TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 10

INVESTMENT PANEL REPORT

27 SEPTEMBER 2017

STRATEGIC DIRECTOR FINANCE, GOVERNANCE & SUPPORT – JAMES BROMILEY

FUNDING UPDATE REPORT - 2017

1 PURPOSE OF THE REPORT

1.1 To inform Members of the Teesside Pension Fund & Investment Panel (the Panel) of the outcome of the Actuary's Funding Update Report, as at 31 March 2017 (Appendix A). Providing this update to Members is an action agreed following the recommendations and observations from the Fund's External Auditor, following their review of the 2015/16 Report & Accounts.

2 RECOMMENDATION

2.1 That Members consider the report.

3 FINANCIAL IMPLICATIONS

3.1 There are no direct financial implications from the update report, however, it does give Members an indication as to how the performance of the Fund's assets has impacted on its funding level, and provides guide to the outcome of the next Actuarial Review, due in 2019.

3.2 Changes to the Fund's Employer's contribution rates can only be made every three years after a full Actuarial Review.

4 2016 ACTUARIAL VALUATION

4.1 The Administering Authority is required by Regulation 62 of the Local Government Pension Scheme Regulations 2013 to appoint an actuary to carry out a full valuation of the Fund.

4.2 The main purpose of the valuation is to review the financial position of the Fund and to determine the rate at which employing bodies in the Fund should contribute in the future to ensure that the existing assets when combined with future contributions from both employers and scheme members will be sufficient to meet future benefit payments from the Fund.

4.3 The Actuary must balance the desirability of maintaining as stable a contribution rate as possible with the requirement to set contribution rates which ensure the solvency and long term cost efficiency of the Fund. The effective date of the last valuation is 31 March 2016, with contribution rate changes effective from April 2017.

4.4 The following summary shows the main findings of the valuation:

Funding Level The position of the Fund is very good and, on a whole of fund basis, the funding level is 100%. The value of assets (£3.1bn) exceeds the liabilities by £11.1m.
Cost of future benefits (Primary Contribution Rate) At each valuation the actuary determines how much it will cost to buy new or future service. That is any service bought going forward from the valuation. The assumption is that by paying the future service rate any service purchased will be paid for in full. The employers' average cost of future service benefits is 15.7% of pensionable pay with effect from 1 April 2017.
Deficit recovery period Whilst, the fund is fully funded overall, the funding level of individual employers vary. Some employers still have deficit which need to be recovered and the payments required are spread over a number of years; the *deficit recovery period*. At the 2016 valuation the deficit recovery period has been set at 20 years.

5 FUNDING UPDATE REPORT AS AT 31 MARCH 2017

5.1 The Fund's Actuary, AON Hewitt, were asked to provide a Funding Update Report as at 31 March 2017 (Appendix A). The report was based on the movement in the Fund's assets over the period since 31 March 2016, but did not consider changes to the Fund's membership base.

5.2 The purpose of the report is to guide the Fund and prepare Panel Members and Scheme Employers for the next Actuarial Valuation, which has an effective date of 31 March 2019 and will be carried out over financial year 2019/20. The comparison to the 2016 Actuarial Valuation is shown below:

	2016	2017
Funding Level	100%	118%
Surplus	£11.1 M	£588.0 M
Future Service Rate	15.7%	16.7%
Total Employer Contribution Rate	15.6%	8.2%

5.3 The improved funding level is entirely because of the large increase in the Fund's assets (a performance return of 24.9% over 2016/17). On the face of these result, this puts the Fund in a good position going into the next Actuarial Valuation and confirms that the current investment strategy has worked so far into this valuation period.

5.4 The one downside is the assumptions used by the Actuary results in an increase in the future service rate by 1%. This is as a result of the discount rate used decreasing by 0.2% (from 4.7% to 4.5%) following a reassessment of the forecast assumptions for the financial markets.

5.5 Caution is needed when considering the reduced total employer contribution rate of 8.2%. This rate is calculated using the surplus to discount the employer rate. It is more likely that this would not happen. The Actuary recommends that this surplus benefits the Fund, increasing the probability of funding success to higher than 70% set at the 2016 valuation which in turn reduces the required rate of return for the Fund making it more likely for the Fund to achieve this lower annualised rate. A consequence of this may be an increased employer contribution rate, however this could be offset by using some of the surplus to discount the future service contribution rate back to either current or slightly lower levels.

5.6 A second note of caution is that the Actuary, when setting the assumptions used in each valuation, is working on long term (25 year) assumptions. Favourable updates to the funding level are welcomed, but any action taken should be for the long term benefit of the Fund; improving solvency and long term cost efficiency in line with the DCLG requirements for management and investment of LGPS Funds, as well as for the Fund's wider stakeholders.

5.7 In addressing the sudden increase and the extent of the increase in the funding level, the Actuary has made the following written statement regarding whether:

- the funding level increase is wholly because of the asset increase,
- the assumptions set for the 2016 Actuarial Valuation were too prudent, and
- could the Fund's employers see a discount to the contribution rate set at the next valuation if there is still a surplus:

"We see the improvement in funding level over the year to 31 March 2017 as a positive development. The reason for the improvement is mainly down to investment returns on the fund's assets exceeding our investment return assumption. This investment return is in a large part due to the additional return caused by the fall in sterling following the Brexit referendum. This increased the value of foreign investments directly and for UK equities caused a rise in value due to the increased value of foreign earnings. This is very much a one off event and could reverse over time. The investment return assumption used in the 2016 valuation (of 4.7% pa) is a long term assumption, and is set using a timescale of 25 years, and a probability of 70% of remaining 100% funded at the end of that 25 year period (referred to as the "probability of funding success"). Investment returns, particularly on equities which form

the majority of the fund's investments, can be volatile. Therefore when there have been such strong positive returns the Fund, together with the Fund Actuary and their investment advisors, needs to consider what action (if any) should be taken. For example, the fund is about to start a review of their assets and liabilities to help determine their future investment strategy, and as part of this the Fund may decide to lock in some of these investment gains, to reduce the risk of a future fall in asset values reversing the positive developments seen as at 31 March 2017.

If the increase in funding level persists until 31 March 2019 (the date of the next triennial actuarial valuation of the fund), and there is no change to investment or funding strategy, then further decisions will need to be made at that point about how to allow for this improvement. Historically, where an individual employer's funding position has been in surplus, the Fund has had a policy of not reducing employer contributions below the future service contribution rate to allow for that surplus. We understand that following this prudent approach in the past has contributed to the Teesside Fund currently being one of the better funded LGPS funds. In the event of a significant surplus such as that shown in the funding update as at 31 March 2017, we would expect the administering authority to review this policy, in conjunction with the Fund Actuary. My view, as the Fund Actuary, is that it would be reasonable to allow for some reduction to employer contribution rates if such a surplus still exists at the 2019 valuation. However, there is also a requirement in both the Funding Strategy Statement and the Regulations to maintain stability of employer contributions, and this would apply to contribution decreases as well as increases, and so for long term employers I would not anticipate recommending significant contribution decreases. We believe it will be important for the Fund to protect employers from an adverse movement in the future as employer contributions in the Fund are already among the lowest, and any adverse movement could result in a significant increase in employers' contribution rates in percentage terms.

When setting the assumptions to use at triennial valuations, a long term view is taken as the benefits being valued will be paid for many years into the future. In particular, the assumed future investment return and assumed future inflation are set using a 25 year time horizon. It is therefore not possible to say whether the assumptions used at the 2016 valuation were "too prudent" by looking at the experience over a single year. Using the "probability of funding success" to set the assumed future investment return gives us a way to measure the prudence inherent in this assumption, and the other financial assumptions are set consistently. There are some assumptions which are more subjective, such as the salary increase assumption, and for the 2016 valuation this was set allowing for the views of the administering authority and the employers. We can also look at how the Teesside Fund compares to other LGPS funds at the 2016 valuation, and on that measure the Teesside Fund had relatively optimistic financial assumptions compared to both our portfolio and the majority of funds not advised by us. Using a *prudent approach to set the assumptions is consistent with guidance and regulations which have a focus on the solvency of the fund. The Fund also needs to bear in mind the review by the Government Actuary's Department (GAD) under Section 13 of the Public Sector Pension Act, which will test each LGPS fund's valuation, assumptions and employer contributions against various metrics, and flag these up if they do not fall within GAD's parameters for solvency and long term cost efficiency. Overly optimistic assumptions could result in investigation by GAD and adverse publicity for the Fund.*

With regard to contribution rates the employer contribution rate are amongst the lowest in the LGPS. At the 2013 valuation Teesside had the lowest contribution rate of all the England & Wales Funds with the range of contribution rates being from 14.8% to over 37% of pay. Even Funds with similar funding levels on the standardised basis at the 2013 valuation were paying more than the Teesside Fund. From this viewpoint it would not appear that we are being overly prudent. The figures for the 2016 valuation have not yet been published by the SAB, but we are expecting the Teesside Fund to still have one of the lowest employer contribution rates.

In summary, the improvement in the funding level of the Fund is to be welcomed, however it would be premature to make any decisions on employer contributions based on one year of experience (and this would equally be true if the position had deteriorated). The Fund will continue to monitor the funding position using annual funding updates, and if the 2019 valuation shows a similar improvement in funding position then we will work with the Administering Authority to determine what combination of risk reduction and reduction of employer contribution rates to allow for the surplus would be appropriate."

CONTACT OFFICER:	Paul Campbell Head of Investments & Treasury Management
TEL. NO.:	(01642) 729024