



# **Devon County Council Pension Fund Funding Strategy Statement**

**Approved by the Investment and Pension Fund Committee  
28 February 2020**

## **1. Introduction**

This is the Funding Strategy Statement for the Devon County Council Pension Fund. It has been prepared in accordance with Regulation 58 of the Local Government Pension Scheme Regulations 2013 (the Regulations) and describes Devon County Council's strategy, in its capacity as administering authority, for the funding of the Devon County Council Pension Fund (the Fund).

The Fund Actuary, Barnett Waddingham LLP, has been consulted on the contents of this Statement.

This statement should be read in conjunction with the Fund's Investment Strategy Statement (ISS) and has been prepared with regard to the 2016 guidance issued by CIPFA.

## **2. Purpose of the Funding Strategy Statement**

The purpose of this Funding Strategy Statement is to:

- Establish a clear and transparent fund-specific strategy that will identify how employers' pension liabilities are best met going forward;
- Support the desirability of maintaining as nearly constant a primary contribution rate (as defined in Regulation 62(5) of the Regulations) as possible;
- Ensure that the regulatory requirements to set contributions to meet the future liability to provide scheme member benefits in a way that ensures the solvency and long-term cost efficiency of the fund are met; and
- Take a prudent longer-term view of funding those liabilities.

## **3. Aims and purposes of the Fund**

The aims of the Fund are to:

- Manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due;
- Enable primary contribution rates to be kept as nearly constant as possible and (subject to the administering authority not taking undue risks) at reasonable cost to all relevant parties (such as the taxpayers, scheduled, resolution and admitted bodies), while achieving and maintaining fund solvency and long-term cost efficiency, which should be assessed in light of the risk profile of the fund and employers, and the risk appetite of the administering authority and employers alike; and
- Seek returns on investment within reasonable risk parameters.

The purposes of the Fund are to:

- Pay pensions, lump sums and other benefits to Scheme members as provided for under the Regulations;
- Meet the costs associated in administering the Fund; and
- Receive and invest contributions, transfer values and investment income.

## 4. Funding objectives

Contributions are paid to the Fund by Scheme members and the employing bodies to provide for the benefits which will become payable to Scheme members when they fall due.

The funding objectives are to:

- Ensure that pension benefits can be met as and when they fall due over the lifetime of the Fund;
- Ensure the solvency of the Fund;
- Set levels of employer contribution to target a 100% funding level over an appropriate time period and using appropriate actuarial assumptions;
- Build up the required assets in such a way that employer contribution rates are kept as stable as possible, with consideration of the long-term cost efficiency objective; and
- Adopt appropriate measures and approaches to reduce the risk, as far as possible, to the Fund, other employers and ultimately the taxpayer from an employer defaulting on its pension obligations.

In developing the funding strategy, the administering authority should also have regard to the likely outcomes of the review carried out under Section 13(4)(c) of the Public Service Pensions Act 2013. Section 13(4)(c) requires an independent review of the actuarial valuations of the LGPS funds; this involves reporting on whether the rate of employer contributions set as part of the actuarial valuations are set at an appropriate level to ensure the solvency of the Fund and the long-term cost efficiency of the Scheme so far as relating to the pension fund. The review also looks at compliance and consistency of the actuarial valuations.

## 5. Key parties

The key parties involved in the funding process and their responsibilities are as follows:

### The administering authority

The administering authority for the Fund is Devon County Council. The main responsibilities of the administering authority are to:

- Operate the Fund in accordance with the LGPS Regulations;
- Collect employee and employer contributions, investment income and other amounts due to the Fund as stipulated in the Regulations;
- Invest the Fund's assets in accordance with the Fund's Investment Strategy Statement (ISS);
- Pay the benefits due to Scheme members as stipulated in the Regulations;
- Ensure that cash is available to meet liabilities as and when they fall due;
- Take measures as set out in the Regulations to safeguard the Fund against the consequences of employer default;
- Manage the actuarial valuation process in conjunction with the Fund Actuary;
- Prepare and maintain this FSS and also the ISS after consultation with other interested parties;
- Monitor all aspects of the Fund's performance;
- Effectively manage any potential conflicts of interest arising from its dual role as both Fund administrator and Scheme Employer; and
- Enable the Local Pension Board to review the valuation process as they see fit.

### **Scheme employers**

In addition to the administering authority, a number of other Scheme employers, including admission bodies, participate in the Fund.

The responsibilities of each Scheme employer that participates in the Fund, including the administering authority, are to:

- Collect employee contributions and pay these together with their own employer contributions as certified by the Fund Actuary to the administering authority within the statutory timescales;
- Notify the administering authority of any new Scheme members and any other membership changes promptly;
- Develop a policy on certain discretions and exercise those discretions as permitted under the Regulations;
- Meet the costs of any augmentations or other additional costs in accordance with agreed policies and procedures; and
- Pay any exit payments due on ceasing participation on the Fund.

### **Scheme members**

Active scheme members are required to make contributions into the Fund as set by the Ministry of Housing, Communities and Local Government (MHCLG).

### **Fund Actuary**

The Fund Actuary for the Fund is Barnett Waddingham LLP. The main responsibilities of the Fund Actuary are to:

- Prepare valuations including the setting of employers' contribution rates at a level to ensure Fund solvency and long-term cost efficiency after agreeing assumptions with the administering authority and having regard to the FSS and the Regulations;
- Prepare advice and calculations in connection with bulk transfers and the funding aspects of individual benefit-related matters such as pension strain costs, ill health retirement costs, compensatory added years costs, etc;
- Provide advice and valuations on the exiting of employers from the Fund;
- Provide advice to the administering authority on bonds or other forms of security against the financial effect on the Fund of employer default;
- Assist the administering authority in assessing whether employer contributions need to be revised between valuations as permitted or required by the Regulations;
- Ensure that the administering authority is aware of any professional guidance or other professional requirements which may be of relevance to his or her role in advising the Fund; and
- Advise on other actuarial matters affecting the financial position of the Fund.

## **6. Funding strategy**

The factors affecting the Fund's finances are constantly changing, so it is necessary for its financial position and the contributions payable to be reviewed from time to time by means of an actuarial valuation to check that the funding objectives are being met.

The most recent actuarial valuation of the Fund was carried out as at 31 March 2019. A summary of the methods and assumptions adopted is set out in the sections below.

The actuarial valuation involves a projection of future cashflows to and from the Fund. The main purpose of the valuation is to determine the level of employers' contributions that should be paid to ensure that the existing assets and future contributions will be sufficient to meet all future benefit payments from the Fund.

#### **Funding method**

The key objective in determining employers' contribution rates is to establish a funding target and then set levels of employer contribution to meet that target over an agreed period.

The funding target is to have sufficient assets in the Fund to meet the accrued liabilities for each employer in the Fund.

For all employers, the method adopted is to consider separately the benefits accrued before the valuation date (past service) and benefits expected to be accrued after the valuation date (future service). These are evaluated as follows:

- The past service funding level of the Fund. This is the ratio of accumulated assets to liabilities in respect of past service. It makes allowance for future increases to members' pay for pensions in payment. A funding level in excess of 100% indicates a surplus of assets over liabilities; while a funding level of less than 100% indicates a deficit; and
- The future service funding rate (also referred to as primary rate as defined in Regulation 62(5) of the Regulations) which is the level of contributions required from the individual employers which, in combination with employee contributions is expected to support the cost of benefits accruing in future.

The adjustment required to the primary rate to calculate an employer's total contribution rate is referred to as the secondary rate, as defined in Regulation 62(7). Further details of how the secondary rate is calculated for employers is given further below.

The approach to the primary rate will depend on specific employer circumstances and in particular, may depend on whether an employer is an "open" employer – one which allows new recruits access to the Fund, or a "closed" employer which no longer permits new staff access to the Fund. The expected period of participation by an employer in the Fund may also affect the total contribution rate.

For open employers, the actuarial funding method that is adopted is known as the Projected Unit Method. The key feature of this method is that, in assessing the future service cost, the primary contribution rate represents the cost of one year's benefit accrual only.

For closed employers, the actuarial funding method adopted is known as the Attained Age Method. The key difference between this method and the Projected Unit Method is that the Attained Age Method assesses the average cost of the benefits that will accrue over a specific period, such as the length of a contract or the remaining expected working lifetime of active members.

The approach by employer may vary to reflect an employer's specific circumstance, however, in general the closed employers in the Fund are admission bodies who have joined the Fund as part of an outsourcing contract and therefore the Attained Age Method is used in setting their contributions. All other employers (for example councils, higher education bodies and academies) are generally open employers and therefore the Projected Unit Method is used. The administering authority holds details of the open or closed status of each employer.

## 7. Valuation assumptions and funding model

In completing the actuarial valuation it is necessary to formulate assumptions about the factors affecting the Fund's future finances such as inflation, pay increases, investment returns, rates of mortality, early retirement and staff turnover etc.

The assumptions adopted at the valuation can therefore be considered as:

- The demographic (or statistical) assumptions which are essentially estimates of the likelihood or timing of benefits and contributions being paid, and
- The financial assumptions which will determine the estimates of the amount of benefits and contributions payable and their current (or present) value.

### Future price inflation

The base assumption in any valuation is the future level of price inflation over a period commensurate with the duration of the liabilities, as measured by the Retail Price Index (RPI). This is derived using the 20 year point on the Bank of England implied Retail Price Index (RPI) inflation curve, with consideration of the market conditions over the six months straddling the valuation date. The 20 year point on the curve is taken as 20 years is consistent with the average duration of an LGPS Fund. The RPI assumption adopted as at 31 March 2019 was 3.6% p.a.

### Future pay inflation

As some of the benefits are linked to pay levels at retirement, it is necessary to make an assumption as to future levels of pay inflation. Historically, there has been a close link between price and pay inflation with pay inflation exceeding price inflation in the longer term. The long-term pay increase assumption adopted as at 31 March 2019 was CPI plus 1.0% p.a. which includes allowance for promotional increases.

### Future pension increases

Pension increases are linked to changes in the level of the Consumer Price Index (CPI). Inflation as measured by the CPI has historically been less than RPI due mainly to different calculation methods. A deduction of 1.0% p.a. is therefore made to the RPI assumption to derive the CPI assumption. The CPI assumption adopted as at 31 March 2019 was 2.6% p.a.

### Future investment returns/discount rate

To determine the value of accrued liabilities and derive future contribution requirements it is necessary to discount future payments to and from the Fund to present day values.

The discount rate that is adopted will depend on the funding target adopted for each Scheme employer.

For open employers, the discount rate that is applied to all projected liabilities reflects a prudent estimate of the rate of investment return that is expected to be earned from the underlying investment strategy by considering average market yields in the six months straddling the valuation date. The discount rate so determined may be referred to as the "ongoing" discount rate. The discount rate adopted for the 31 March 2019 valuation was 5.1% p.a.

For closed employers, an adjustment may be made to the discount rate in relation to the remaining liabilities, once all active members are assumed to have retired if at that time (the projected "termination date"), the employer becomes an exiting employer under Regulation 64.

The Fund Actuary will incorporate such an adjustment after consultation with the administering authority.

The adjustment to the discount rate for closed employers may be set to a higher funding target at the projected termination date, so that there are sufficient assets to fund the remaining liabilities on a “minimum risk” rather than on an ongoing basis if the Fund does not believe that there is another Scheme employer to take on the responsibility of the liabilities after the employer has exited the Fund. The aim is to minimise the risk of deficits arising after the termination date.

#### **Asset valuation**

For the purposes of the valuation, the asset value used is the market value of the accumulated Fund at the valuation date adjusted to reflect average market conditions during the six months straddling the valuation date. This is referred to as the smoothed asset value and is calculated as a consistent approach to the valuation of the liabilities.

The Fund’s assets are notionally allocated to employers at an individual level by allowing for actual Fund returns achieved on the assets and cashflows paid into and out of the Fund in respect of each employer (e.g. contributions received and benefits paid).

#### **Demographic (Statistical) assumptions**

The demographic assumptions incorporated into the valuation, such as future mortality rates, are based on Fund-specific experience and national statistics. These are adjusted as appropriate to reflect the individual circumstances of the Fund and/or individual employers.

Further details of all of the assumptions adopted are included in the latest actuarial valuation report.

#### **2019 valuation results**

As at 31 March 2019, as calculated at the 2019 valuation, the Fund was 91% funded, corresponding to a deficit of £399m.

The primary rate required to cover the employer cost of future benefit accrual was 16.9% of payroll p.a.

#### **McCloud/Sargeant judgements**

The McCloud/Sargeant judgements were in relation to two employment tribunal cases which were brought against the government in relation to possible age and gender discrimination in the implementation of transitional protection following the introduction of the reformed 2015 public service pension schemes from 1 April 2015. These judgements were not directly in relation to the LGPS, however, do have implications for the LGPS.

In December 2018, the Court of Appeal ruled that the transitional protection offered to some members as part of the reforms amounted to unlawful discrimination. On 27 June 2019 the Supreme Court denied the government’s request for an appeal in the case. A remedy is still to be either imposed by the Employment Tribunal or negotiated and applied to all public service schemes, so it is not yet clear how this judgement may affect LGPS members’ past or future service benefits. It has, however, been noted by government in its 15 July 2019 statement that it expects to have to amend all public service schemes, including the LGPS.

Further details of this can be found below in the Regulatory risks section.

At the time of drafting this FSS, it is still unclear how the McCloud/Sargeant judgements will affect current and future LGPS benefits. As part of the Fund's 2019 valuation, in order to mitigate the risk of member benefits being uplifted and becoming more expensive, the potential impact of McCloud was covered by the prudence allowance included in the discount rate assumption. As the remedy is still to be agreed the cost cannot be calculated with any certainty, however, the Fund Actuary expects it is likely to be less than the impact of reducing the discount rate assumption by 0.05%.

#### **Guaranteed Minimum Pension (GMP) indexation and equalisation**

As part of the restructuring of the state pension provision, the government needs to consider how public service pension payments should be increased in future for members who accrued a Guaranteed Minimum Pension (GMP) from their public service pension scheme and expect to reach State Pension Age (SPA) post-December 2018. In addition, a resulting potential inequality in the payment of public service pensions between men and women needs to be addressed. Information on the current method of indexation and equalisation of public service pension schemes can be found at: <https://www.gov.uk/government/consultations/indexation-and-equalisation-of-gmp-in-public-service-pension-schemes/consultation-on-indexation-and-equalisation-of-gmp-in-public-service-pension-schemes>.

On 22 January 2018, the government published the outcome to its Indexation and equalisation of GMP in public service pension schemes consultation, concluding that the requirement for public service pension schemes to fully price protect the GMP element of individuals' public service pension would be extended to those individuals reaching SPA before 6 April 2021. HMT published a Ministerial Direction on 4 December 2018 to implement this outcome, with effect from 6 April 2016. Details of this outcome and the Ministerial Direction can be found at: <https://www.gov.uk/government/publications/indexation-of-public-service-pensions>.

The 2019 valuation assumption for GMP is that the Fund will pay limited increases for members that have reached SPA by 6 April 2016, with the government providing the remainder of the inflationary increase. For members that reach SPA after this date, it is assumed that the Fund will be required to pay the entire inflationary increase.

## **8. Deficit recovery/surplus amortisation periods**

Whilst one of the funding objectives is to build up sufficient assets to meet the cost of benefits as they accrue, it is recognised that at any particular point in time, the value of the accumulated assets will be different to the value of accrued liabilities, depending on how the actual experience of the Fund differs to the actuarial assumptions. Accordingly the Fund will normally either be in surplus or in deficit. This theory applies down to an individual employer level; each employer in the Fund has their own share of deficit or surplus attributable to their section of the Fund.

Where the actuarial valuation for an employer discloses a significant surplus or deficit then the level of required employer contribution will include an adjustment to either amortise the surplus or fund the deficit over a period of years. The adjustment may be set either as a percentage of payroll or as a fixed monetary amount.

Deficit contributions required from an employer are expressed as a minimum requirement, with employers able to pay regular contributions at a higher rate, or one-off contributions, to reduce their deficit. Employers should discuss with the Administering Authority and gain agreement

from the Administering Authority before making one-off payments. The individual employer contribution rates are set out in the Rates and Adjustments Certificate which forms part of the Fund's 2019 valuation report.

The employers must pay contributions in line with the Rates and Adjustment Certificate but they may be able to alter the timing of contributions payable and/or pay in additional contributions with agreement from the Administering Authority. The Administering Authority has agreed to allow a discount to employers who pay their deficit contributions up front, as long as the payment is received by the end of April in a particular Scheme year (i.e. the discount for the 2020/21 contributions would only apply if the lump sum payment was made by 30 April 2020). The discounts are 1.5% for an annual payment in advance or 4.5% for paying three years of contributions in advance. Employers should discuss with and gain agreement from the Administering Authority before making up front payments at the discounted rate.

The maximum recovery period across the Fund at the 2019 valuation was 21 years. This represents a reduction of three years from the maximum 24 year recovery period set at the 2016 valuation. The ultimate aim is to reach 100% funding, and a reduction of three years in the recovery period since the 2016 valuation demonstrates that the Fund is progressing towards that goal. Please note that recovery periods varied between individual employers.

Where the valuation for an employer discloses a surplus then the level of required employer contribution may include an adjustment to amortise the surplus over a period to be agreed with the Administering Authority and the Fund Actuary.

The period that is adopted for any particular employer will depend on:

- The significance of the surplus or deficit relative to that employer's liabilities;
- The covenant of the individual employer and any limited period of participation in the Fund;
- The remaining contract length of an employer in the Fund (if applicable); and
- The implications in terms of stability of future levels of employers' contribution.

## 9. Pooling of individual employers

The policy of the Fund is that each individual employer should be responsible for the costs of providing pensions for its own employees who participate in the Fund. Accordingly, contribution rates are set for individual employers to reflect their own particular circumstances.

However, certain groups of individual employers are pooled for the purposes of determining contribution rates to recognise common characteristics or where the number of Scheme members is small.

The main purpose of pooling is to produce more stable employer contribution levels in the longer term whilst, recognising that ultimately there will be some level of cross-subsidy of pension cost amongst pooled employers.

### **Forming/disbanding a funding pool**

Where the Fund identifies a group of employers with similar characteristics and potential merits for pooling, it is possible to form a pool for these employers. Advice will be sought from the Fund Actuary to consider the appropriateness and practicalities of forming the funding pool.

Conversely, the Fund may consider it no longer appropriate to pool a group of employers. This could be due to divergence of previously similar characteristics or an employer becoming a

dominant party in the pool (such that the results of the pool are largely driven by that dominant employer). Where this scenario arises, advice will be sought from the Fund Actuary.

Funding pools will be monitored on a regular basis, at least at each actuarial valuation, in order to ensure the pooling arrangement remains appropriate.

The funding pools adopted for the Fund at the 2019 valuation are summarised in the table below:

Pool	Type of pooling	Notes
Police	Past and future service pooling	Devon and Cornwall Police and the Police and Crime Commissioner pay the same primary contribution rate (Devon and Cornwall Police pays an additional secondary rate) and both have the same funding level
North Devon	Past and future service pooling	North Devon District Council and North Devon Joint Crematorium pay the same total contribution rate and have the same funding level
Small scheduled bodies	Past and future service pooling	All town and parish councils in the pool pay the same total contribution rate and have the same funding level
Academies	Past and future service pooling	All academies in the pool pay the same total contribution rate and have the same funding level
ISS contracts	Past and future service pooling	All employers in the pool pay the same total contribution rate and have the same funding level
Compass contracts	Past and future service pooling	All employers in the pool pay the same total contribution rate and have the same funding level

#### **Risk-sharing**

There are employers that participate in the Fund with a risk-sharing arrangement in place with another employer in the Fund.

For example, there are employers participating in the Fund with pass-through provisions: under this arrangement the pass-through employer does not take on the risk of underfunding as this risk remains with the letting authority or relevant guaranteeing employer. When the pass-through employer ceases participation in the Fund, it is not responsible for making any exit payment, nor receiving any exit credit, as any deficit or surplus ultimately falls to the letting authority or relevant guaranteeing employer.

At the 2019 valuation, risk-sharing arrangements were allowed for by allocating any deficit/liabilities covered by the risk-sharing arrangement to the relevant responsible employer.

## 10. New employers joining the Fund

When a new employer joins the Fund, the Fund Actuary is required to set the contribution rates payable by the new employer and allocate a share of Fund assets to the new employer as appropriate. The most common types of new employers joining the Fund are admission bodies and new academies. These are considered in more detail below.

### Admission bodies

New admission bodies in the Fund are commonly a result of a transfer of staff from an existing employer in the Fund to another body (for example as part of a transfer of services from a council or academy to an external provider under Schedule 2 Part 3 of the Regulations). Typically these transfers will be for a limited period (the contract length), over which the new admission body employer is required to pay contributions into the Fund in respect of the transferred members.

### Funding at start of contract

Generally, when a new admission body joins the Fund, they will become responsible for all the pensions risk associated with the benefits accrued by transferring members and the benefits to be accrued over the contract length. This is known as a full risk transfer. In these cases, it may be appropriate that the new admission body is allocated a share of Fund assets equal to the value of the benefits transferred, i.e. the new admission body starts off on a fully funded basis. This is calculated on the relevant funding basis and the opening position may be different when calculated on an alternative basis (e.g. on an accounting basis).

However, there may be special arrangements made as part of the contract such that a full risk transfer approach is not adopted. In these cases, the initial assets allocated to the new admission body will reflect the level of risk transferred and may therefore not be on a fully funded basis or may not reflect the full value of the benefits attributable to the transferring members.

### Contribution rate

The contribution rate may be set on an open or a closed basis. Where the funding at the start of the contract is on a fully funded basis then the contribution rate will represent the primary rate only; where there is a deficit allocated to the new admission body then the contribution rate will also incorporate a secondary rate with the aim of recovering the deficit over an appropriate recovery period.

Depending on the details of the arrangement, for example if any risk sharing arrangements are in place, then additional adjustments may be made to determine the contribution rate payable by the new admission body. The approach in these cases will be bespoke to the individual arrangement.

### Security

To mitigate the risk to the Fund that a new admission body will not be able to meet its obligations to the Fund in the future, the new admission body may be required to put in place a bond in accordance with Schedule 2 Part 3 of the Regulations, if required by the letting authority and administering authority.

If, for any reason, it is not desirable for a new admission body to enter into a bond, the new admission body may provide an alternative form of security which is satisfactory to the administering authority.

#### **New academies**

When a school converts to academy status, the new academy (or the sponsoring multi-academy trust) becomes a Scheme employer in its own right.

#### **Funding at start**

On conversion to academy status, the new academy will become part of the Academies funding pool and will be allocated assets based on the funding level of the pool at the conversion date.

#### **Contribution rate**

The contribution rate payable when a new academy joins the Fund will be in line with the contribution rate certified for the Academies funding pool at the 2019 valuation.

Where an academy joins an existing multi-academy trust in the Fund, additional contributions will be certified for the multi-academy trust in respect of the academy.

## **11. Cessation valuations**

When an employer leaves the Scheme and becomes an exiting employer, the Fund Actuary will be asked to make a termination assessment. Any deficit in the Fund in respect of the employer will be due to the Fund as an exit payment, unless it is agreed by the administering authority and the other parties involved that the assets and liabilities relating to the employer will transfer within the Fund to another participating employer.

In certain circumstances the Fund may agree with an exiting employer that it will continue to be treated as an active employer with deficit contributions being set on an ongoing basis. This will only be permitted where the employer organisation is assessed as having a long term stable financial position, and where security is put in place to cover the full cessation deficit.

A Town or Parish Council may defer their exit if the last member leaves the scheme but the Town or Parish Council is intending to offer the scheme to a new employee. This will be in agreement with the Devon Pension Fund and any deficit payments due by the Town or Parish Council must continue to be paid during the suspension period. Any suspension period will be time-limited and at the discretion of the Fund.

The Local Government Pension Scheme (LGPS) (Amendment) Regulations 2018 were introduced in May 2018 which allow administering authorities to make an exit credit payment to exiting employers. This will be reviewed on a case by case basis before any payment is made.

Considerations will be based on any previous agreements made and discussions between the Administering Authority, the Exiting Employer and the guaranteeing employer (if relevant).

In assessing the financial position on termination, the Fund Actuary may adopt a discount rate based on gilt yields and adopt different assumptions to those used at the previous valuation in order to protect the other employers in the Fund from having to fund any future deficits which may arise from the liabilities that will remain in the Fund.

### **Regulatory factors**

At the date of drafting this FSS, the government is currently consulting on potential changes to the Regulations, some of which may affect the regulations surrounding an employer's exit from the Fund. This is set out in the Local government pension scheme: changes to the local valuation cycle and the management of employer risk consultation document.

Further details of this can be found in the Regulatory risks section below.

## **12. Bulk transfers**

Bulk transfers of staff into or out of the Fund can take place from other LGPS Funds or non-LGPS Funds. In either case, the Fund Actuary for both Funds will be required to negotiate the terms for the bulk transfer – specifically the terms by which the value of assets to be paid from one Fund to the other is calculated.

The agreement will be specific to the situation surrounding each bulk transfer but in general the Fund will look to receive the bulk transfer on no less than a fully funded transfer (i.e. the assets paid from the ceding Fund are sufficient to cover the value of the liabilities on the agreed basis).

A bulk transfer may be required by an issued Direction Order. This is generally in relation to an employer merger, where all the assets and liabilities attributable to the transferring employer in its original Fund are transferred to the receiving Fund.

## **13. Links with the Investment Strategy Statement (ISS)**

The main link between the Funding Strategy Statement (FSS) and the ISS relates to the discount rate that underlies the funding strategy as set out in the FSS, and the expected rate of investment return which is expected to be achieved by the underlying investment strategy as set out in the ISS.

As explained above, the ongoing discount rate that is adopted in the actuarial valuation is derived by considering the expected return from the underlying investment strategy. This ensures consistency between the funding strategy and investment strategy.

## **14. Risks and counter measures**

Whilst the funding strategy attempts to satisfy the funding objectives of ensuring sufficient assets to meet pension liabilities and stable levels of employer contributions, it is recognised that there are risks that may impact on the funding strategy and hence the ability of the strategy to meet the funding objectives.

The major risks to the funding strategy are financial, although there are other external factors including demographic risks, regulatory risks and governance risks.

### **Financial risks**

The main financial risk is that the actual investment strategy fails to produce the expected rate of investment return (in real terms) that underlies the funding strategy. This could be due to a number of factors, including market returns being less than expected and/or the Brunel Pension Partnership Ltd. and other fund managers, who are employed to implement the chosen investment strategy, failing to achieve their performance targets.

The valuation results are most sensitive to the real discount rate. Broadly speaking an increase/decrease of 0.5% p.a. in the real discount rate will decrease/increase the valuation of the liabilities by 10%, and decrease/increase the required employer contribution by around 2.5% of payroll p.a.

However, the Investment and Pension Fund Committee regularly monitors the investment returns achieved by Brunel and the other fund managers and receives advice from the independent advisers and officers on investment strategy. The Fund's strategic asset allocation is reviewed on a regular basis.

The Committee may also seek advice from the Fund Actuary on valuation related matters.

In addition, the Fund Actuary provides funding updates between valuations to check whether the funding strategy continues to meet the funding objectives.

#### **Demographic risks**

Allowance is made in the funding strategy via the actuarial assumptions for a continuing improvement in life expectancy. However, the main demographic risk to the funding strategy is that it might underestimate the continuing improvement in longevity. For example, an increase of one year to life expectancy of all members in the Fund will increase the liabilities by approximately 4%.

The actual mortality of pensioners in the Fund is monitored by the Fund Actuary at each actuarial valuation and assumptions are kept under review. For the past two funding valuations, the Fund has commissioned a bespoke longevity analysis by Barnett Waddingham's specialist longevity team in order to assess the mortality experience of the Fund and help set an appropriate mortality assumption for funding purposes.

The liabilities of the Fund can also increase by more than has been planned as a result of early retirements. However, the administering authority monitors the incidence of early retirements; and procedures are in place that require individual employers to pay additional amounts into the Fund to meet any additional costs arising from early retirements.

#### **Maturity risk**

The maturity of a Fund (or of an employer in the Fund) is an assessment of how close on average the members are to retirement (or already retired). The more mature the Fund or employer, the greater proportion of its membership that is near or in retirement. For a mature Fund or employer, the time available to generate investment returns is shorter and therefore the level of maturity needs to be considered as part of setting funding and investment strategies.

The cashflow profile of the Fund needs to be considered alongside the level of maturity: as a Fund matures, the ratio of active to pensioner members falls, meaning the ratio of contributions being paid into the Fund to the benefits being paid out of the Fund also falls. This therefore increases the risk of the Fund having to sell assets in order to meet its benefit payments. The Fund regularly monitors its cashflow forecasts, and will at least once every three years commission the Fund Actuary to provide a forward looking cashflow forecast for the next 20-25 years to inform its investment strategy.

The government has published a consultation (Local government pension scheme: changes to the local valuation cycle and management of employer risk) which may affect the Fund's exposure to maturity risk. More information on this can be found in the Regulatory risks section below.

### Regulatory risks

The benefits provided by the Scheme and employee contribution levels are set out in Regulations determined by central Government. The tax status of the invested assets is also determined by the Government.

The funding strategy is therefore exposed to the risks of changes in the Regulations governing the Scheme and changes to the tax regime which may affect the cost to individual employers participating in the Scheme.

However, the administering authority participates in any consultation process concerning proposed changes in Regulations and seeks advice from the Fund Actuary on the financial implications of any proposed changes.

There are a number of general risks to the Fund and the LGPS, including:

- If the LGPS was to be discontinued in its current form it is not known what would happen to members' benefits.
- The potential effects of GMP equalisation between males and females, if implemented, are not yet known.
- More generally, as a statutory scheme the benefits provided by the LGPS or the structure of the scheme could be changed by the government.
- The State Pension Age is due to be reviewed by the government in the next few years.

At the time of preparing this FSS, specific regulatory risks of particular interest to the LGPS are in relation to the McCloud/Sargeant judgements, the cost cap mechanism and the timing of future funding valuations consultation. These are discussed in the sections below.

### McCloud/Sargeant judgements and cost cap

The 2016 national Scheme valuation was used to determine the results of HM Treasury's (HMT) employer cost cap mechanism for the first time. The HMT cost cap mechanism was brought in after Lord Hutton's review of public service pensions with the aim of providing protection to taxpayers and employees against unexpected changes (expected to be increases) in pension costs. The cost control mechanism only considers "member costs". These are the costs relating to changes in assumptions made to carry out valuations relating to the profile of the Scheme members; e.g. costs relating to how long members are expected to live for and draw their pension. Therefore, assumptions such as future expected levels of investment returns and levels of inflation are not included in the calculation, so have no impact on the cost management outcome.

The 2016 HMT cost cap valuation revealed a fall in these costs and therefore a requirement to enhance Scheme benefits from 1 April 2019. However, as a funded Scheme, the LGPS also had a cost cap mechanism controlled by the Scheme Advisory Board (SAB) in place and HMT allowed SAB to put together a package of proposed benefit changes in order for the LGPS to no longer breach the HMT cost cap. These benefit changes were due to be consulted on with all stakeholders and implemented from 1 April 2019.

However, on 20 December 2018 there was a judgement made by the Court of Appeal which resulted in the government announcing their decision to pause the cost cap process across all public service schemes. This was in relation to two employment tribunal cases which were brought against the government in relation to possible discrimination in the implementation of transitional protection following the introduction of the reformed 2015 public service pension schemes from 1 April 2015. Transitional protection enabled some members to remain in their

pre-2015 schemes after 1 April 2015 until retirement or the end of a pre-determined tapered protection period. The claimants challenged the transitional protection arrangements on the grounds of direct age discrimination, equal pay and indirect gender and race discrimination.

The first case (McCloud) relating to the Judicial Pension Scheme was ruled in favour of the claimants, while the second case (Sargeant) in relation to the Fire scheme was ruled against the claimants. Both rulings were appealed and as the two cases were closely linked, the Court of Appeal decided to combine the two cases. In December 2018, the Court of Appeal ruled that the transitional protection offered to some members as part of the reforms amounts to unlawful discrimination. On 27 June 2019 the Supreme Court denied the government's request for an appeal in the case. A remedy is still to be either imposed by the Employment Tribunal or negotiated and applied to all public service schemes, so it is not yet clear how this judgement may affect LGPS members' past or future service benefits. It has, however, been noted by government in its 15 July 2019 statement that it expects to have to amend all public service schemes, including the LGPS.

At the time of drafting this FSS, it is not yet known what the effect on the current and future LGPS benefits will be.

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

On 8 May 2019, the government published a consultation seeking views on policy proposals to amend the rules of the LGPS in England and Wales. The consultation covered:

- amendments to the local fund valuations from the current three year (triennial) to a four year (quadrennial) cycle;
- a number of measures aimed at mitigating the risks of moving from a triennial to a quadrennial cycle;
- proposals for flexibility on exit payments;
- proposals for further policy changes to exit credits; and
- proposals for changes to the employers required to offer LGPS membership.

The consultation is currently ongoing: the consultation was closed to responses on 31 July 2019 and an outcome is now awaited. This FSS will be revisited once the outcome is known and reviewed where appropriate.

*Timing of future actuarial valuations*

LGPS valuations currently take place on a triennial basis which results in employer contributions being reviewed every three years. In September 2018 it was announced by the Chief Secretary to HMT, Elizabeth Truss, that the national Scheme valuation would take place on a quadrennial basis (i.e. every four years) along with the other public sector pension schemes. This results of the national Scheme valuation are used to test the cost control cap mechanism and HMT believed that all public sector scheme should have the cost cap test happen at the same time with the next quadrennial valuation in 2020 and then 2024.

*Managing employer exits from the Fund*

The consultation covers:

- Proposals for flexibility on exit payments. This includes:

- Formally introducing into the Regulations the ability for the administering authority to allow an exiting employer to spread the required exit payment over a fixed period.
- Allowing employers with no active employees to defer payment of an exit payment in return for an ongoing commitment to meeting their existing liabilities (deferred employer status).
- Proposals for further policy changes to exit credits. The proposed change would require the exiting employer's exposure to risk to be taken into account in calculating any exit credit due (for example a pass through employer who is not responsible for any pensions risk would likely not be due an exit credit if the amendments are made to the Regulations).

*Changes to employers required to offer LGPS membership*

At the time of drafting this FSS, under the current Regulations further education corporations, sixth form college corporations and higher education corporations in England and Wales are required to offer membership of the LGPS to their non-teaching staff.

With consideration of the nature of the LGPS and the changes in nature of the further education and higher education sectors, the government has proposed to remove the requirement for further education corporations, sixth form college corporations and higher education corporations in England to offer new employees access to the LGPS. Given the significance of these types of employers in the Fund, this could impact on the level of maturity of the Fund and the cashflow profile. For example, increased risk of contribution income being insufficient to meet benefit outgo, if not in the short term then in the long term as the payroll in respect of these types of employers decreases with fewer and fewer active members participating in the Fund.

This also brings an increased risk to the Fund in relation to these employers becoming exiting employers in the Fund. Should they decide not to admit new members to the Fund, the active membership attributable to the employers will gradually reduce to zero, triggering an exit under the Regulations and a potential significant exit payment. This has the associated risk of the employer not being able to meet the exit payment and thus the exit payment falling to the other employers in the Fund.

**Governance**

Many different employers participate in the Fund. Accordingly, it is recognised that a number of employer-specific events could impact on the funding strategy including:

- Structural changes in an individual employer's membership;
- An individual employer deciding to close the Scheme to new employees; and
- An employer ceasing to exist without having fully funded their pension liabilities.

However, the administering authority monitors the position of employers participating in the Fund, particularly those which may be susceptible to the events outlined, and takes advice from the Fund Actuary when required. In particular, the Fund will commission an employer risk review from the Fund Actuary on a regular basis, as part of each actuarial valuation as a minimum, to help identify the employers in the Fund that might be considered as high risk. In the case of admitted bodies, the Fund has a policy of requiring some form of security from the employer, in the form of a guarantee or a bond, in case of employer default where the risk falls to the Fund. Where the risk of default falls on the original letting authority, the Fund provides

advice to the letting authority to enable them to make a decision on whether a guarantee or a bond should be required.

In addition, the administering authority keeps in close touch with all individual employers participating in the Fund to ensure that, as administering authority, it has the most up to date information available on individual employer situations. It also keeps individual employers briefed on funding and related issues.

## **15. Monitoring and review**

This FSS is reviewed formally, in consultation with the key parties, at least as part of each actuarial valuation process.

The most recent valuation was carried out as at 31 March 2019, certifying the contribution rates payable by each employer in the Fund for the period from 1 April 2020 to 31 March 2023.

The timing of the next funding valuation is due to be confirmed as part of the government's Local government pension scheme: changes to the local valuation cycle and management of employer risk consultation which closed on 31 July 2019. At the time of drafting this FSS, it is anticipated that the next funding valuation will be due as at 31 March 2022 but the period for which contributions will be certified remains unconfirmed.

The administering authority also monitors the financial position of the Fund between actuarial valuations and may review the FSS more frequently if necessary.