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beyond the expected

Essex Pension Fund

Section 13 summary report

Introduction

This paper has been requested by Essex County Council, as Administering Authority to the Essex Pension Fund (the Fund). This paper summarises the review of the actuarial valuation of the Fund at 31 March 2019 as carried out by the Government Actuary's Department (GAD), under section 13 of the Public Service Pensions Act 2013 ("the Section 13 valuation").

For the avoidance of doubt, the formal actuarial valuation is still carried out by the Fund's actuary based on assumptions set locally and agreed with the Fund. The key objectives of the formal actuarial valuation are to review the financial position of the Fund and to set appropriate employer contribution rates for the subsequent three years, as required under Regulation 62 of the Local Government Pension Scheme Regulations 2013 (the Regulations). The Section 13 valuation does not directly impact employer contribution rates.

Background

The Section 13 valuation carried out by GAD is based on the formal actuarial valuations of the English and Welsh LGPS Funds, as carried out by their Fund actuary. The Section 13 valuation adopts standard assumptions for all LGPS Funds with the aim of providing a level playing field so that Funds can be compared on a like for like basis.

For the purposes of comparing funding levels, GAD use a standardised market basis (standardised basis) consistent with the basis used by the Scheme Advisory Board for comparing Funds. This will be different from the funding basis the Fund adopted for the triennial valuation.

In summary, the purpose of the Section 13 valuation is to identify any outlying Funds measured against the following objectives:

1. Compliance – whether the actuarial valuation has been carried out in accordance with the Regulations;
2. Consistency – whether the actuarial valuation has been carried out "not inconsistently" with other Funds;
3. Solvency – whether a Fund has sufficient assets together with employer and employee contributions to pay all the benefits due over the long term; and
4. Long term cost efficiency – whether a Fund is paying sufficient contributions to meet the cost of benefits accruing and repair any existing deficit over an appropriate period.

As part of the Section 13 valuation a number of measures have been calculated to help GAD consider the above objectives. GAD have then chosen to use a Red/Amber/Green (RAG) flagging system to identify any Funds that are outliers relative to the other measures of the other LGPS Funds. This may not always lead to appropriate conclusions. For example, a Fund in surplus may still be flagged as they are less in surplus than other Funds. Should a fund be identified as an outlier, they would be expected to put a plan in place to help improve their position, having had relevant discussions with GAD and their actuary.

However, our view is that this application of measures is not helpful when each is considered in isolation and a more holistic view is required. For example, a reader may conclude that significant contribution increases may be required at the next formal actuarial valuation, when in fact, given other factors, this is highly unlikely.

Analysis of results

In summary, **the Fund did not receive any red or amber flags and achieved green flags on all measures** disclosed in the GAD summary. Further details of the analysis are given below.

SAB funding level and employer contribution rate

This graph shows the Fund's funding level relative to the average LGPS funding level against the total employer contribution rate, expressed as a percentage of pay. In theory, this graph should show a direct relationship between funding level and contribution rate – funds with a lower funding level should be paying higher contributions and vice versa, all else being equal. However, there are lots of factors to consider and so in practice this will not always be the case.

The Fund's SAB funding level is 109.9% which is around 6% - 7% above the SAB LGPS average funding level, as shown by the larger blue dot. However, the Fund is paying broadly the same contributions as the majority of funds at 22.8% of pay. From the graph this looks like the Fund are paying a bit more than most funds relative to the funding level and contributions of other LGPS funds (i.e. your blue dot is to the right and slightly higher compared to other funds on the chart). Despite the use of a 5% asset shock reserve when setting the contributions, that effectively reduced the funding level of all employers meaning in theory they would pay more deficit contributions, the main reason for the relatively high contributions was the cautious approach taken to reducing overall contributions. Due to the Fund's policy of reducing the deficit recovery period by three years each triennial valuation, tax-raising bodies had been paying a high rate of deficit contributions. Aided with strong investment returns, the tax-raising bodies now have a very small deficit or are over 100% funded. Rather than reduce deficit contributions significantly they were reduced slightly in order to keep overall contributions relatively stable and avoid increases in the near future.

Solvency

Funding level is the most commonly used measure of solvency. The Section 13 valuation provided some other measures of solvency which are given below. **The Fund achieved green flags on all these measures.** The measures are defined as follows:

- Asset shock – this measures the annual deficit payments spread over 20 years and expressed as a percentage of the Fund's core spending if there was a fall in markets and the Fund's return seeking assets fell in value by 15%. A lower percentage is good here as it indicates the Fund can manage the risk of volatile, falling markets.
- Liability shock – liabilities are assumed to increase by 10% and the resulting additional deficit amount is spread across the tax-raising authorities and assumed to be repaid over 20 years. This amount is then expressed as a percentage of core spending. Again, a lower percentage is good here as it indicates the Fund can withstand an increase in liabilities.
- Employer default shock – this is the change in average employer contributions if all employers without tax raising powers/statutory backing cannot repay their deficit amount as calculated at the 2019 valuation. A low percentage means the Fund is less exposed to the default of more risky employers and the impact on employer contribution rates would be low.

The data for the Fund are set out below:

Asset shock	2.3%
Liability shock	surplus
Employer default	surplus

Long term cost efficiency

Where a Fund achieved a green flag, this demonstrates that the contributions being paid are, in GAD's view, sufficient to meet the cost of benefits accruing and to repair any deficit over an "appropriate period". In particular, it demonstrates the Fund is not deferring payments excessively so that they impact future generations.

As pension funding is very long term and the LGPS is an open scheme with Government backing many Funding Strategy Statements require overall contribution stability. A more sensible approach is to try and reduce the recovery period when and if this is affordable. Otherwise Funds could end up paying very high levels of contributions during the recovery period and then coming to a cliff edge as the deficit at that point is paid off.

A number of measures were calculated to check if the objective was met. Some of these are defined below.

- Deficit recovery period – this measures the time it will take to pay off the deficit calculated using the standardised basis at the current level of deficit contributions. A low number is good as this indicates the Fund is paying sufficient deficit contributions to clear the deficit more quickly. As the Fund is in surplus on the SAB basis there is no deficit recovery period.
- Required return – this shows the return the Fund's assets need to achieve to be fully funded in 20 years' time on the standardised basis. A lower required return means a lower bar for the Fund to exceed and so a greater chance of doing so. The Fund has the 14th lowest required return out of the 87 E&W funds.
- Repayment shortfall – this calculates the difference between actual deficit contributions and the implied deficit contributions based on the standardised basis. The actual deficit contributions are calculated as the difference between the total contributions certified and the primary rate on the standardised basis. A large positive difference is good as this shows the Fund is paying more than sufficient contributions to meet the cost of benefits accruing and repay the deficit. As mentioned above, as the Fund is in surplus but agreed to use an asset reserve to help keep contributions stable, employers are paying more than expected on the SAB basis.
- Return scope – The estimated return that the Fund's investment strategy is expected to deliver, in excess of the required return. A higher percentage is good as it means there is a much higher chance of the Fund's investment strategy beating the return needed.
- Deficit recovery plan – a check on whether the current deficit recovery period is a continuation of the previous deficit recovery period. Despite the increase by 9 years this is a green flag. The reason is that the Deficit Recovery End Point at the 2016 valuation was an average calculated across the Fund. However, the actual Deficit Recovery End Points for each employer in the Fund is different so the Deficit Recovery End Point at the 2019 valuation is based on the employer/pool with the longest recovery period which is 21 years, a decrease of 3 years from the equivalent at the 2016 valuation.

The results for the Fund are as follows:

Deficit recovery period	surplus
Required return	2.6%
Repayment shortfall	6.1%
Return scope	1.9%

Deficit recovery plan	9

Impact on the next valuation

We will be reviewing our assumptions and approach ahead of the next valuation and, although the Section 13 valuation is a useful check on the health of the LGPS and its funds, it would not be helpful to allow this to influence decisions. We will of course take the Section 13 valuation into our considerations as we want to ensure the Fund continues to not raise any flags but it is important that the Fund also continues to meet its objectives in line with the Funding Strategy Statement and Investment Strategy statement and any decisions are taken for the right reasons.

The assumptions adopted for the Section 13 valuations have become more prudent over time. This is a result of the assumptions being linked to the expected growth in the UK economy which has been reducing. The LGPS is a funded scheme, and this is not necessarily an appropriate approach, however this is the approach adopted for the unfunded public sector schemes and so the Section 13 valuations use the same approach for the LGPS schemes. We will need to consider whether any changes to the market related basis is likely in light of the pandemic and any impact on future expected economic growth, when setting our assumptions.

Conclusions

The key point for the Fund and other interested parties is that it has met all the criteria of the Section 13 valuation. This evidences that the contributions set and the assumptions and approach adopted, is appropriate when considering the funding objectives. There is an increasing amount of scrutiny on the LGPS from external parties and it is becoming increasingly important to ensure the Fund is well governed and takes a balanced, sensible approach to funding and investment strategy, which the Fund has of course been doing.

There are therefore no concerns for the Fund and it's not expected that GAD will engage further with the Fund. The Fund may want to report to GAD's analysis and results to the Pension Committee and Local Pension Board. We would be happy to present this and answer any questions.