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LGPS Briefing Note

Section 13 valuations – unlucky for some?

As I'm sure you are aware, as part of the scheme reform changes, the Public Service Pensions Act 2013 means that DCLG are required to commission a "Section 13" valuation which will look at the 2016 valuation results for LGPS Funds and check whether, in their opinion, the various Funds have carried out their valuations in a way that:

- Is compliant with the LGPS Regulations
- Is not inconsistent with other Funds
- Will ensure solvency
- Will ensure long-term cost efficiency

"The long-term cost efficiency test is a test of how quickly the deficit is being paid off and is the one that is likely to be of most interest to Funds".

DCLG have commissioned GAD to do these valuations. DCLG or GAD would discuss the results with any Funds that are flagged by these tests and have a discussion with them to establish whether GAD have fully understood the position and are aware of any relevant factors before a final report is published. This final report may include remedial actions that DCLG feel are appropriate (e.g. an out-of-sync valuation to set the contribution rates in such a way that would pass the tests).

Funds shouldn't need to worry too much about compliance with the Regulations – unless Funds do something bizarre the compliance test is mainly aimed at us and our valuation report. Consistency is mainly aimed at the actuaries too and is based around the same old nonsense about why does every Fund not have identical approaches and assumptions. So we'll mainly be picking this one up to the extent it's down to different funding models but it is possible that Funds that use assumptions towards the edges of the range that we would recommend will need to explain their approach. The solvency principle is pretty sensible in that an LGPS Fund open to new members, that is made up of mainly tax-raising bodies, is meant to pass without any problems so attention is meant to be directed towards more mature Funds with employers with weaker covenants.

That leaves the long-term cost efficiency test which is a test of how quickly the deficit is being paid off and is the one that is likely to be of most interest to Funds.

Assumptions used

One of the intended advantages of this process is extra transparency but this particular objective isn't helped by the various tests being based on one of three sets of assumptions:

- The assumptions actually used at the last valuation
- The Scheme Advisory Board's ("SAB") assumptions (i.e. the ones that the standardised funding levels will be reported on)
- A new set of assumptions for this exercise which are GAD's "market consistent" set of assumptions

The long-term cost efficiency tests are mainly based on this last set of assumptions

and, at 31 March 2013, they placed a lower value on the liabilities, or cost of pension benefits, than every Fund's assumptions or what they would have been on the Scheme Advisory Board's standard assumptions. This is perhaps not unexpected as the market consistent assumptions are supposed to be "best estimate" whereas funding assumptions should include some element of prudence. However best estimate is still subjective and so different actuaries will have different views as to what "best estimate" is. Surely no-one would seriously expect even 2 actuaries (never mind the number involved with the LGPS) to agree on something like this……

Dry run

GAD have carried out a dry run of the process using the 2013 valuation results in order to allow Funds to be aware of any areas that would have been highlighted and this allows this to be fed into the process for the 2016 valuation.

Their report can be found here on the Scheme Advisory Board website.

On long-term cost efficiency, there are seven tests and Funds can be green, amber or red on each of them.

Although there are seven tests, they are more or less measuring the same thing which is simply whether GAD believed the 2014/15 contributions were "enough". The tests are broadly whether their assessment of 2014/15 deficit contributions, if increased in line with assumed salary increases, would be enough to make each Fund fully funded in 20 years' time.

The four firms of actuaries have been liaising with GAD in relation to their "dry run" report and have assisted where necessary to clear up any misunderstandings or errors. GAD are looking to hold a number of regional seminars to discuss their approach to s13 valuations and have invited the four actuarial firms advising LGPS funds to participate. We of course said we are happy to participate.

Commentary

"Are employers paying "enough"?"

We have had a few issues with the approach GAD have adopted in carrying out the dry run and some concerns about the first proper s13 valuations as at 31 March 2016. That said we do recognise some of the difficulties that GAD face in carrying out this work – mainly due to the legislation in the first place.

One of our key initial concerns was the way they went about formulating a view on whether employers were "paying enough". In essence they determined the minimum level of deficit contributions that Funds should have been receiving during 2014/15 assuming a deficit recovery plan that had a constant level of employer contribution as a percentage of payroll over 20 years. This approach therefore does not reflect the fact that where employers face large increases in contributions, it is quite normal to phase this increase in over a period of 3 or sometimes 6 years. The regulatory environment that we have operated in for many years has been to adopt methods and assumptions that keep employers' contributions as stable as possible – something that is invariably included in Funding Strategy Statements – which we have to take into account when completing valuations.

Simplistically therefore if the GAD minimum level of deficit contribution was 5% of payroll for 20 years and a Fund was targeting 6% also over say 20 years (so paying in

more over the same period), but was stepping up from an existing 3% to 4% in year 1, 5% in year 2 and 6% in year 3 onwards, then as 4% is less than 5%, this produced a red flag. Therefore despite the fact that employers in this Fund would be paying more overall towards deficit than the GAD minimum over the next 20 years, they would still be red flagged as "not paying enough". The two Funds mentioned in the report (who just happen to be ours) were "victims" of this approach.

Equally, some Funds had employers who paid 3 years' worth of deficit contributions up front in 2014/15 so it will have looked like they were paying way more than "enough" when they might not in fact be.

We did of course point this out to GAD who subsequently agreed to amend their approach at the 2016 valuation to look at the average contributions to be paid over the 3 year contribution period rather than just the first year. This could still be flawed if Funds have a stepping period of more than 3 years. We suggested they revisit the dry run and correct this flaw but they declined.

Another of the issues we had was their "asset shock" and "liability shock" tests – what would happen to contribution rates if assets suddenly reduced by x% or liabilities suddenly increased by x% (with everything else staying the same). On the face of it might appear a sensible test but it is overly simplistic – in the real world this just doesn't happen. It of course depends on how assets and liabilities are valued but some of the more sensible funding models will have assets and liabilities moving in the same direction at the same time.

"Consistency is mainly aimed at us actuaries and is based around the same old nonsense about why does every Fund not have identical approaches and assumptions?"

The slightly bizarre thing about these tests is that it is more likely to be the better funded Funds (worse still if slightly more mature) who are paying little or no deficit contributions that will be flagged.

Consistency was another issue that generated some debate. s13 of the Act says that (GAD) have to report as to whether for a particular Fund "the valuation has been carried out in a way which is not inconsistent with other valuations". GAD would appear to interpret this as requiring all Fund valuations to have been carried out on a consistent basis which they've then taken to mean a near-identical set of assumptions. We (and indeed the other actuarial firms) beg to differ. One thing the four firms do agree on – it can happen.....

We recognise that there could be a few areas where more consistency could be achieved but given that actuarial valuations model the future and nobody – not even GAD – know what the future holds then it would be rather unlikely that we all hold the same view of the future. In addition different Funds will have different investment strategies and attitudes to risk etc. so you would expect some variation.

We will be carrying out 22 of the 89 LGPS Fund valuations at 2016 and will, subject to discussions with clients, generally be adopting a consistent approach based on our smoothed "economic" model. However this will not mean that assumptions will be the same across all Funds – some will be but one of the key assumptions – the discount rate – will vary from Fund to fund depending on investment strategy and the amount of prudence each Fund wants to allow for. The other 67 Funds may well be adopting different models (if past experience is any guide to the future).

The key thing here is if s13 requires "consistent" approaches to valuations, then why did it say "not inconsistent"?

The reason is of course that a double negative does not necessarily make a positive!

2016 valuations

So putting to one side the issues with the dry run, how will s13 impact on the 2016 valuations?

Although it's the elephant in the room – s13 has effectively introduced something of the equivalent of a minimum funding requirement for the LGPS. If from the 2016 s13 valuations, GAD and DCLG believe there is a Fund where employers are "not paying enough" then they will want to discuss this with the Fund in question and their actuary and if they cannot be persuaded that the employers are in fact paying enough, then ultimately the Secretary of State can effectively "intervene" and impose levels of contributions on employers in the Fund.

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Whilst this does sound like it could be a lot of fun, it of course is something that is probably best avoided. So how do we avoid all this potential excitement? Ideally, as part of the 2016 valuation calculations, we determine what would be required to avoid this – which of course would require us to know how GAD will carry out their s13 valuations and in particular what their assumptions will be.

The dry run report sets out the assumptions they adopted for the dry run. Unfortunately it doesn't really explain how they derived them, particularly for the all-important discount rate (in fact the discount rate in excess of inflation). Is their discount rate something more than gilts, something more than inflation, something sensible or something else? So we thought it might be an idea to ask them where the goal posts might be for 2016 but they declined. Understandably if they were to disclose them now then we really would have an LGPS minimum funding requirement and the inevitable "race to the bottom" with more than likely lower employer contributions being paid into the LGPS in aggregate than before. This was what happened with the private sector MFR, brought in after Maxwell fell off his boat – the heroic aim of ensuring employers were paying enough (at least on an individual basis) but in fact resulted in less overall.

So the 2016 actuarial challenge for us will be trying to guess what it might be. We do know what the SAB comparative basis will be – it will be a real discount rate of 3% more than CPI – the so called "SCAPE" rate used for the unfunded schemes. This rate of course was changed in the March 2016 budget to CPI + 2.8% but we understand that it will still be the 3% real rate that is adopted by the SAB.

Of course this is a fairly notional discount rate used, amongst other things, to allocate costs to employers within the unfunded schemes and of course we all know ONLY chosen to allow comparisons to be made between Funds – not to be used to set contributions........

In the dry run GAD did in fact use this SAB basis to rank Funds in funding level order (and if you were unlucky enough to be in the bottom 10 you got an amber flag). At the dry run, the assumptions used by GAD for the rather more important "are employers paying enough" tests were less prudent than the SCAPE rate – will it be the same at 2016? Would GAD come out with a so called best estimate basis at 2016 that was more prudent than the SAB basis? (thus implying the SAB basis is imprudent?) Does seem a little unlikely but always prepare for the unexpected!

"Administering authorities are reminded that securing solvency and long term cost efficiency is a regulatory requirement whereas a constant as possible employer contribution rate remains only a desirable outcome".

Summary

So the dry run report is now in the public domain. We were more than happy to help GAD try and get it right but we still have concerns about some of their methodology, albeit recognising they have a tough job on their hands.

Most of their tests are "cliff edged" in that we know that the 2 Funds that were red flagged were only just red flagged and had some recognition of contribution stepping been included they would have been okay. However, what about the Fund that maybe only just missed some red flags but is not in fact stepping up? Maybe you need to set the tests so that someone fails to make the whole exercise worthwhile....

Finally the latest guidance from CIPFA on how to prepare a Funding Strategy Statement says

"Administering authorities are reminded that securing solvency and long term cost efficiency is a regulatory requirement whereas a constant as possible employer contribution rate remains only a desirable outcome".

Interesting times ahead.......

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