

2013 Actuarial Valuation Framework for Setting Contribution Rates

1. Introduction

The 2013 actuarial valuation of the Fund will take place on the 31st March 2013. This valuation of the assets and liabilities will determine the funding level, and from this the individual employer contributions required from 1 April 2013.

This report presents a proposed framework within which employer contribution rates will be set as a result of the 2013 actuarial valuation of the fund.

It is important for the Committee to agree this framework in advance of the valuation in order that the Committee can effectively exercise its responsibilities for stewardship of the Fund as a whole. Equally, some flexibility in approach needs to be retained, in order to be able to address later on in the process any reasonable issues raised by employers, particularly around the affordability of contributions.

This is an important aspect of the transparent governance of the Fund, and will clearly set out the ground rules for setting employer contribution rates.

The 2013 actuarial valuation of LGPS Funds is probably the most significant valuation in the history of the LGPS. There are a number of significant factors coming together at one point in time which will impact on the actuary's calculations. These include:

- The introduction of the new CARE scheme from April 2014 which will affect the calculation of the future service contribution rate.
- The continuing instability in the financial markets, particularly the bond markets which impacts on various factors used within the actuary's calculations.
- The introduction of auto-enrolment on a rolling basis which will impact on fund membership, contributions received and future liabilities.
- The continuation of public sector austerity which will have an impact both on pay growth, scheme membership and the cash flow profile.
- The need to continue to make progress in reducing the past service deficit within the context of ongoing pressure on employers' budgets.

All of these factors combine to make this probably the most challenging valuation in LGPS history.

By setting a clear set of ground rules for the valuation now, all stakeholders can be clear on the parameters for the valuation and will have time to prepare for the potential impact. It allows the Committee to fulfil its responsibility to the Fund as a whole and to engage with Fund employers around the preparation of the Funding Strategy Statement which forms one of the key outputs from the valuation process. Feedback will be provided to the Committee on the views of Fund Employers in due course which will allow the Committee to make adjustments to the framework if it is not meeting the objectives set.

2. The Objectives of the Valuation Process

The purpose of the valuation process is to establish the scheme's funding level and as a consequence enable the setting of employer contribution rates. In doing this it is important to bear in mind two specific objectives:

1. The need to deliver a credible plan to reduce any past service deficit that might exist within the Fund at the point of valuation. In this context credible is taken to mean a plan that continues to reduce the length of time the deficit exists and which relies upon assumptions which the Fund's actuary is able to agree to as giving a significant chance of delivering the elimination of any deficit taking account of the various uncertainties which exist.
2. The need to maintain stability in employer contribution rates over the longer term, i.e. more than any single valuation period.

What the valuation is seeking to achieve is a "contribution plan" that gives the greatest possible chance of addressing any deficit over the agreed period while giving employers as much certainty as possible over contribution rates.

It needs to also be borne in mind that achieving these objectives at the level of the Fund as a whole will not necessarily mean they will be achieved for each individual employer as the circumstances of each employer are different. While the Committee needs to have regard to the circumstances of individual employers its duty is to the Fund as a whole.

3. The Factors Affecting the Valuation

The valuation of the Fund's liabilities is the result of a complex series of calculations involving a range of assumptions any of which might have an impact on the end result. It is important to set out and agree the assumptions to be made prior to the valuation in order that the process can be seen to be free from undue influence.

The key factors and the assumptions proposed by the Fund's actuary are as follows:

- Pay Growth – Public sector pay restraint has a significant effect on the potential liabilities of the Fund. Previous valuations have assumed a rate of pay growth that is significantly in excess of current experience. It is therefore proposed to assume that pay growth will be limited to 1% in the first three years post valuation and thereafter reduce the previous long term assumption by 0.5% pa. This is considered to be an assumption that more accurately reflects the likely trend of pay growth.
- Life Expectancy – It is proposed to continue the practice of basing assumed life expectancy on Fund specific data, which will reflect the impact on the Fund of the fact that life expectancies in Lancashire tend to be lower than the national average.
- Discount Rate – The yield on government bonds is used as a discounting factor within the calculation of the Fund's liabilities. As has previously been reported to the Committee yields are currently at historic lows which has the effect of increasing the value of the Fund's liabilities. It does not seem

reasonable to assume that yields will remain at these historic lows for the entire life of the Fund's liabilities and it is therefore proposed to assume within deficit recovery periods (and where the employer's covenant is sufficient to support it) that after five years yields will revert to a more normal pattern. The five year period is an assessment by the actuary and Fund officers of the point at which yields revert to a fair value.

- **Increased Investment Return** – In previous valuations the assumptions for "high covenant" employers have included an assumption around an increased investment return, although this assumption was not applied where it would have resulted in a reduction in employer contribution rates. In this valuation cycle it is not proposed to include any assumption around investment returns over and above the actuary's base assumption as it is considered that within the current investment context increasing return assumptions might result in a need to reassess the Fund's investment risk appetite which would be undesirable in the context of the current market situation. In practice the assumption above in relation to the reversion of yields is an alternative way of allowing for more favourable experience during the term of a recovery plan.

It is considered by the actuary that setting assumptions in this framework will provide a basis for the valuation which is rooted in reality and provides a prudent and sensible assessment of yields.

4. Fund Membership

Overall membership of the Fund is also an issue that will impact on the valuation as the number of members will drive both the level of liabilities and the level of contributions to be received over time. There are two conflicting drivers in terms of membership, firstly the overall reductions in the public sector workforce which have had a noticeable impact on the Fund, in terms of changing the balance between pensioner and active members. Secondly the impact of auto-enrolment where those members who do not chose to opt out will increase the active member and contribution base although increasing liabilities in the longer term.

At this stage it is too early for the actuary to make a judgement on how these two factors will interact within the valuation and members will be updated as the results of the valuation are reported back.

5. Dealing with the Deficit

A key part of the valuation process is to set out how the Fund will address the past service deficit. There are two key variables in the deficit recovery plan:

1. The time over which the deficit is to be recovered. This period is due to reduce to 16 years at this valuation, although Funds do have the option of resetting this period. It is not currently proposed to reset the period and to produce a 16 year recovery plan as it is felt that this is the prudent course given the impact of the new scheme in reducing future service contributions and the other pressures from austerity measures which create risk for the Fund. It is, however, recognised that this aspect may need to be reviewed further as part of the valuation process, partly as discussions with employers begin in connection with the affordability of any new contribution rates

following the valuation. It also needs to be borne in mind that at the 2010 actuarial valuation the deficit recovery period was kept as short as possible, in part due to a desire to offset some of the reductions in contributions which might have emerged through workforce reductions, as outlined below.

2. The amount paid in towards the deficit. This is currently set as a proportion of pay in the same way as the future service contribution rate. However, this means that as employers reduce their workforce the amount paid towards the deficit will reduce although the deficit itself may increase as a result of changes in an employer's membership profile. It is therefore proposed to set deficit contributions as an annual cash amount so that reducing the deficit is not affected by the reducing workforce. This represents the most prudent position and protects individual employers and the Fund. The three local education authorities within the Fund will need to make special arrangements in relation to schools as it is not possible to charge a single cash sum of this sort to the schools budget.

Reducing and eliminating the deficit is a key focus for the Fund and these measures are considered by officers and the actuary to represent the approach most likely to deliver success, all other things being equal, in the context of an overall employer contribution plan.

6. Academies and Free Schools

Academies and Free Schools are deemed to be scheduled bodies and where they are created by the "reclassification" of an existing maintained school they inherit a proportion of the previous host employer's deficit within the Fund. These institutions, unlike maintained schools receive a funding agreement from the Department for Education for 7 years. In ordinary circumstances an employer with a 7 year funding agreement would be treated in valuation terms as having to recover any deficit over 7 years. This is the methodology used for a number of admission agreements resulting from outsourcing contracts.

Guidance to Funds is expected from central government on the issue of how to treat such deficits in due course and therefore it is not proposed at this stage to determine a policy for the Fund.

7. Dealing with Workforce Reductions

The valuation process allows employers to deal with workforce reductions in two ways. While the cost of these is borne by employers they are at the discretion of the Fund, and it is proposed that changes are made.

1. A cash allowance for pension strain payments on early retirement is contained within the individual employer's contribution rate. It is proposed that this practice is ended for two reasons. Firstly it results in the cost of early retirement not being transparent and secondly it creates a timing difference as the Fund is receiving contributions in advance of the pension strain payments which is potentially to the disadvantage of the employer.
2. Cash payments of actuarially calculated "pension strain" are made either as one off lump sums or by instalments over 3 or 5 years. It is proposed that in

future the instalment option will not be allowed, although instalment plans in relation to early retirements which have already taken place will be honoured. This ensures that the amount payable to the Fund in respect of the lost contributions from an early retirement is invested in full as quickly as possible and therefore, all other things being equal, reduces the risk of an early retirement impacting on the deficit within the Fund.

These measures are likely to make early retirement a less affordable option for achieving workforce reductions for some employers. This is accepted, however, there is an overriding need to protect the overall interests of the Fund which is what these measures do to the greatest extent possible.

8. Conclusion

The various assumptions set out in this report represent a clear framework within which the actuary and the Fund's Officers can carry out the work in relation to the 2013 valuation. It is proposed that Fund employers and members are consulted on this framework alongside the valuation process as part of the preparation of the revised Funding Strategy Statement.