Agenda Item 6

Valuation Update

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Falkirk Council

Subject: Valuation Update

Meeting: Joint Meeting of Pensions Committee and Pension Board

Date: 7 December 2017

Submitted by: Director of Corporate and Housing Services

1. Purpose of Report

1.1 This report provides the Committee and Board with an update on the progress of the 2017 Fund Valuation, including details of the assumptions proposed by the Actuary.

2. Recommendations

2.1 The Committee and Board are asked to note the developments outlined in the report regarding the valuation of the Pension Fund as at 31 March 2017.

2.2 The Committee is asked to agree the assumptions proposed by the Actuary for the 2017 valuation.

3. Background

3.1 The rules of the Local Government Pension Scheme require that a fund valuation is undertaken every three years by an independent actuary. In accordance with that timescale, a valuation as at 31 March 2017 is being conducted by the Fund's actuary, Hymans Robertson.

3.2 The purpose of the valuation is to establish the financial position of the Fund in terms of its assets and liabilities and, for this valuation, to set an appropriate rate of employers' contribution for the three years' commencing 1 April 2018.

4. Valuation Process and Considerations

4.1 In order to assess the solvency of the Fund, the actuary needs to take account of the Fund's assets (i.e. its investments) and liabilities (its obligation to pay current and future benefits).

4.2 Assets are calculated at their market value on 31 March 2017, whilst liabilities are assessed as the amount of money that needs to be held now in order to meet all future pension payments. The lower the return in the future that is expected from investments then the higher the value that has to be placed on the liabilities (and vice versa). This future expected return assumption is referred to as the discount rate and is usually expressed as the return on Long-dated government bonds plus an outperformance assumption (e.g. government bonds - or “gilts” - plus 1.8%).

4.3 The actuarial assessment also has to take into account such factors as salary growth, price inflation and member longevity as all of these factors, along with the discount rate, affect the value of the liabilities.

4.4 In setting employer contribution rates, the actuary is obliged to take account of the Fund’s funding objectives as set out in its Funding Strategy Statement (FSS). The key funding objectives of the Falkirk Fund (as set out in the preceding report of today’s meeting) are to:

- ensure there are sufficient funds to pay benefits as they arise
- pursue a funding target of 100% over a 20 year period
- take a prudent long term view when funding liabilities
- maintain as stable an employer contribution rate as possible
- maintain contributions at an affordable level for employers
- recognise the different characteristics of Fund employers when setting rates
- be conscious of the need for inter generational fairness in funding liabilities, and
- not take more investment risk than is necessary

5. Valuation Assumptions

5.1 The main assumptions adopted by the actuary for the 2014 valuation and the new assumptions proposed for the 2017 valuation are as follows:

	2014 Valuation	**2017 Valuation**
Discount Rate	5.1%	3.5%
Benefit Increases	2.7%	2.4%
Salary Growth	4.0%	2.9%
Longevity	See Paragraph 5.5 below	

5.2 The Discount Rate for the 2017 valuation of 3.5% assumes that the Fund will achieve year on year investment returns of gilts plus 1.8%. The margin allowed for above gilts has increased since the 2014 valuation (gilts plus 1.6%) but is considered appropriate in view of the current low return on government bonds (i.e. gilts) and still appropriately prudent in terms of meeting the Fund’s key funding objectives.

5.3 The assumption for Benefit Increases reflects long term inflation (CPI) expectations.

5.4 The assumption for Salary Growth has been reduced from the 2014 valuation. With the introduction of the new scheme in 2015 and its link to a member's career average salary rather than final salary at retirement, there is more certainty on when the final salary linked benefits will come into payment. When agreeing the salary growth assumption for 2017, the analysis, conducted by the fund actuary, has shown that more weight can now be placed on short term salary growth (at their current low levels). The proposed 2.9% assumption, which is a long term average, is therefore deemed appropriate even in the current climate of speculation concerning the end of the public sector pay cap.

5.5 The Actuary's Longevity assumptions are that:

- Male Pensioners will live 21.9 years in retirement (22.1 years in 2014)
- Female Pensioners will live 24.3 years in retirement (23.8 years in 2014)
- Male Members will live 24.3 years in retirement (same as 2014)
- Female Members will live 26.7 years in retirement (26.3 years in 2104)

5.6 Catherine McFadyen from Hymans Robertson, the Fund's Actuary, is attending the meeting and can provide more detail around the rationale for these key assumptions.

6. Valuation as at 31 March 2017

6.1. The actuary has completed the initial assessment of the 2017 data. The table below sets out the results at a whole fund level and compares this with the 2011 and 2014 valuation results:

	Funding Level	**Assets**	**Liabilities**	**Deficit**
2017 Valuation	92%	£2,219m	£2,403m	£184m
2014 Valuation	85%	£1,577m	£1,860m	£283m
2011 Valuation	86%	£1,198m	£1,392m	£194m

6.2 The results indicate that the gap between assets and liabilities has narrowed due essentially to strong asset returns and despite low gilt yields requiring a higher value to be placed on the liabilities. **A short paper summarising the whole fund results is attached as an appendix to the report**.

6.3 In spite of the reduction in the deficit, there is still an upward pressure on contribution rates due to there being lower expectations for future investment returns going forward (implied by the current low yield environment for gilts). This anticipated lower investment return increases the expected cost to employers of paying for future member benefits (e.g. the Primary Rate for each employer)

6.4 In keeping with the 2011 and 2014 valuations, the actuary is proposing to allow employers with strong covenants (e.g. the Councils, SEPA and SCRA) to increase their contribution rates on a gradual basis in the interests of stability and affordability.

6.5 This approach – known as a contribution stabilisation strategy – involves "stabilised employers" increasing their contribution rates by 0.5% annually. Actuarial modelling had also shown that the stabilised approach still gives these employers a better than 50:50 chance of returning to the 100% funding level over a twenty year period and thus meeting the prudence objectives within the key funding objectives.

6.6 Where deemed appropriate, contribution rates for smaller fund employers will continue to be determined by pooling together their assets and liabilities in order to deliver a more stable rate. The remaining employers, including the larger admission bodies, will have their rates determined according to their individual circumstances and characteristics.

6.7 Individual employer results are currently in the process of being calculated and will be shared with employers shortly. As with the 2014 valuation, employers will be invited to individual sessions to discuss their contribution strategies with the actuary.

6.8 A presentation of the valuation results will be given to the joint meeting of the Committee and Board at the meeting of 15 March 2018.

7. Implications

Financial

7.1 The outcome of the 2017 valuation will determine employer contribution rates for the 3 years from April, 2018. The setting of new contribution rates will be of great interest to Fund employers given their relevance to employer budgets (e.g. employer contributions made by Falkirk Council in 2016/17 were £20m).

Resources

7.2 Staffing resources, along with actuarial support of the actuary, will continue to be deployed in order to bring the 2017 valuation process to a satisfactory conclusion.

Legal

7.3 There is a statutory requirement for the Fund to be subject to an actuarial valuation as at 31 March 2017 and for the valuation to be completed by 31 March 2018.

Risk

7.4 Failure to complete the valuation would be a breach of statutory duty and could impact fund solvency through inadequate contributions being collected.

Equalities

7.5 None.

Sustainability/Environmental Impact

7.6 None.

8. Conclusion

8.1 The valuation exercise for 2017 has revealed that the funding level at 31 March 2017 has increased to 92% largely as a result of the strong asset returns during the inter valuation period. Employer contributions are likely to be increasing for the majority of employers.

8.2 The formal valuation report will be presented to the Joint meeting of the Committee and Board on 15 March 2018.

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Appendices

2017 Fund Valuation Initial Results Paper – Hymans Robertson

List of Background Papers:

None

2017 Formal Valuation Initial Results

1.1 Purpose

This document has been requested by and is addressed to Falkirk Council in its capacity as Administering Authority to the Falkirk Council Pension Fund ("the Fund"). The document and the draft Funding Strategy Statement (the "FSS") are to be discussed at the Pensions Committee Meeting on 7 December 2017.

1.2 Scope

This document sets out the initial whole fund solvency level based on the proposed funding assumptions.

In addition to the initial whole fund solvency level, this report sets out the key reasons for the change in solvency level from the 2014 valuation. This information is useful to understand the movement, identify any areas of potential risk that the Administering Authority may wish to consider and explore possible avenues of risk mitigation during the valuation process.

1.3 Financial assumptions

Your proposed financial assumptions are set out below, along with the assumptions adopted for the 2014 formal valuation:

Financial assumptions	31 March 2014	31 March 2017
Discount rate (p.a.)		
Return on long-dated gilts	3.0%	2.2%
Asset Outperformance Assumption*	1.6%	1.8%
Discount rate	**5.1%**	**3.5%**
Benefit increases (p.a.)		
Retail Prices Inflation (RPI)	3.3%	3.2%
Assumed RPI/CPI† gap*	(0.8%)	(1.0%)
Benefit increase assumption (CPI)	**2.7%**	**2.4%**
Salary increases (p.a.)		
Retail Prices Inflation (RPI)	3.3%	3.2%
Increases in excess of RPI*	0.5%	(0.5%)
Salary increase assumption	**4.0%**	**2.9%**

† *Consumer Prices Index*

* *Applied arithmetically for the 2014 valuation and geometrically for the 2017 valuation*

We have discussed and agreed with the Administering Authority to prepare initial whole fund valuation results using the financial assumptions shown above. The Administering Authority commissioned the following actuarial advice to assist its assumption setting:

- Our paper "2017 valuation – pay growth assumption" which set out the factors influencing the choice of salary increase assumption and commented on some possible choices
- Our paper "2017 valuation – Asset Outperformance Assumption" which summarises modelling testing the appropriateness of possible choices of Asset Outperformance Assumption (AOA). Based on this modelling, there is a 74% likelihood that the Fund's investment strategy can support the chosen AOA. This modelling allowed for the Fund's long term investment strategy as outlined in the Statement of Investment Principles.

We believe the proposed discount rate of 3.5% p.a. is a sufficiently prudent estimate of the return that can be expected from the Fund's assets in the long term. All other assumptions are intended to represent our best estimate of future experience. Taken in aggregate, the proposed funding basis results in a prudent estimate of the Fund's pension liabilities.

It is our opinion that there has been no material change to the level of prudence between the 2014 and proposed 2017 funding assumptions.

1.4 Demographic assumptions

Longevity

Your proposed longevity assumptions result in the following typical future life expectancies from age 65 (figures for 2014 shown for comparison):

	31 March 2014	31 March 2017
Male		
Pensioners	22.1 years	21.9 years
Non-pensioners	24.3 years	24.3 years
Female		
Pensioners	23.8 years	24.3 years
Non-pensioners	26.3 years	26.7 years

Non-pensioners are assumed to be aged 45 at 31 March 2017

Retirement age pattern

We have adopted the retirement age pattern assumption as specified by the England and Wales Scheme Advisory Board for preparing Key Performance Indicators.

50/50 option

Following analysis of both the Fund's actual take up rate, and national statistics, the Fund has assumed that 1% of members will take up the 50/50 option in the future. (The assumed take up was 10% at the 2014 valuation).

Other demographic assumptions

All other assumptions have been updated to reflect the latest experience of LGPS funds in Scotland.

1.5 Whole Fund Initial Results

The solvency of the Fund as at 31 March 2017 based on your proposed assumptions is set out below. The results at the 2014 formal valuation are shown for comparison. These results are sensitive to the underlying financial and demographic assumptions as well as the quality of the underlying data.

Valuation Date	31 March 2014	31 March 2017
Past Service Liabilities	**(£m)**	**(£m)**
Employees	930	1,116
Deferred Pensioners	216	354
Pensioners	714	933
Total Liabilities	**1,860**	**2,403**
Assets	**1,577**	**2,219**
Surplus / (Deficit)	**(283)**	**(184)**
Funding Level	**85%**	**92%**

Liabilities

The liabilities have grown since 2014 mainly as a result of new benefit accrual and the change in the financial assumptions. The change in the net discount rate (the difference between the discount rate and the assumed rates of increase of salaries, deferred pension revaluation or pensions in payment) results in a higher value being placed on the liabilities.

Assets

The assets have also grown over the inter-valuation period. This is primarily as a result of much better than assumed asset returns.

1.6 Inter-valuation experience

The table below illustrates the various factors that have led to the change in the solvency position between the 2014 and 2017 valuations.

Analysis		(£m)
Surplus / (deficit) at 31 March 2014		**(283)**
Interest on surplus / (deficit)	(45)	
Investment returns greater than expected	332	
Contributions greater than cost of accrual	11	
Membership experience over the period	137	
Change in demographic assumptions	(24)	
Change in base mortality assumption	15	
Change in longevity improvements assumption	11	
Change in financial assumptions	(440)	
Impact of LGPS 50/50 take up	(12)	
Other experience items	114	
Surplus / (deficit) at 31 March 2017		**(184)**

Further comments on some of the items in this chart:

- There is an interest cost of £45m. This is broadly three years of compound interest at 5.1% p.a. applied to the previous valuation deficit of £283m (and can be thought of as the investment return that would have been achieved on the extra assets the Fund would have held if fully funded).
- Investment returns being higher than expected since 2014 lead to a gain of £332m. This is roughly the difference between the actual three-year return (38.1%) and expected three-year return (16.1%) applied to the whole fund assets from the previous valuation of £1,577m, with a further allowance made for cashflows during the period.
- The impact of the change in demographic assumptions has been a loss of around £24m.
- The change in mortality assumptions (baseline and improvements) has given rise to a gain of £26m.
- The change in financial assumptions since the previous valuation has led to a loss of £440m. There has been a significant drop in gilt yields over the inter-valuation period which reflects a general reduction in anticipated investment returns and therefore a reduction in the discount rate used to place a value on the liabilities. Long term expectations for Retail Prices Inflation (RPI) have also fallen slightly since 2014. This will offset some of the increases caused by the fall in gilt yields.
- Other experience items, such as changes in the membership data, have served to reduce the deficit at the 2017 valuation. The most material items of membership experience have been:
    - More active members withdrawing early from Fund than expected
    - The pensioner mortality experience has been very close to expectations
    - Salary increases have been less than assumed
    - Pension increases have been less than assumed

- Ill health retirement experience has been less than expected
- Data cleansing work carried out on the Fund's membership data has reduced the liabilities

1.7 Next steps

The next milestone in the valuation process is preparation of the draft individual employer funding results and proposed employer contribution rates.

1.8 Reliances and limitations

This document has been requested by and is provided to Falkirk Council in its capacity as Administering Authority to the Falkirk Council Pension Fund. It has been prepared by Hymans Robertson LLP to support a discussion on funding strategy with the Fund as part of the 2017 funding valuation.

This document should not be released or otherwise disclosed to any third party (including Fund employers) without our prior written consent, in which case it should be released in its entirety. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability

The valuation results are wholly dependent on the data provided to us and the assumptions that we use in our calculations. We have previously issued a separate report confirming that the data provided is fit for the purposes of this valuation and have commented on our perception of the quality of the data provided. The data used in our calculations is as per our report which will follow shortly.

The figures in this report are based on our understanding of the benefit structure of the LGPS in Scotland as at 31 March 2017.

1.9 Actuarial Standards

The following Technical Actuarial Standards[1] are applicable in relation to this report and have been complied with where material:

- TAS 100 – Principles for technical actuarial work;
- TAS 300 – Pensions.

However, it should be noted that this report does not comply with paragraph 12 b) or c) of TAS 300.The figures in this report provide a notification of the whole fund solvency level. This report is not proposing individual employer contributions. Therefore we do not believe the exclusion of the information required under these paragraphs are material.

Prepared by:-

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01 December 2017

For and on behalf of Hymans Robertson LLP

[1] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work.