

Appendix 'A'

Initial Approach to the 2016 Actuarial Valuation

Introduction

The Fund is required to undertake a full actuarial valuation of its liabilities every three years for the purpose of setting employer contribution rates and deficit recovery periods and payments. The next valuation is due to be undertaken based on data at 31st March 2016, with any new contribution rates taking effect from 1st April 2017.

In preparation for the valuation process it is important that the Fund engages with employers in order to:

- Inform them of the risks and issues that exist in the valuation process and their possible financial impact.
- Gain an understanding of the objectives which employers might have for the valuation process.

This report provides background to the valuation process and recommends an approach to engagement with employers for adoption by the Fund over the course of the process.

The Purpose of the Valuation

The valuation provides an estimate of the total value of the pension promises in relation to those individuals in the fund at the valuation point. As this means creating a forecast of the relevant values over a very long time period (for a 16 year old school leaver joining the scheme their life expectancy could be 90+ meaning a forecast over more than 70 years) a range of assumptions is required to produce a meaningful result. These include:

- The level of inflation, as this will impact on the level of benefits to be paid, and will impact on the revaluation of CARE scheme earnings;
- The level of pay awards which will impact on the value of pre 2014 protected benefits;
- The length of time over which it is assumed benefits will be paid;
- The level of benefits payable, which is determined by whether members chose to participate in the 50/50 scheme or not;
- The assumed level of investment returns;
- The discount rate used, which is the factor used to restate the value of liabilities at a future date to today's value, i.e. how much money we would need to put aside now given a particular liability value at a future point.

All these assumptions interact to give a total value for the various pension promises which in combination with the value of assets at the valuation date is then used to establish the value of any deficit or surplus in the Fund and then set contribution rates and the deficit recovery plan.

The Valuation Equations

Looked at simplistically the approach to the valuation can be expressed in the form of the equations set out below:

Projected deficit = Employer + Return on those contributions from
paid off deficit contributions Investment Strategy

Future service liability = Employer normal + Employee + Return on those contributions
Contributions contributions

So if you can establish all but one of the elements of the above equations then they can be solved for the remaining element.

In practice, there are a number of interdependencies in the process. So, for example, it is possible to say that in order to achieve a given level of employer contributions investment returns at a given level are required (or, alternatively, for a given level of investment returns the employer contributions will need to be set at a certain level in order for the projected deficit to be paid off). Clearly the lower the level of employer contributions set the higher investment returns will need to be to meet a given value of liabilities, as employee contributions are in effect constant. The higher the level of investment return assumed clearly the more difficult it is to achieve, and potentially the greater the degree of investment risk that needs to be taken in order to deliver return, which is the reward for risk.

Expressing the valuation question in this way will enable a more effective debate with employers about their objectives and about approaches to contribution rates that would provide results acceptable both to employers and the Fund.

The 2013 Valuation Results in Context

The results of the 2013 valuation for the Fund produced a moderate increase in employer contributions at Fund level, but there was significant variability between employers, caused in part by the move to using fixed cash sums for the deficit contribution.

Following the valuation a number of organisations have conducted work to set valuation results on a like for like basis in order to provide a sensible comparison between funds. The graph at Annex 1 has been produced by PWC for the Scheme Advisory Board as part of work on deficit management. This source of comparison has been chosen as it is independent of the actuarial firms operating in the LGPS market place and thus less likely to be swayed by a "house view", although the results from other sources are similar. What the graph shows is the funding level reported plotted against the real investment return (i.e. return in excess of CPI) assumed in the valuation. Based on this Lancashire comes out in the 20% "most prudent" funds with an assumed real investment return of around 2.25% per annum. If we assume that CPI runs at the Bank of England target of 2% per annum then this equates to a nominal return of 4.25% per annum, which reflects a relatively prudent (lower than average risk funding strategy). However, a lower risk strategy does have more certainty of delivery over the assumed deficit recovery period of 19 years. To set some context the average nominal increase in the value of the Fund over the last 10 years is 8.5%pa.

What Has Happened Since 2013?

All actuarial valuations are based on a range of assumptions, for example about how much pensions will increase each year, and how long pensioners will live in retirement. To understand where we start from for the 2016 valuation we need to understand whether the assumptions made in 2013 have been borne out by reality. The Fund actuary will be in attendance at the Committee to discuss these issues. However, the table below outlines the key assumptions made and what has happened in reality, where information is available.

Factor	2013 Assumption	What Has Actually Happened	Favourable (+) / Unfavourable (-)
Pensions would increase by % pa	2.6% p.a.	2.7% Apr 2014 1.2% Apr 2015	+c£60m over two years
Pay would increase by % pa	1.0% p.a. for 3 years 4.1% p.a. thereafter	Actual experience unknown, at the detailed level but pay bill effect of pay awards is c. 1%, which is in line with assumptions.	+/- c£30m p.a. for each 1% below/above assumption
Investment returns would be % pa	4.8% pa.	4.7% 2013/14 14.9% 2014/15	+c£500m over two years
Pensioners would live for ? years in retirement	Approx 23 yrs (M), 27 yrs (F)	Actual experience unknown and will only be available at the valuation. Research on life expectancy is equivocal as to whether the rate of increase is being maintained.	c£170m per 1 yr increase in life expectancy
Long term real interest rates would be %	-0.4% pa. rising gradually to +1% pa.	-1% pa.	-c£800m
Deficit contributions would be £m pa	£55m increasing by 4.1% pa	£50m in 2013/14 £55m in 2014/15	+c£105m over two years
Take up of the 50/50 option would be % of membership	10% in line with the assumption by the Government Actuary in costing the new scheme. N.B. some employers chose to assume nil.	Actual experience unknown, but take-up expected to be relatively small and possibly 1% or less.	-£10m (max) over two years

Given the relative significance of each of these factors the broad conclusion has to be that despite strong performance in those areas susceptible to direct influence by the

Fund overall the position against the assumptions is negative, or put simply despite all efforts to the contrary and all other things being equal the deficit in the Fund will have increased.

Clearly this is a matter of considerable frustration for both the management of the fund and for employers as the movements in long term real interest rates which have driven the deterioration in the position are deliberate results of the fact that Quantitative Easing reduces the supply of gilts in the marketplace together with the policy of reducing the proportion of gilt issuance made in index linked form, these factors have been coupled with the market movements resulting from instability within the Eurozone. Thus the assumption underlying the choice of the gilt rate as a key factor, i.e. that it is the risk free rate of interest (because it involves the government's credit) in a free market has become invalid because the market is not operating effectively due to the imbalance between supply and demand for gilts. It is true that at some point the Bank will have to unwind QE, and some sort of stability will be achieved in the Eurozone. The most likely scenario is a gradual drip back into the market of that portion of gilt supply held by the Bank. But, gilt supply is reducing anyway, as government is slowly, reducing the amount of new borrowing each year and if plans are reflected in reality within five years the national debt and consequently the supply of gilts will begin shrinking, which given demand for gilts from institutional investors will result in increased prices and reduced yields, magnifying the problem already faced by pension funds.

The current position is clearly unsustainable and a new approach is needed to the valuation of liabilities which does not leave pension funds which should be long term investors in thrall to the short term movements of an imperfectly functioning gilt market.

Setting an Overall Valuation Objective

Given the pressure on employers' budgets it would seem sensible to set out in advance for them what the Fund is, all other things being equal, seeking to achieve from the valuation.

As indicated above there are a range of pressures following the last valuation that will manifest themselves in this valuation and which will need to be addressed one way or another. However, the Fund needs to recognise affordability for employers as an issue. A statement of intent, prior to the valuation and any guidance either from the Scheme Advisory Board or the Secretary of State, which seeks to balance the competing interests would be that:

"The Fund's objective for employer contributions is, at the whole fund level, to maintain, in cash terms, the contribution plan set in 2013"

At this stage it would be difficult to set an objective other than at the whole fund level, as the valuation at individual employer level will be significantly affected by the way in which the workforces of individual employers have changed over the inter-valuation period. The Fund will also need to discuss with major employers (for example the County Council and the unitary councils) their intentions in relation to the size of their workforces going forward in order to make properly informed forecasts of future membership and cash flows.

The Future Approach to Valuation

The Fund's actuary, John Livesey from Mercer, will be present at the Committee's meeting to address the proposed overall approach to the valuation process.

As part of the process of preparing for the valuation it is suggested that the Committee engage with employers on the basis that:

- It is assumed that pay increases for the period to 2020 are no more than 1% in line with the announcements contained in the summer budget. Employers should realise that this represents a risk in that it makes no short term allowance for increments (which are still part of most local government pay structures) and that there is a risk that employers agree greater levels of increase as local government pay awards are not centrally controlled. There is also a risk from the introduction of the National Living Wage which may result in pay awards weighted to the bottom of the pay scale which could impact on the accuracy of this assumption.
- Assumptions on life expectancy will continue to be based on specific fund level data rather than on generic assumptions.
- No assumption will be built in about take up of the 50/50 option, given that so few members have actually taken this up.

Academy Schools

At the time of the last valuation the Department for Education was encouraging funds to "pool" contribution rates for Academy Schools, that is treat all academies as though they were a single employer.

There are pro's and con's to this approach. It is slightly administratively simpler, and as it, in effect, reduces the number of employers there is a potential impact on the amount of work required to complete the valuation, although this is marginal. However, the effect is that to some degree liabilities become pooled which means that there is the potential for one school to take decisions which impact on other schools. This dilutes accountability and is not something that the Fund would wish to encourage. It is therefore recommended that the Fund state that, with the exception outlined below, it has no proposals to pool rates for academies. The exception would be where an academy chain (or Multi Academy Trust) requests a pooled rate. Chains are single employers and therefore the issues which exist in terms of a more general pool and potential cross subsidy are not apparent. Given this it is proposed that the Fund accept requests from academy chains (Multi Academy Trusts) to adopt a pooled rate approach.

Employer Covenant and Risk

There are over 200 active employers within the Lancashire County Pension Fund with an enormous variety in terms of scale and financial strength. Some of these employers have their participation in the Fund guaranteed by one of the local authorities, others do not. All of these sorts of factors mean that each employer presents a different risk to the Fund in terms of the potential for them to fail to pay contributions, or meet their other responsibilities as an employer in the Fund.

The Fund needs to take steps to manage this risk and reduce the risk that failure of one employer could impact on others. The first step towards doing this is to understand the strength (or covenant) of each employer. In order to do this work has been commissioned from the London Pensions Fund Authority who are an acknowledged centre of expertise in this area of work. The results of this work will allow the Fund to categorise employers into four "buckets"

Level 1 – Those with the very strongest covenant

Level 2 – Those with an above average covenant

Level 3 – Those with a below average covenant

Level 4 – Those with the weakest covenant

This categorisation can then influence the way in which contribution rates are set for employers, thus an employer with a weak covenant is less able to take investment risk than one with a strong covenant, because they (and the Fund) need certainty that they are meeting their financial obligations. This is achieved through the mix of assets allocated to specific employers within the actuarial valuation.

The Deficit Recovery Period

At the 2013 valuation the deficit recovery period was set at 19 years, which, in effect pushed back the planned elimination of the deficit by three years. This was a pragmatic response to the need to try to maintain some stability in contributions while not placing undue strain on key assumptions. The 19 years was a maximum, with shorter periods being set for some employers, for example where an outsourced contract was involved or where there were a small number of members and the last active member was due to retire within 19 years.

It is likely that employers, particularly local authorities, will wish to push out the recovery period even further in order to reduce the annual cash deficit recovery payments, thus reducing budgetary pressure. The argument from local authorities would be based on the fact that the strength of their covenant and their tax raising powers mean that they can be allowed to recover the deficit over a longer period than might otherwise be acceptable. Equally the Pension Fund needs to have regard to the need to produce as part of the valuation process a credible plan to recover the deficit. The question for members of the Committee, acting for the Fund, is whether a deficit recovery plan that either maintains or extends the recovery period can be considered credible.

The context for this is that the regulator requires comparable private sector schemes to recover deficits in much shorter timescales, thus the greater strength of covenant possessed by tax-raising bodies can be argued to already be reflected in the Fund's overall deficit recovery plan.

It is also arguable whether having a deficit recovery plan where the deficit recovery period does not reduce over the life of the plan is credible. While, it is accepted that the level of the deficit is the result of a somewhat abstract set of equations, it is a fact

that has to be addressed and simply to keep "kicking the can down the road" is not an approach which the Fund should support.

Thus it is recommended that the Fund indicate to employers that it is minded to bring the deficit recovery period down to a maximum of 16 years in line with the previous plan, with the usual range of exceptions related to specific circumstances.

Managing the Risk of Ill Health for Small Employers

The potential costs of ill health retirement represent a very serious risk for small employers such as charities and parish councils. One ill health retirement within a small membership of 3 or 4 can significantly destabilise the funding position of an organisation. Officers have for some time been considering with the actuary whether it would be possible to "insure" this risk either within the Fund or externally. Advice is that the most cost effective option for employers would be to construct a mechanism within the Fund to achieve this, and it is proposed that the Fund consult employers in order to establish whether there is support for a proposal of this sort.

The Plan for the Valuation Process

The table overleaf sets out a high level plan for the valuation process, specifically including engagement with employers at an early stage and once actual data is available. This includes the process for the preparation and approval of the statutory Funding Strategy Statement and a refresh and review of the Fund's Investment Strategy to ensure that the returns required by the valuation results have the greatest possible certainty of being delivered.

September 2015	Agree planned approach to valuation with Mercers
	'Setting the Scene' report to Pension Fund Committee
December 2015	Directors Briefing and initial communication to employers
April 16 to June 16	Data collection and data cleaning
	Data quality checks
	Prepare cash flow spreadsheets
	Submit interim data reports to actuary
	Resolve actuary's data queries
August/September 2016	Actuary signs off data Initial employer groups meetings (e.g. local authorities, F&HE, Academies, Charities)
	Valuation assumptions signed off
October/November 2016	Actuary reports produced and checked
	Provisional (whole fund) results and draft funding strategy statement to Pension Fund Committee
December 2016	Directors Briefing and provisional results (whole fund) to employers
January 2017	Individual employer results available – further employer group meetings.
	One to one sessions with employers
Feb 2017 to March 2017	Final report to Pension Fund Committee, including final Funding Strategy Statement.
April 2017	Revised contribution rates and revised Funding Strategy Statement in place

As in previous valuations the Fund will seek to engage with Groups of employers as well as providing the opportunity for individual employers to discuss their position with officers and the actuary. The intention would be to do this on more occasions over a longer period than previously in order to promote understanding of the issues involved in the valuation amongst employers. The Fund will also need to take steps to engage with employers who represent risk to the Fund but are do not wish to engage.

Summary of Proposed Fund Position

The following summarises the position which it is proposed that the Fund is minded to adopt and which following agreement will be issued to employers for consultation.

Overall Objective

The Fund's objective for employer contributions is, at the whole fund level, to maintain, in cash terms, the contribution plan set in 2013.

Deficit Recovery Period

The deficit recovery period will be set at a maximum of 16 years.

Key Assumptions

It is assumed that pay increases for the period to 2020 are no more than 1% in line with the announcements contained in the summer budget.

Assumptions on life expectancy will continue to be based on specific fund level data rather than on generic assumptions.

No assumption will be built in about take up of the 50/50 option, given that so few members have actually taken this up.

Employer Risk

The Fund will set contribution rates taking into account employer covenant, based on 4 categories of employer:

Level 1 – Those with the very strongest covenant

Level 2 – Those with an above average covenant

Level 3 – Those with a below average covenant

Level 4 – Those with the weakest covenant

Academy Schools

The Fund will not allow the general pooling of academy schools for the purpose of setting contribution rates, but will be prepared to allow academy chains or multi-academy trusts to pool all their constituent schools for the purpose of setting contribution rates.

Ill Health Retirement

The Fund would propose to create an internal insurance mechanism to manage the risks around the costs of ill health retirements for smaller employers.