is to succeed (i.e. reach/maintain full funding over various time horizons) and the level of downside risk (i.e. how bad could the funding position get in a challenging economic climate). As discussed at the Committee's July 2019 Strategy Day, this modelling work has been carried out for each of the three groups of employers.

When considering the contribution strategies to model, we are acutely aware that the financial situation of all public sector employers means that any 'relief' in budgets would be helpful. Given this budgetary climate and recent strong assets returns for the Fund, we have been exploring with Fund Officers whether any relief in contribution rates can be passed on to employers. A contribution rate freeze or slight reduction is likely to be viewed as relief in this context. Of course, the Fund still needs to balance this desire against ensuring funding plans are robust and that there is sufficient likelihood to have enough money to pay members' benefits.

With all this in mind, we have modelled explicit short-term contribution patterns for each group for the five years from 1 April 2020 as below:

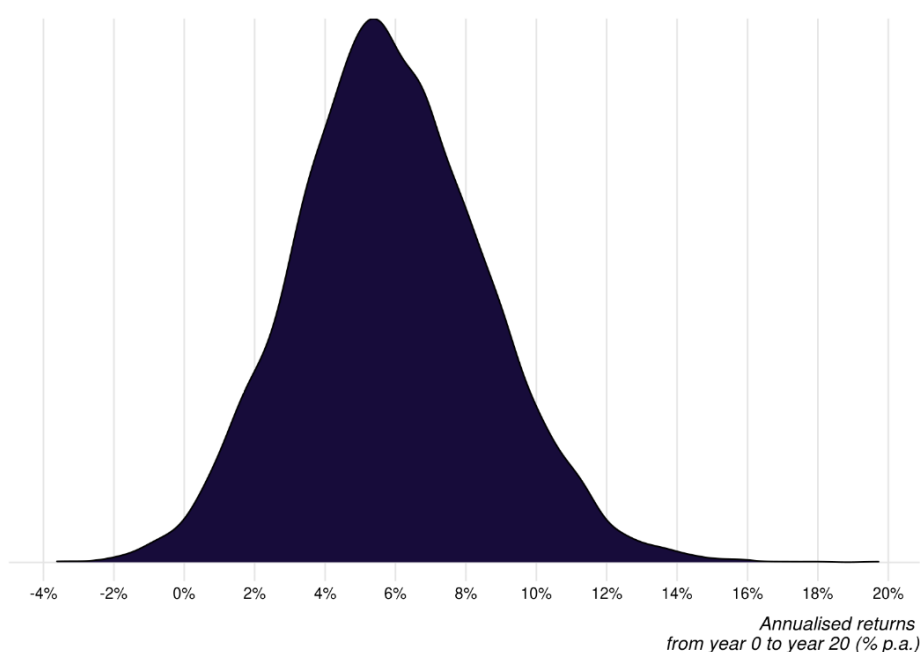
- *Gradual increase* - increase by existing maximum stabilisation parameter in each year (e.g. an increase of 0.5% of pay p.a. for Major Authorities)
- *Freeze* - freeze at current 2019/20 rates for the years up to and including 2024/25
- *Gradual reduction* - reduce the rates by the existing maximum stabilisation parameter in each year (e.g. a reduction of 0.5% of pay p.a. for Major Authorities)
- *Immediate reduction* - recognise the full 5-year contribution cycle step down immediately in 2020/21 (e.g. a reduction of 2.5% of pay for Major Authorities) then freeze at this rate up to and including 2024/25

The headline results of the modelling shows that there is some scope to reduce employer contribution rates across all employer groups but this should be discussed alongside the wider considerations (such as current regulatory risk, strength of employer covenant, external scrutiny, climate change risk, etc). Fund Officers are in the process of communicating and discussing these options with each of the three employer groups. The outcome of these discussions will be presented to the Committee for approval before the contribution rates come into payment from 1 April 2020.

## b) Measuring a funding level

At the 2016 valuation, for the purpose of showing a funding level at the valuation date, the Fund's approach was to report an assumed investment return that was based on a chosen margin above the return on long-term nominal gilt yields as at 31 March 2016.

At the 2019 valuation, we will extend the evolution we made at the last valuation to our risk based contribution rate setting methodology to the calculation of the assumed future investment return used in assessing the current funding position. Valuation outputs are more meaningful when stakeholders can understand the likelihood attached to them. Instead of using an assumption based on one market indicator (a deterministic approach), we can use an assumption that reflects the range of possible future investment returns and the likelihood of a fund's assets returning this assumption (a stochastic approach). We do this by using the Fund's current investment strategy and our proprietary economic model, the Economic Scenario Service (ESS), to generate a distribution of possible annual investment returns over the next 20 years. The distribution is shown here:

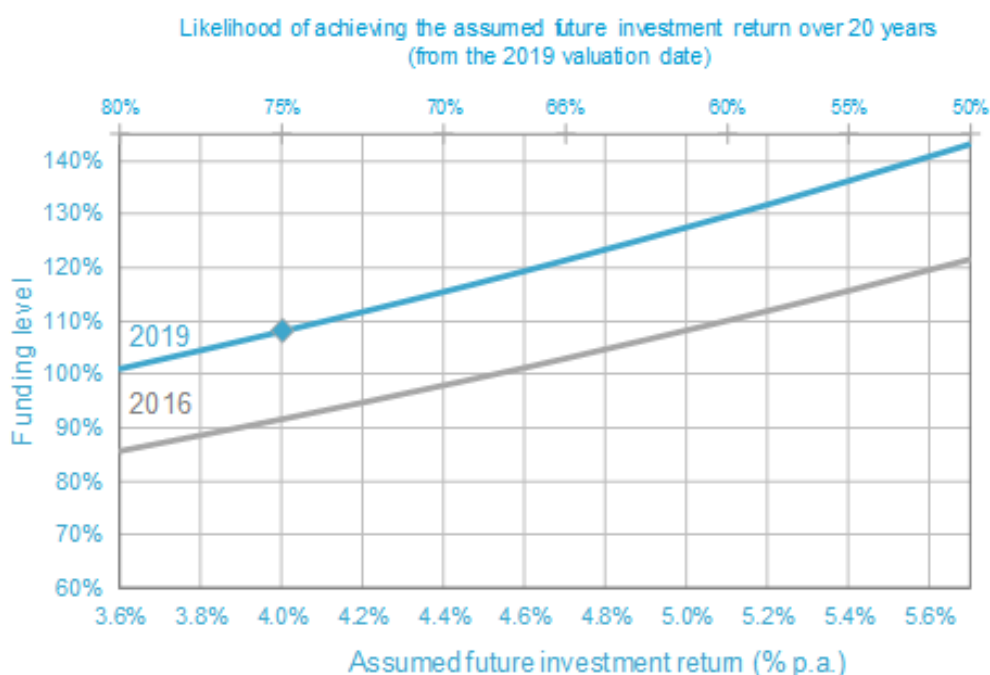


The above chart illustrates that:

- the median expected return on the Fund's assets over the next 20 years is around 5.7% p.a. (i.e. there is a 50% likelihood that the Fund's assets will return at least this level in the 5,000 scenarios modelled);
- the Fund's assets can be expected to return at least 4.4% p.a. in 70% of the 5,000 scenarios modelled; and
- the Fund's assets can be expected to return at least 3.6% p.a. in 80% of the 5,000 scenarios modelled. As the Fund is required to take a prudent approach in the valuation, and all other assumptions are best estimate, the assumption for future investment returns needs to be prudent.

The following chart demonstrates how the funding level varies with the level of prudence in the future investment return assumption. For comparison, the funding level associated with the same choice of investment return assumption for the Fund at the 2016 valuation is also shown. When communicating valuation results, LGPS funds need to present a single funding level. The above analysis allows funds to do this by selecting their level of prudence in the calculation of the funding position and reading off the associated funding level.





This approach at the 2019 valuation to measuring a current funding level allows stakeholders to have a better appreciation and understanding of the risk inherent in their funding strategy when looking at the funding level metric.

Following discussion with Fund Officer's, the proposal is to present the funding level using an expected future investment return assumption of 4.0% p.a., which would be expected to be returned (on average) in 75% of future economic scenarios modelled over the next 20 years. Based on this assumption the funding position of the Fund as at 31 March 2019 is shown below. The 31 March 2016 valuation position is shown for comparison. Further details are available in the report "East Sussex Pension Fund - 2019 Valuation Initial Results Report" (dated 16 September), which has been discussed with Fund Officers.

Valuation Date	31 March 2016	31 March 2019
<b>Past Service Liabilities</b>	<b>(£m)</b>	<b>(£m)</b>
Employees	994	1,035
Deferred Pensioners	604	737
Pensioners	1,414	1,587
<b>Total Liabilities</b>	<b>3,012</b>	<b>3,359</b>
<b>Assets</b>	<b>2,771</b>	<b>3,633</b>
<b>Surplus / (Deficit)</b>	<b>(240)</b>	<b>273</b>
<b>Funding Level</b>	<b>92%</b>	<b>108%</b>

Please note the Fund's approach to setting employer contribution rates (as summarised in the update above) does not rely on a single set of assumptions but involves the projection of the employer's future benefit payments, contributions and investment returns under 5,000 future economic scenarios. It is critical to note, therefore, that the reported funding level does not directly drive the contributions that will be set. A robust funding plan will be set for each employer which considers how the assets and liabilities will evolve over time in different economic scenarios.

### c) Policy areas within the Funding Strategy Statement (FSS)

The FSS is a key document for your Fund, in two ways:

- 1 The inputs it requires: Fund's officers, Pensions Committee and Local Board need to go through a process to be satisfied that the Fund will be collecting an appropriate level of contributions from each and every employer in the Fund. The FSS provides a helpful framework for organising this process and covering all the necessary areas;
- 2 The outputs it gives you: the finalised FSS itself should be a clear and transparent reference point for the Fund's stakeholders, to provide proof that the contribution arrangements are solidly derived, fair and consistent. It will also help in any future discussions with employers, perhaps where an approach is queried or questions are raised.

The table below sets out the areas under consideration as part of the review of the Fund's FSS:

Area	Description
Regulatory and other tidy up	<p>Changes to allow for:</p> <ul style="list-style-type: none"> <li>• Exit credits legislation</li> <li>• Valuation cycle consultation and Fund's policy on interim valuation assessments</li> <li>• Dealing with McCloud/cost cap benefit uncertainty</li> <li>• Clarifying approach to academies joining the Fund or moving MAT</li> <li>• Clarifying employer post cessation agreements</li> <li>• Climate change risk</li> <li>• GMP equalisation</li> <li>• MHCLG instead of DCLG</li> </ul>
Contribution stabilisation	Stabilisation parameters for long-term employers under review and any changes will be reflected
Employer cashflow attribution	Clarification of new approach to tracking the assets of all employers (i.e. adoption of HEAT system - Hymans Employer Asset Tracker)
Multiple investment strategies	Updates to allow for approach to offering multiple investment strategies within the Fund, if required.
Other policy areas	<p>May include but not limited to:</p> <ul style="list-style-type: none"> <li>• Any updates required in relation to managing ill health retirement risk within the Fund</li> <li>• Pass through contractor arrangements</li> </ul>

Under the current valuation timetable, a draft of the updated FSS including the above changes will be discussed at the 25 November 2019 Committee meeting. The draft FSS will then be circulated to all employers, alongside their draft valuation results, for the required consultation. A finalised draft will be presented to the Pension Committee for approval at the February 2020 meeting.

#### d) Setting employer contribution rates

The next major step in the valuation process is to calculate the funding positions and set the contribution rates for all employers in the Fund. As set out in the update above, this process is already underway for the Major Authorities, Academies and Colleges in the Fund.

For the other employers, this requires the Fund to consider for each employer:

- 1 The employer's funding target (i.e. how much assets to hold to meet liabilities)
- 2 How long the employer has in the Fund to reach the funding target
- 3 An appropriate likelihood of meeting the target (or 'likelihood of success') e.g. 2/3rds, 75%.

As part of the 2019 valuation of the Fund, a formal framework is being developed jointly by Fund officers and the Fund Actuary, to classify employers into risk categories. The details of this framework, in particular how to establish the above three parameters for each employer, will be set out in the draft Funding Strategy Statement for Committee approval.

#### Professional notes

As the purpose of this paper is purely to provide information on the progress of the 2019 actuarial valuation, it does not represent any formal actuarial advice and hence does not need to comply with the Technical Actuarial Standards prepared by the FRC. 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.

Prepared by:-

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Fund Actuary

16 September 2019

For and on behalf of Hymans Robertson LLP

## Appendix A – 2019 Valuation data timeline

Date	Key actions/events
27 Jun 2019	<p>Initial valuation data provided by Administrator with large number and variety of 'critical errors' (e.g. missing data from important fields) and 'warnings' (e.g. data outside tolerances or inconsistent with 2016 valuation data)</p> <p>Hymans advised by Fund to suspend any work on valuation data until critical errors addressed by Administrator</p>
30 Jun 2019	Agreed deadline for submitting final valuation data passes
18 Jul 2019	<p>Hymans commissioned to provide paper setting out guidelines for Administrator to address current errors in the data. Paper to focus on how to address 'critical errors' and managing any risks arising from the data 'warnings'</p> <p>Fund agrees extension to 31 July for Administrator to address errors</p>
31 Jul 2019	<p>Agreed extended deadline passes without data being submitted</p> <p>Call arranged between Fund, Administrator and Hymans to agree way forward</p>
2 - 12 Aug 2019	<p>Administrator continues work on valuation data and submits data on 12 August with critical errors cleared using various assumptions and adjustments</p> <p>Fund requests a high-level "audit trail" from Administrator of the assumptions and adjustments applied to data in order to review appropriateness (with possible input from Hymans required)</p> <p>Fund requests Hymans to continue to suspend standard data checks until audit trail received</p>
21 Aug 2019	High-level audit trail received from Administrator with notes on assumptions and adjustments applied to data
23 Aug 2019	Hymans asked by Fund to begin standard checks on valuation data and provide comments on audit trail for Fund to review.
30 Aug 2019	Hymans returns audit trail with comments for Fund to review
2 Sept 2019	Hymans returns feedback from standard data checks (e.g. flagging areas which could result in significant impact on valuation results) for the Administrator and Fund to investigate
3 Sept 2019	Fund requests Hymans to proceed with producing initial whole fund results based on data as it currently stands
16 Sept 2019	<p>Initial whole Fund results provided for discussion with Officers</p> <p>Response to standard data checks remains outstanding</p>