Agenda Item 6

Falkirk Council

Subject: **Funding Update**

Meeting: **Joint Meeting of Pensions Committee and Pension Board**

Date: **22 September 2016**

Submitted by: **Director of Corporate and Housing Services**

1. Purpose of Report

1.1 This purpose of this report is to advise the Committee and Board of the latest funding position of the Falkirk Council Pension Fund as set out in Appendix 1.

2. Recommendation

2.1 The Committee is asked to note the funding position as at 31 August 2016 and the steps being taken to bring this to the attention of Fund employers.

3. Background

3.1 The Fund's overall funding position is established every three years as part of the formal valuation process, however, in the interests of good governance, it has been agreed that the funding position should be reviewed on a regular basis in the interim.

3.2 The funding position describes the extent to which the Fund's liabilities are matched by its assets. Fund assets are the investments held by the Fund, whilst liabilities are the benefits promised to members in the future. A funding level of less than 100% means that assets are less than liabilities in which case there is a funding deficit.

3.3 The Fund's funding strategy is to target a funding level of exactly 100% and to recover any deficit position over a period of 20 years.

3.4 In assessing the funding position, assets are calculated at their market value whilst liabilities are calculated according to the return likely to be achievable on investments (i.e. usually the return on government bonds plus an outperformance assumption). There is an inverse relationship between interest rates and liabilities in that an environment of falling rates will mean an escalation in liabilities.

3.5 The estimated funding position at 31 August 2016 has been calculated by the Fund's Actuary, Hymans Robertson, taking account of cash flows and investment returns arising since the 2014 valuation.

3.6 Steven Scott from Hymans Robertson is attending the meeting and will provide comment on the funding assessment.

4. Funding Update

4.1 The current estimated funding position is set out below, together with the position at both the 2014 valuation and at March 2016:

	As at 31/03/2014	**As at 31/03/2016**	**As at 31/08/2016**
Fund Assets	£1,577m	£1,837m	£2,106
Fund Liabilities	£1,860m	£2,387m	£2,921
Funding Deficit	-£283m	-£550m	-£815m
Discount Rate	**5.1%**	**3.8%**	**2.8%**
Funding Level	**85%**	**77%**	**72%**

4.2 The funding update shows that the funding level has fallen from 85% at the 2014 valuation to 72% at August, 2016. The deterioration in the funding level has been the result of the continuing decline in gilt yields and has taken place despite fund assets having increased over the period from March 2014 by £530m.

4.3 The decline in gilt yields has been fuelled by monetary policy easements in the face of concerns over global growth. There has also been a trend for investors to seek out safe haven assets which has pushed up bond prices, automatically reducing gilt yields and exaggerating scheme liabilities. Uncertainty over global growth has also been compounded by the UK vote to leave the European Union.

5. Implications

5.1 The funding level is an important factor in setting investment strategy. As long as the funding level remains at current levels, the Fund will have to pursue a deficit recovery investment strategy with a heavy weighting towards equities. If, however, the funding level were to improve, then as agreed at the investment strategy review, there could be an opportunity to reduce the equity weighting (i.e. de-risk) in order to dampen the volatility which comes from an equity based strategy.

5.2 In view of the fall in the funding level and the consequential pressure that this will place on employer contribution rates following the valuation in March 2017, officers have asked Hymans Robertson to determine whether there would be scope to apply less stringent assumptions in certain areas (i.e. the asset outperformance and long term pay growth assumptions). Officers have also asked Hymans to calculate funding assessments to be shared with employers later in the year and to convene a meeting of employers to enable individual funding positions to be fully explored. The meeting is scheduled for 23 November.

5.3 As evidence of the pressure that employers are finding themselves in, three employers have already indicated to the Pensions Manager that they wish to close the scheme to new entrants or close it completely to further accrual. Discussions with these employers are ongoing.

6. Conclusion

6.1 The funding level has deteriorated from the 2014 position mainly as a result of the continuing fall in bond yields. Work is being undertaken to bring this to the attention of employers and to prepare them for possible rate increases at the 2017 valuation. An increase in contribution rates may be difficult for some employers to absorb and some have opened discussions with the Fund regarding an exit from the scheme.

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pp **Director of Corporate & Housing Services**

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Date: 8 September 2016

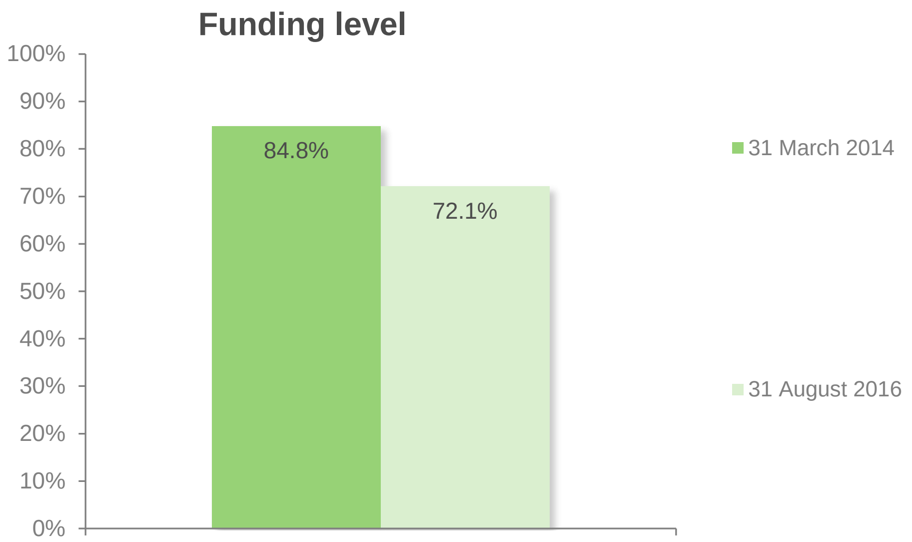
Appendices

Appendix 1 – Hymans Robertson Funding Update as at 31 August 2016

List of Background Papers:

None

Funding update as at 31 August 2016
Falkirk Council Pension Fund



HYMANS ROBERTSON

Summary

This funding update is provided to illustrate the estimated development of the funding position from 31 March 2014 to 31 August 2016, for the Falkirk Council Pension Fund ("the Fund"). It is addressed to Falkirk Council in its capacity as the Administering Authority of the Falkirk Council Pension Fund and has been prepared in my capacity as your actuarial adviser.

The funding level at the latest formal valuation was 84.8%. As at 31 August 2016 the funding level has decreased to 72.1%. This is largely as a result of a signficant decrease in bond yields, and subsequent discount rate, which places a higher value on the Fund's liabilities. This has been offset by a decrease in expected future inflation and higher than expected asset returns.

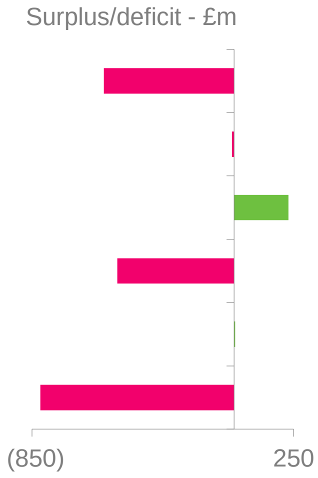
This report has been produced exclusively for the Administering Authority. This report must not be copied to any third party without our prior written consent.

This report looks at the whole fund position and does not allow for the circumstances of individual employers. The results for individual employers can be quite different to the fund as a whole depending on their own experience and the profile of their liabilities. Differences in the relationship between the ratio of accrued liabilities and the payroll can have a large influence on changes in contributions.

Steven Scott
Fund Actuary

What's happened since the last update – ongoing funding basis

Surplus/(deficit) as at 31 March 2016	(548)
Interest on surplus/deficit	(9)
Excess return on assets	228
Change in yields & inflation	(491)
Contributions (less benefits accruing)	5
Surplus/(deficit) as at 31 August 2016	(815)



Differences between this funding update and a full actuarial valuation

The accuracy of this type of funding update calculation is expected to decline over time as the period since the last valuation increases. This is because this funding update does not allow for changes in individual members' data since the last valuation.

Details of the approach used in this funding update are given in the appendix.

The figures in tables throughout this document may not add up due to rounding.

Estimated financial position at 31 August 2016

Ongoing funding basis

£m	31 Mar 2014	31 Mar 2016	31 Aug 2016
Assets	1,577	1,839	2,106
Liabilities	1,860	2,387	2,921
Surplus/(deficit)	**(283)**	**(548)**	**(815)**
Funding level	84.8%	77.0%	72.1%

Gilts funding basis

£m	31 Mar 2014	31 Mar 2016	31 Aug 2016
Assets	1,577	1,840	2,108
Liabilities	2,572	3,375	4,239
Surplus/(deficit)	**(996)**	**(1,535)**	**(2,131)**
Funding level	61.3%	54.5%	49.7%

Investment Return

Quarter Ending	%
30/06/2014	2.3%
30/09/2014	2.4%
31/12/2014	3.1%
31/03/2015	5.0%
30/06/2015	-2.6%
30/09/2015	-3.2%
31/12/2015	4.4%
31/03/2016	3.2%
30/06/2016	5.4%

Basis summary

	31 Mar 2014	31 Aug 2016
Pre retirement discount rate		
Nominal	5.1%	2.8%
Real	1.6%	-0.3%
Post retirement discount rate		
Nominal	5.1%	2.8%
Real	1.6%	-0.3%
Salary increase rate	4.0%	3.5%

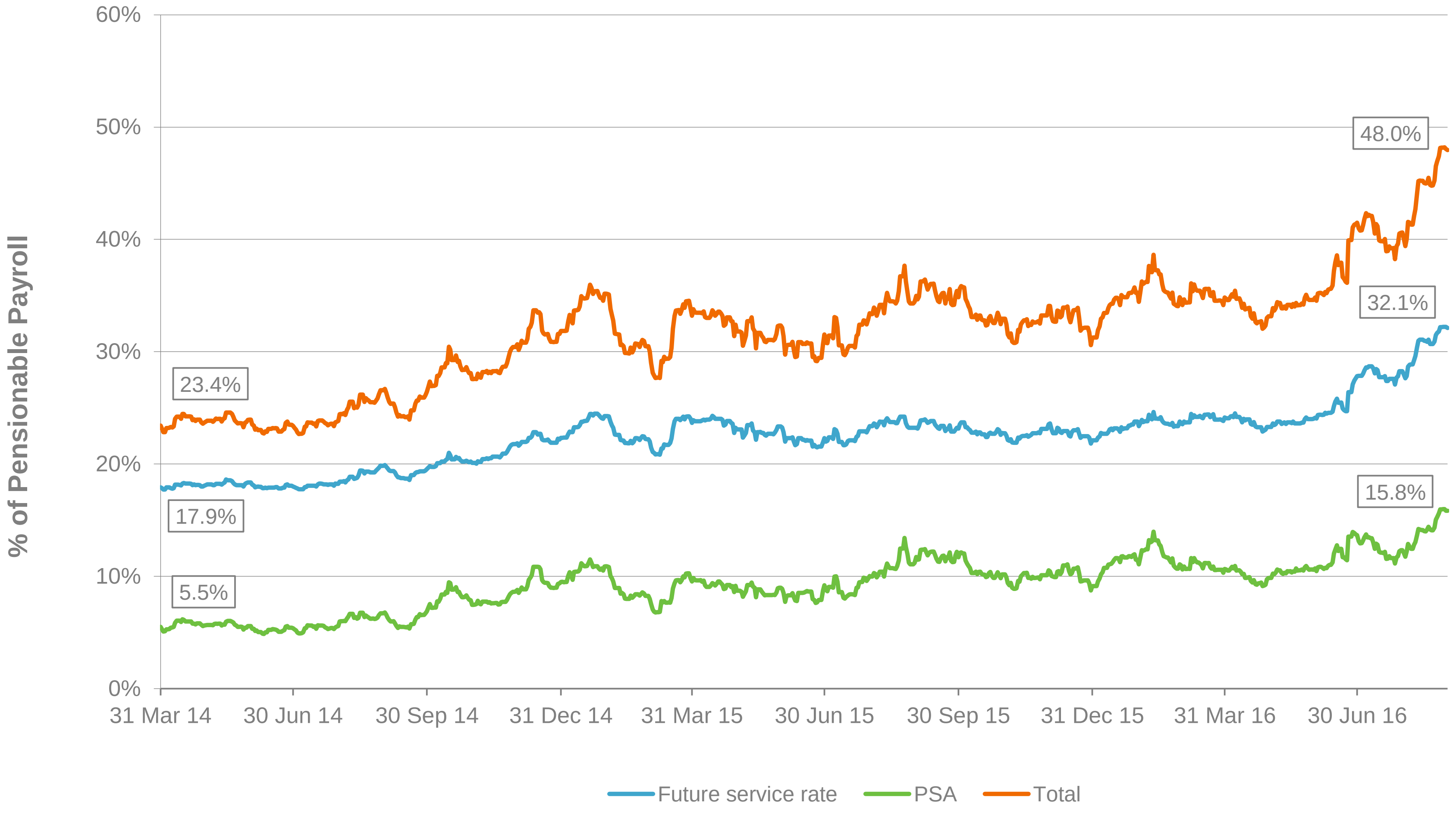
The assumptions underlying the funding bases are set out in the Funding Strategy Statement. They are those set for the 2014 valuation of the Fund updated for market conditions as at the calculation date.

Market indicators

	31 Mar 2014	31 Aug 2016
Market yields (p.a.)		
Fixed interest gilts	3.46%	1.17%
Index linked gilts	-0.04%	-1.78%
Implied inflation (RPI)	3.50%	3.00%
Implied inflation (CPI)	2.70%	2.20%
AA corporate bonds	4.30%	1.96%
AOA	1.60%	1.60%
Price indices		
FTSE All Share	3,556	3,697
FTSE 100	6,598	6,782

Change in funding level since last valuation

Change in contribution rate



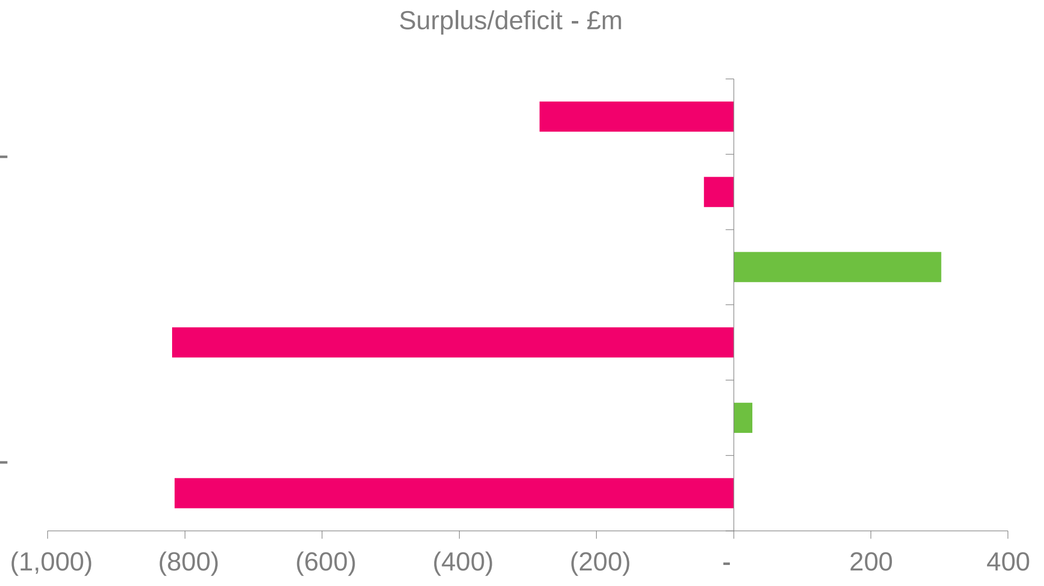
What's happened since last valuation? – ongoing funding basis

Assets		£m
Asset value as at 31 March 2014	**1,577**	
Contributions paid in:		**177**
Benefit payments:		**(154)**
Expected return on assets:		**204**
Excess return on assets:		**303**
Asset value as at 31 August 2016	**2,106**	

Liabilities		£m
Liability value as at 31 March 2014	**1,860**	
Cost of benefits accruing:		**150**
Interest on liabilities:		**247**
Change in yields & inflation:		**819**
Benefit payments:		**(154)**
Liability value as at 31 August 2016	**2,921**	

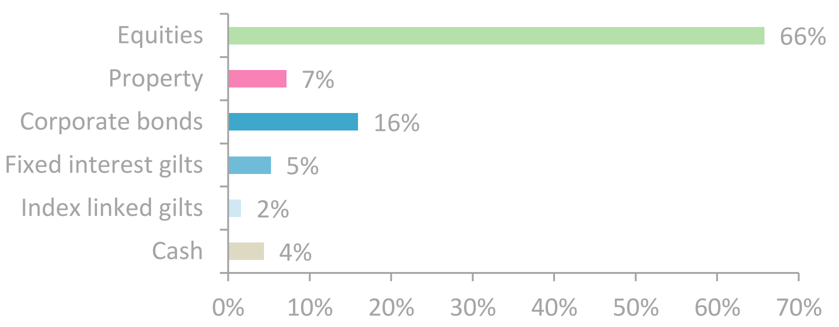
Overall effect

Surplus/(deficit) as at 31 March 2014	(283)
Interest on surplus/deficit	(43)
Excess return on assets	303
Change in yields & inflation	(819)
Contributions (less benefits accruing)	27
Surplus/(deficit) as at 31 August 2016	(815)

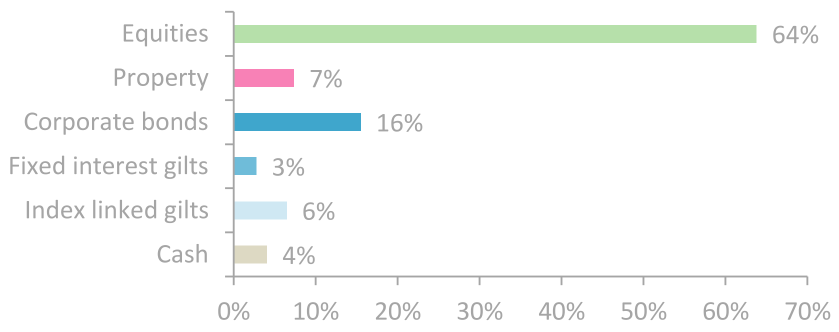


What caused your assets to change?

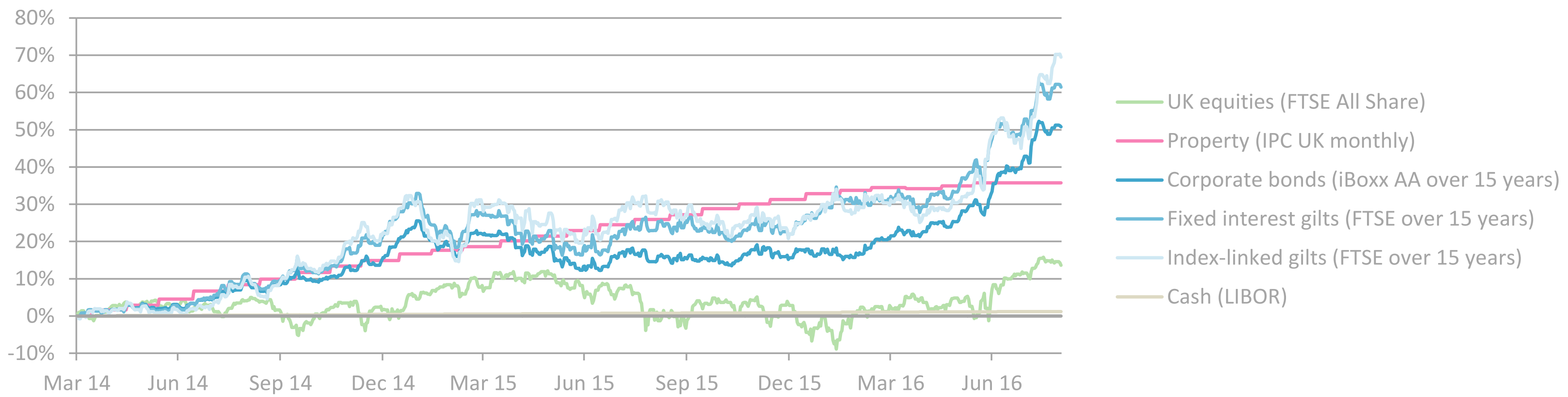
Allocation at valuation date



Allocation at 31 August 2016



Sterling total returns of major asset classes



Sensitivity matrix – ongoing funding basis

Better outcomes

Bond yields (% p.a.)	4,747	5,425	6,103	6,782	7,460	8,138	8,816
1.78	62.8% (952)	68.7% (802)	74.5% (652)	80.4% (502)	86.2% (353)	92.1% (203)	97.9% (53)
1.58	60.8% (1,049)	66.4% (899)	72.0% (750)	77.6% (600)	83.2% (450)	88.8% (300)	94.4% (150)
1.37	58.7% (1,153)	64.1% (1,003)	69.4% (854)	74.8% (704)	80.2% (554)	85.5% (404)	90.9% (254)
1.17	56.7% (1,265)	61.8% (1,115)	67.0% (965)	72.1% (815)	77.2% (665)	82.4% (515)	87.5% (366)
0.97	54.7% (1,384)	59.6% (1,234)	64.5% (1,085)	69.4% (935)	74.3% (785)	79.2% (635)	84.1% (485)
0.77	52.8% (1,512)	57.5% (1,363)	62.1% (1,213)	66.8% (1,063)	71.5% (913)	76.2% (763)	80.9% (613)
0.57	50.9% (1,650)	55.3% (1,500)	59.8% (1,350)	64.3% (1,200)	68.7% (1,051)	73.2% (901)	77.6% (751)

Equity level (using FTSE 100 Price Index as a proxy)

Better outcomes

72.1%	Funding level
(815)	Surplus/(deficit) – £m

Appendix: Scope, methodology, reliances, limitations and market data

Scope

This funding update is provided to Falkirk Council as the Administering Authority of the Falkirk Council Pension Fund to illustrate the funding position as at 31 August 2016. It should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except with Hymans Robertson LLP's prior written consent, in which case it is to be released in its entirety. Hymans Robertson LLP accepts no liability to any third party unless we have expressly accepted such liability in writing.

Compliance with professional standards

The method and assumptions used to calculate the updated funding position are consistent with those used in the latest formal actuarial valuation, although the financial assumptions have been updated to reflect known changes in market conditions. As such, the advice in this report is consistent with that provided for the last valuation, as set out in the:

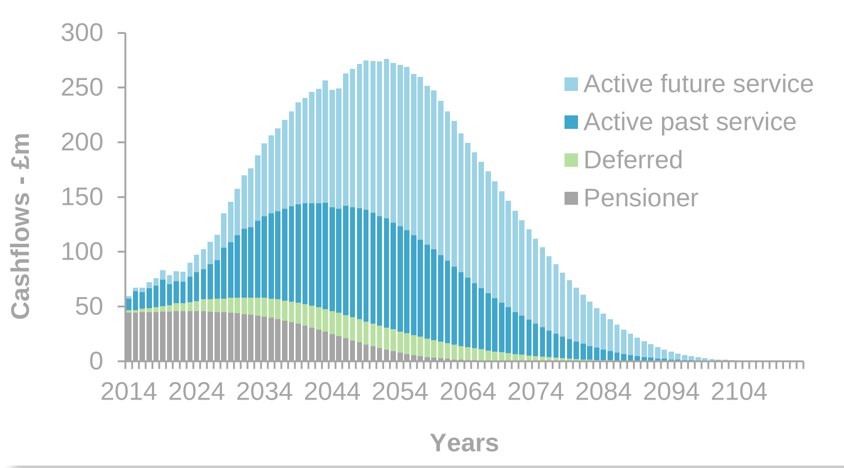
- Valuation Assumptions Briefing Note
- Funding Strategy Statement
- Valuation Report
- Rates and Adjustments Certificate

This update therefore complies with the following Technical Actuarial Standards (TASs):

- Reporting ("TAS R")
- Modelling ("TAS M")
- Data ("TAS D")
- Pensions TAS

How liabilities are calculated

- The future benefits that are payable from the Fund ("cash-flows") were calculated on a specific set of assumptions at the last valuation date.
- These cash-flows (on the ongoing funding basis) are shown below.
- These cash-flows were adjusted using available financial and Fund information to produce estimated cash-flows at post valuation dates.
- The specific information used for this update is set out on the next page.
- Market information is used to produce discount rates at these dates.
- The estimated cash-flows are discounted to produce the estimated liability value at a specific date.



How assets are calculated

Assets are projected from the valuation date allowing for actual or estimated Fund cash-flows, actual quarterly returns (where available) and daily benchmark indices.

The update allows for:

1. Movements in the value of the assets as measured by index returns and data from the administering authority where available.
2. Movements in liabilities as a result of changes in yields and hence inflation and discount rate assumptions.
3. Estimated cash-flows (contributions and benefit payments).
4. Expected accrual of benefits for employee members accrued since the last valuation (based on projected salary roll).
5. Demographic experience in line with assumptions.
6. Variations in liabilities arising from the changes in RPI since the valuation date differing relative to assumptions.
7. Benefit accrual in line with the 2014 scheme.

The update does not allow for:

1. Asset allocations differing from those assumed (other than when asset data is recalibrated based on available information).
2. The asset values as at the date of this report have not been based on audited Fund accounts.
3. Variations in liabilities arising from salary rises differing relative to assumptions.
4. Differences between estimated and actual salary roll of employees.
5. Variation between actual and expected demographic experience (e.g. early retirement or mortality).

Membership data

My calculations are based on the membership data provided for the most recent actuarial valuation. Details on the quality of this data and a data summary can be found in the last formal actuarial valuation report.

Limitations of this model

In the short term, the typical main contributors to funding position volatility are movements in the value of assets held, liability changes due to yield movements, benefit changes and deficit contributions to the Fund.

The accuracy of this type of funding update calculation is expected to decline over time. Differences between the position shown in this report and the position which a valuation would show can be significant; particularly if there have been volatile financial markets or material membership changes (these are more likely to occur in smaller Funds). It is not possible to fully assess the accuracy of this update without carrying out a full actuarial valuation.

Liability calculations are performed on the valuation date, the funding update date, anniversaries of the valuation date and each month-end in between. Interpolation is used for other dates shown in graphs. Some asset classes are not easily tracked by the benchmark indices used in this model which can lead to significant differences between actual and projected asset values.

Indices used to update projected asset values

Some of the following indices have been used to update projected asset values in this funding update.

- FTSE 100
- FTSE 250
- FTSE Small Cap
- FTSE All Share
- FTSE All World Series North America (£)
- FTSE All World Series Japan (£)
- FTSE All World Series Developed Europe (£)
- FTSE All World Series Developed Asia Pacific (£)
- FTSE All World Series All World Developed Ex UK (£)
- FTSE All World Series All World Ex UK (£)
- FTSE All World Series All Emerging (£)
- UK Government Fixed Interest Gilts (Over 15 Years)
- UK Government Index-Linked Gilts (Over 5 Years)
- UK Government Index-Linked Gilts (Over 15 Years)
- iBoxx A rated UK Corporate Bonds (Over 15 Years)
- iBoxx AA rated UK Corporate Bonds (Over 15 Years)
- iBoxx AAA rated UK Corporate Bonds (Over 15 Years)
- iBoxx All Investment Grades rated UK Corporate Bonds (Over 15 Years)
- IPD Property
- Cash Indices LIBOR 1 Month

The indices are a standard list and are not necessarily the same indices that managers have been asked to track or beat. All indices used to estimate projected asset values are total return indices. However, the market indicators quoted in this report are price indices, as these are more widely recognised.

Market information used to update liability values

Some of the following market information has been used to update liabilities values in this funding update.

- FTSE Actuaries UK Fixed Interest Gilts Yields (Over 15 Years)
- FTSE Actuaries Index-Linked Gilts (3% Inflation) Yields (Over 15 Years)
- iBoxx AA rated UK Corporate Bond Yields (Over 15 Years)

Note: Market yields displayed in the market indicators table are on an annual basis.