2009.

# CYNGOR SIR *POWYS* COUNTY COUNCIL.

**Pensions Committee**
**25th September 2009**

**REPORT BY:** **Head of Finance & Corporate Performance**

**SUBJECT:** **LGPS Consultation Response**

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**REPORT FOR:** **Decision**

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The Department for Communities & Local Government (CLG) in a discussion document dated 25th June – 'Delivering Affordability, Viability and Fairness' invites responses from LGPS stakeholders by 30th September.

The discussion document sets out suggestions as a response to current stock market impacts on pension fund liabilities likely to be identified at the forthcoming 2010 valuation exercise. The principal propositions are:

- A possible new approach to solvency;
- The introduction of 'Financing Plans' to demonstrate how over the short, medium and long term, authorities will fund pension liabilities;
- Alternatively, the introduction of 'Local Funding Targets' to be incorporated into Funding Strategy Statements;
- A revised employee contribution tariff.

These issues are discussed in detail by the Council's pension fund Actuary (Hewitt) in their August 2009 Spotlight publication (attached). Hewitt conclude that there is sufficient scope within the existing regulatory framework, coupled with flexibilities at the actuarial assumption level, to ensure continuing stability and transparency to the prudential funding of LGPS liabilities.

Officers have considered the Hewitt response and are in broad agreement with it. Consequently, it is proposed that the Council's response to CLG should be supportive of the Hewitt approach.

| **Recommendation:** | **Reason for Recommendation:** |
|---|---|
| To support the Hewitt approach to CLG's consultation on 'Affordability, Viability and Fairness'. | |

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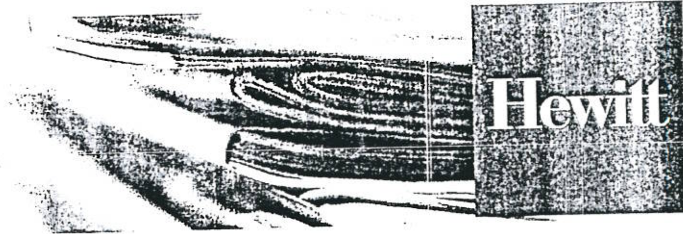
|---|---|
| **Person(s) To Action Decision:** | Joe Rollin |
| **Date By When Decision To Be Actioned:** | 30th September 2009 |
| **Relevant Policy** | N/A |




# Local Government Spotlight

## Local Government Pension Scheme Delivering Affordability, Viability and Fairness

## August 2009

# Delivering affordability, viability and fairness

**Introduction**

On 25 June 2009 Communities and Local Government issued a letter initiating an informal consultation exercise on possible amendments to the Local Government Pension Scheme. The proposed changes relate, in the main, to the 2010 valuation, although they would have implications for future valuations. There are also some proposed changes to member contribution rates.

Responses are requested by the middle of September 2009 if possible, or the end of September at the latest.

**Overview of the consultation**

As noted above, the consultation is in two parts:

**2010 valuation**

The consultation explains the general level of concern amongst various stakeholders over the potential outcome of the 2010 valuation. In particular, the concern is that under the approach traditionally used to date, contribution rates emerging will be unaffordably high.

Two proposals are made for mitigation of this.

1) Use of a Financing Plan
2) Redefining solvency

**Employee contribution rates**

The consultation suggests a higher rate of contribution for the highest paid members, with some readjustment of band widths at lower pay levels. The overall contribution yield appears to be expected to increase slightly from 6.3% to 6.42%.

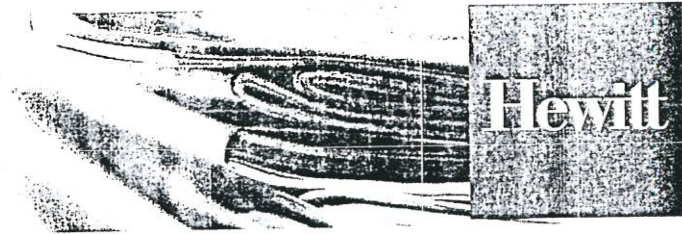
**Our key observations on 2010 valuation proposals**

So long as economic conditions do not worsen markedly from the current position in the run up to the 2010 valuation, we are not convinced that either approach is necessary.

We favour openness and transparency in scheme funding. As such, we do not favour redefinition of the general interpretation of solvency. We see such an approach as only serving to cloud the position.

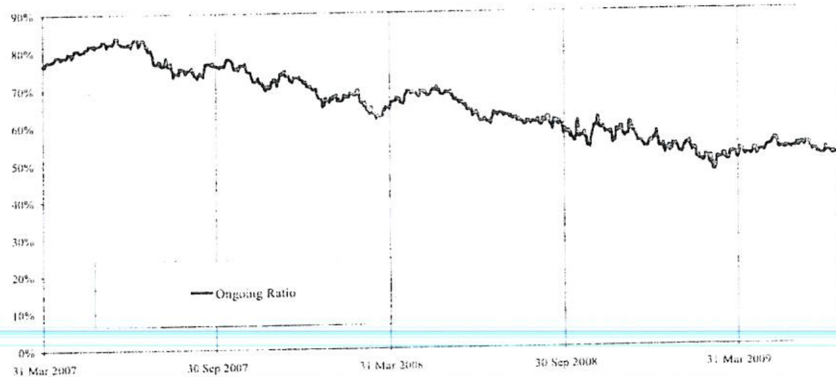
We are particularly concerned that the proposals fail to convey the special considerations that should be applied as regards funding targets for different types of employer in the Fund.

There are a number of significant shortcomings in Regulations 36 and 38 of the Administration Regulations. We would prefer CLG to focus on addressing those issues

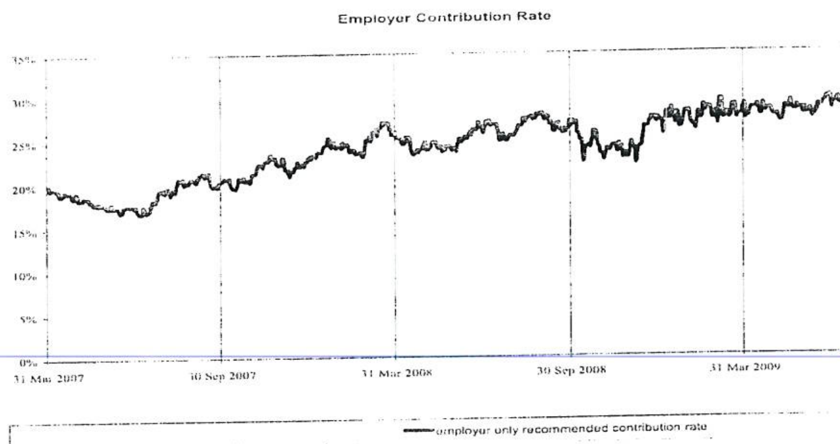



**Analysis of the underlying issue**

The underlying issue is clear enough. Looking at a sample Local Government Pension Fund, and rolling forward the position to the current date, we see the following progression of funding level:



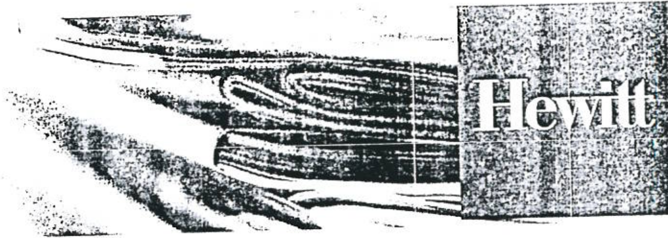

The implied progression of the aggregate employer contribution rate is as follows:




Note – in both charts the roll forward only takes account of investment returns (relative to an index basked where necessary) and changes in economic conditions. The impact of any demographic movements is ignored.

So, if nothing in the valuation process is changed, and things stay as they are up to 31 March 2010, a typical employer could be facing contribution rate increases of around 10% of pay or more.

The position for admission bodies is worse, particularly where employer specific considerations dictate use of a short recovery period.




## CLG discussions

We now move on to look at the areas discussed in CLG's letter which relate to the 2010 valuation.

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## Financing Plan proposal

Parts of this proposal are open to different interpretations, and varying levels of sophistication. The more sophisticated interpretations would use stochastic modelling to produce cashflow projections and the risk analysis, though this would involve not insignificant additional costs and would be impracticable within the timescales proposed. Simpler, but far less informative, interpretations would involve deterministic cash flow projections and subjective and largely narrative based risk analyses. We presume, given the time scales proposed, a more simplistic approach is envisaged.

Our interpretation of the proposal is that this seeks to adjust the pattern and period of the deficit recovery contributions. As we understand it, the result of a Financing Plan could be envisaged as a hand crafted pattern of deficit recovery contributions rather than the usual fairly straight line approach adopted.

So, for example, the valuation might produce a required rate increase of 10% per annum. That could be phased in over a period of 6 years, where the first "step up" was 3 years in the future rather than now. The rationale would be that the rate increase would be more affordable then than now.

From a pure mathematical viewpoint this all stacks up, so there is nothing inherently wrong with it. However, there are two main reasons why we favour adjusting the risk in the basis rather than this approach as follows:

- It is very difficult to gauge the amount of extra risk taken into the funding strategy where changes such as this are made
- There is an underlying assumption that things can only get better. Recent history has shown that this is not necessarily the case. Is it prudential to make no contribution towards the increase in the deficit since 2007 until after the next actuarial valuation?
- If the level of risk in the valuation assumptions as used for the 2007 valuation is retained, the resultant funding levels could be quite low. This could be emotive.

That said, there is a maximum acceptable level of risk on which Hewitt is prepared to sign off. If conditions deteriorate further, that may not be enough to achieve continuity of contribution rates. Tactically, you may wish to retain the right to set up a Financing Plan.

On the detail of the proposal, it is proposed that

- The Financing Plan be in place within 6 months of the valuation date. This is unrealistic if CLG intend the Financing Plan to reflect data and financial conditions at the valuation date.

- The proposal appears to envisage eliminating the disclosure of a funding level or funding ratio. Whilst this measure has its limitations, and is open to abuse, it is a simple way to encapsulate the adequacy of the assets (and future contributions) to meet the anticipated liabilities (however these may be determined). It is unclear how the proposal would enable a non expert reader to assess the adequacy of the assets and proposed contributions to meet the liabilities in the long term. We would also observe that current professional guidance requires the funding level to be disclosed in formal valuation reports.

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**Local Funding Targets**

Although this proposal appears to adjust the funding target, if such a move is temporary then in practice it is not unlike adjustment of the recovery plan. However, reporting of results in the interim period is affected. This approach is simple in concept and there is a precedent with the 75% funding target which applied for scheduled bodies in the early 1990s.

We are not enthusiastic about this proposal for the following reasons:

- It lacks transparency and lays Authorities open to the criticisms that they don't take funding of the liabilities seriously and that they are seeking to cloud the issue.
- It is also, arguably, the first step on a route towards making the LGPS unfunded – we doubt that this is currently the intention, but there is clearly a danger the "funding target" will be reduced progressively at future valuations whenever experience is not as good as hoped for.
- Again, It is very difficult to gauge the amount of extra risk taken into the funding strategy where changes such as this are made
- It is dangerous as regards admission bodies. It may lead authorities to set lower targets for admission bodies without understanding the consequent chance of legal challenge.

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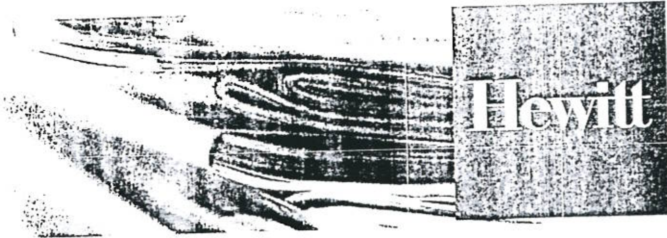
**Points of a triangle**

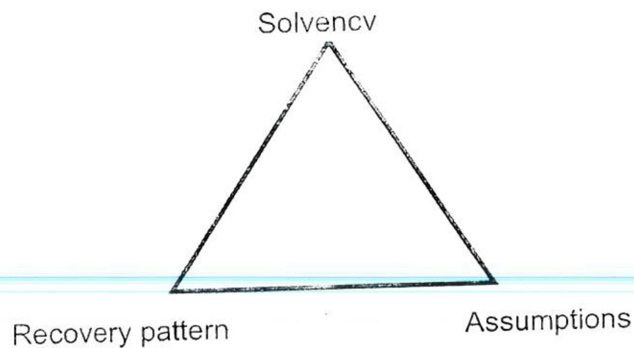
To pull together the various discussion points, it is worth considering the various variables in the funding mechanism and how they relate to each other.

The contribution rate that emerges from the valuation is a function of (amongst other things)

- The solvency target.
- The risk inherent in the assumptions used to set the funding target. (The funding target is here defined to be the solvency target less an amount assumed to be delivered through risky investment returns or other experience gains.)




- The pattern of deficit recovery contributions adopted and the period over which these are spread. The proposition here is that the valuation is done without any other intervention, and then by use of a Financing Plan short term contributions are reduced in lieu of higher anticipated contributions later.




Any or all of these three key areas can be adjusted to achieve a given result. On balance, we at Hewitt do not favour adjusting the solvency definition.

From a purely actuarial viewpoint, we would naturally favour the use of financing plans rather than increasing the level of risk in the assumptions. However, we recognise that such an approach could lead to difficulties for clients where reported funding levels are emotively low, and where making assumptions about the allocation of future spending would be politically difficult.

We are therefore prepared to focus on adjusting assumptions as it can be done within the existing regulatory framework whilst retaining a high level of transparency.

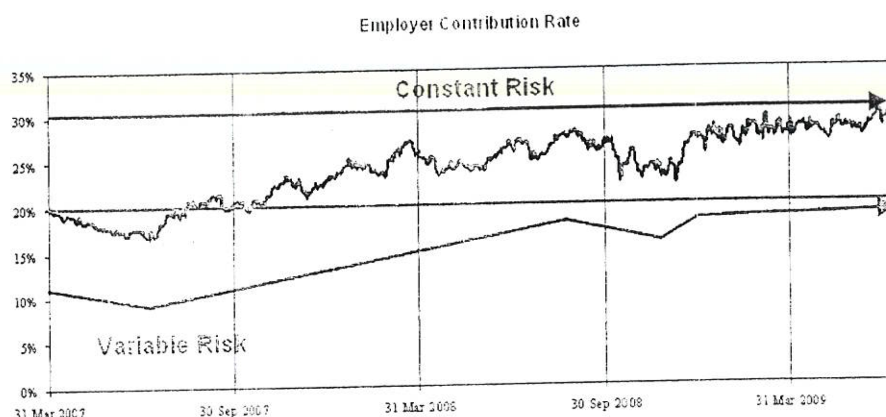
A summary of the main pros and cons, as we see them,follows:

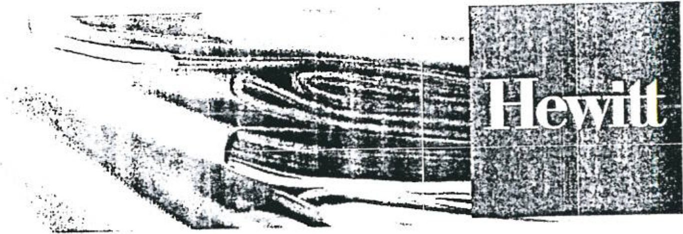
| | Solvency | Recovery pattern | Assumptions |
|---|---|---|---|
| **Pros** | Can produce lower contribution rate changes<br><br>Can produce less emotive funding level<br><br>Clouds the outcome – few will really understand where the Fund is | Can produce lower contribution rate changes<br><br>Can produce emotively low funding level<br><br>Transparency | Can produce lower contribution rate changes<br><br>Can produce less emotive funding level<br><br>Transparency, so long as risk is clearly explained |

| | Solvency | Recovery pattern | Assumptions |
|---|---|---|---|
| **Cons** | Unclear level of risk<br>Undermines the rationale for funding<br>First step on a route to unfunded scheme<br>Lays Administering Authority open to accusation of ducking the issue<br>Requires special consideration for admission bodies | Unclear level of risk<br>Lays Administering Authority open to accusation of mortgaging the future<br>Lays Administering Authority open to accusation of ducking the issue<br>Requires special consideration for admission bodies | Level of risk is clear<br>Increasing risk is not a free lunch – that risk may come home to roost<br>Conditions may be too extreme (not at present)<br>Lays Administering Authority open to accusation of massaging the figures<br>Requires special consideration for admission bodies |

**Hewitt's approach to the 2010 valuation**

The charts on page 2 show the progression of the position of a typical fund moving along a contour of constant risk. However, there is no Regulation preventing adjustment of the level of risk in the funding strategy. By adjusting the level of risk, different results can be achieved. Indeed, if risk is treated as the variable, we can move along a contour of constant resultant contribution rate rather than a contour of constant risk. The chart below shows the result as above, moving along a contour of constant risk, and how the risk level needs to vary to achieve the smoothed (ie constant result) outcome.






The challenge is to measure the level of risk in the funding strategy and whether the increased risk required to achieve stability in funding and/or contribution levels is acceptable. This is not an exact science.

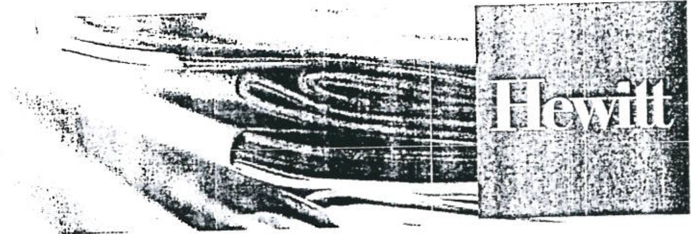
To vary the level of risk in the funding basis, we focus on the discount rate, as this is a variable around which we can do some risk evaluation, and can derive an estimate of the likelihood that a Fund's investments will deliver investment returns at least as high as the assumed discount rate over a suitable recovery period (the "probability of success").

All other assumptions are assumed to be best estimate, ie such that experience has a 50/50 chance of being better or worse. You do need to bear in mind that there is no single "best estimate", and these elements of the funding basis will also be subject to variability and carry a level of risk. However evaluation of the associated risks is at the present time somewhat subjective, and/or disproportionately costly and time consuming to carry out. Hence the focus on the discount rate in evaluating the degree of risk in the funding strategy.

A further complication relates to the amount of risk introduced into the funding strategy by use of one recovery period or another. In practice, the basis in the funding strategy is actually two sets of assumptions – one concerning the assets held at the valuation date, and another concerning the deficit recovery contributions to be invested in the future. If we are of the view that both assumption sets are the same, and represent our best estimate, then in practical terms no additional risk is introduced by using a recovery period.

Of course, the longer the recovery period, the less likely that both assumption sets are the same, and this is a source of uncertainty we will probably have to live with at this time. The obvious message is that the shorter the recovery period the more likely that the assumption sets are at least similar. For practical purposes we suggest that recovery periods below 30 years are treated as risk neutral, based purely on where many Funds are as of today. Where a recovery period is extended, there should at least be some tacit recognition that the risk level in the funding strategy has increased, even if we are unable to quantify precisely by how much.

The key question is whether an acceptable result can be achieved within an acceptable level of risk. At present, on the approach outlined above, for most if not all of our clients that is apparently so. Generally speaking, by adjusting the discount rate to a rate with a "probability of success" of between 50% and 55% the outcome would be broad continuity of existing contribution rates. (This compares with a typical "probability of success" for Hewitt clients in their 2007 valuations in the range of 60% - 66%.)




We would observe that a "probability of success" of 50% - 55% is as low as Funds should consider. Adopting a discount rate which has a lower than 50:50 chance of being delivered represents under-provision for the future liabilities. At Hewitt it is unlikely that we would be persuaded to sign off valuations with a lower than 50% chance of success.

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**Dealing with admission bodies**

The above approach is unlikely to be suitable for most admission bodies.

Failure to target the 'correct reserve' (or a suitable proxy for it) on cessation of participation is, in our view, unacceptable. To do so deludes the admission body about the true cost of its pension obligations, creates the potential for a very unpleasant bill should the body seek (or be required) to leave the Fund and creates a significant risk for the other Fund employers should the body fail.

By 'correct reserve' we mean sufficient assets to cover the liability that would arise in a cessation valuation under Regulation 38. In may cases this may comprise sufficient assets to cover liabilities assuming future investment (ie after cessation) in gilts.

However, this is a rock and hard place situation. On the one hand, the above principles apply. On the other hand, exposing admission bodies to the full cost of meeting the target reserve on cessation, at present, could well precipitate failure. This is an issue about the investment strategy to which admission bodies are exposed within the LGPS, but is also an issue as regards funding targets and we focus on that below.

For this reason some of our clients are consulting with the scheduled bodies in the Fund on the possibility of the scheduled bodies underwriting some of the risk for community admission bodies. Under this mechanism admission bodies could be set a funding target akin to that of the scheduled bodies. In so doing, admission bodies would also achieve broad continuity of contribution levels. However, relative to the "correct" funding target the rate is too low, and underpayment occurs.

Should, during this period of underwriting, an admission body seek to, or have to, leave the Fund, then the funding target in the consequent closure (Regulation 38) valuation would adjusted downwards to take into account the underpayment of contributions to date (relative to the theoretically correct rate). The amount of underpayment relative to the "correct" funding target would then fall as a liability on the scheduled bodies.

As such, this underwriting is not without cost to the extent that admission bodies leave the Fund during the period of underwriting. However, compared to the cost of multiple failures which may occur with no underwriting (as a result of unmanageable increases in contributions) this is judged by many to be the lesser evil.

The key point about this process is clarity. The admission bodies are not provided with a rate which fails to target the correct exit reserve, whilst the scheduled bodies are clear about the degree of underwriting going on. By providing this clarity, the Administering Authority greatly reduces its own risk of challenge from participating employers.

A similar approach is possible for transferee admission bodies. In many cases risk sharing arrangements already exist, but where not, similar mechanisms could be agreed between he relevant scheme employer and admission body.

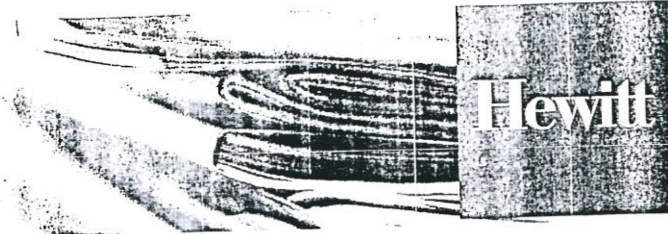
## Pulling the various pieces together

Under the Hewitt approach, we believe an acceptable valuation result can be provided with full transparency under current economic conditions. There is still likely to be some scope for conditions to worsen and for an acceptable valuation result to be possible. However, it is fair to say that if conditions worsen beyond a certain point it will not be possible to provide continuity of rates within an acceptable risk envelope.

If this is the case, then some additional flexibility will be required. Of the two proposals, our strong preference is for use of the Financing Plan approach (based on our interpretation of this). In practice, this would manifest itself as a phasing in of contribution rate increases over a prolonged period with at least the first three steps at a nominal level. Later, larger, steps would be needed to reach a solvency position, but those steps would not come into effect until after the next valuation.

A similar result could be obtained by changing the definition of solvency. (In this context we would note that this would be a decision on the part of the Administering Authority and not the Fund Actuary). However, as this approach lacks transparency and moves the position no further forwards we do not encourage it. Indeed, we see significant risks in terms of adverse publicity if the position is seen to be deliberately obscured by manipulation of the solvency definition.

Further, changing the solvency definition for certain types of employer is fraught with peril. The Administering Authority could lay itself open to challenge from the relevant employer in terms of using an incorrect funding target, and to challenge from other employers in terms of the risk created.




## Employee contributions

Moving now to the second area of the CLG consultation, the proposal is that the employee contribution bands are amended. An example revised scale is provided. Two reasons are cited:

- It is believed that there are many high earners in the local government workforce who are paying a proportionately modest amount towards their pension benefits.
- Given the very high proportion of part time employees it seems equitable to reconsider the breadth of the 5.5% band to help recruit and retain membership as such members find the cost of membership prohibitive.

As regards the first point, it is important to realise that being highly paid does not in itself lead to increased pension costs as a percentage of pay. Higher costs do tend to emerge due to:

- The generally higher average age of highly paid staff
- The rapid progression of pay during membership to get to the higher pay levels

It does not seem to us equitable that higher paid staff should be singled out due to higher average age. There are plenty of older lower paid staff.

The second reason provides good grounds for singling out this category of staff. However, if it were the case that most highly paid staff were being imported from external sources, then the rationale would not hold. We have not investigated this point. If you felt strongly in this area you may care to investigate the pay history of your staff falling into the high paid categories.

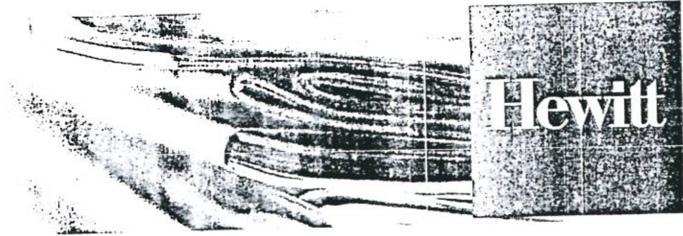
Looking at the lower paid, it seems to us that in order for the scheme to become affordable, you actually need to lower the rate for that category of staff rather than simply extend the same rate to a wider band.

## Responding to the consultation

As ever, your response is your business. However, we would wish to see no weakening of the regulatory framework. Instead, some guidance from CLG should suffice covering:

- The weight that Actuaries should place on the Funding Strategy Statement. The regulatory requirement to 'have regard to' the Statement is very woolly.
- What degree of shaping and back end loading of deficit recovery contributions is acceptable
- If solvency definitions are to be varied, that this is a decision for the Administering Authority

That is not to say that Regulations 36 and 38 cannot be significantly improved as regards their general impact and specific impact in certain circumstances, and we have been engaged in bilateral discussions with CLG to that end.




A regards the proposals on member contributions, the primary financial impact is negligible. However, if the changes lead to pay inflation for the highly paid, the financial impact could be detrimental.

The secondary impact is potentially more significant if the result is an influx of members who would otherwise not have joined the scheme. However, the changes for low earners do not appear to go far enough to create significant movement.

Finally, we note that this Spotlight, and the consultation, focuses on the funding issues around the 2010 valuation. Neither addresses the wider issues around the long term affordability of the current benefit structure. We await CLG's further communications on this issue with anticipation.