City of London Corporation Pension Fund

Section 13 summary report

Introduction

This paper has been requested by City of London Corporation, as Administering Authority to the City of London Corporation Pension Fund.

This paper summarises the review of the actuarial valuations of LGPS Funds as at 31 March 2016 as carried out by the Government Actuary's Department (GAD), under section 13 of the Public Service Pensions Act 2013 ("the Section 13 valuation"). This paper also sets out the results of this review in relation to the City of London Corporation Pension Fund ("the Fund").

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 valuation are to check the financial position of the Fund and to set employer contribution rates for the subsequent 3 years. The Section 13 valuation will not directly impact employer contribution rates.

Background

The Section 13 valuation carried out by GAD is based on the formal actuarial valuations of the 91 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 basis consistent with the basis used by the Scheme Advisory Board for comparing Funds. For the other tests GAD undertake they use a "best estimate" basis across all Funds.

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 receiving sufficient contributions to meet the cost of benefits accruing and to repair any existing deficit over an appropriate period.

Overall, the news is very positive – the weighted funding level of the LGPS as a whole using the GAD best estimate assumptions has increased from 93% as at 31 March 2013 to 106% as at 31 March 2016, and will have improved since, as a result of strong investment performance and deficit contributions paid (Note - the Section 13 valuation is not necessarily appropriate for setting employer contributions, but is instead used as a comparator). The unweighted average has improved from 87% to 96% and the distribution of Funds is shown in a chart in the Appendix.

The Section 13 valuation has calculated a large number of measures to help GAD consider the above objectives and uses a flagging system to identify any outlying Funds. Having been identified as an outlier, the Fund would be expected to put a plan in place to help improve their position.

However, 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 for a particular Fund at the next formal funding valuation, when in fact, this might not be the case.

Summary of overall results

This section summarises the key points against the objectives above.

Compliance

All LGPS actuarial valuation reports complied with Section 13, meeting the requirements of the LGPS regulations and containing appropriate detail in relation to primary and secondary contribution rates for employers.

Consistency

There are no flags raised for any Fund under the objective of consistency. However, GAD's interpretation of the consistency requirement (or lack of non-consistency) is such that valuations should have "consistent" rather than "not inconsistent" assumptions unless local circumstances justify something different. The report therefore focuses heavily on the consistency of assumptions, and in particular each assumption in isolation, instead of considering the overall level of prudence in the assumptions and the funding strategy.

The review therefore suggests there could be more consistency in relation to setting assumptions. GAD believe that the Fund actuary holds a house view and so there is some consistency across Funds by Fund actuary but not across the LGPS.

As expected, there are differences in financial and demographic assumptions across LGPS Funds. This is valid and appropriate as Funds have different investment strategies which impacts the assumed discount rate and different membership profiles which impacts the demographic assumptions.

For example, the life expectancy of members is very different in different parts of the country and an investment strategy that has a heavy growth allocation should in theory over the long term provide a higher return than a more defensive strategy.

The actuarial valuation is a complex process that produces employers' contribution rates in accordance with local Funding Strategy Statements. Setting assumptions is only a small, but important, part of the process and Funds have different views on the economic outlook, attitude to risk and funding objectives which will impact financial assumptions.

In summary, the process each Fund goes through with their adviser is highly consistent and so could be argued the objective of consistency is achieved.

Any move to adopt standardised assumptions set by central government could be dangerous as Funds "race to the middle" which may result in some Funds adopting a less prudent approach. As with any benchmarking type approach the decision making process could lead to bad or at least inappropriate decisions for individual Funds.

The report does acknowledge that there has been an improvement in the consistency of reporting of employer contribution rates since 2013.

Solvency

Where a Fund achieved a green flag, this demonstrates that their current financial position and contribution level should be sufficient to meet all the benefits over the long term, using appropriate assumptions. Most Funds demonstrated they met the objective of solvency, with 74 out of the 91 Funds as at 2016 achieving a green flag. This is a material improvement on the 2013 position where only 56 Funds achieved a green flag.

GAD's approach arbitrarily flags the bottom 10% of Funds on the standardised assumptions. At 2016 this meant that Funds with funding levels below 85% got an amber flag. This does not mean that a Fund is insolvent as solvency will depend not just on current funding level but the funding plan to get back to a 100% funding level. In fact a Fund in the bottom 10% may get back to 100% before one outside the bottom 10 if they are funding their deficit more quickly. This is another aspect of one of the GAD tests that we do not believe is particularly helpful.

City of London Corporation were amber flagged on this with a funding level on the Section 13 valuation standardised assumptions of 84%. This is similar to the position at 31 March 2013 of 83%.

Funding level is the most commonly used measure of solvency. The Section 13 valuation also 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:

- Non- Statutory Employees – the proportion of active members employed by employers without tax raising powers or statutory backing. This is a proxy for the proportion of higher risk employers and therefore liabilities the Fund has as these employers do not have any form of guarantee. A low percentage is a good result as it means the Fund is less exposed to default risk from employers who may not be able to pay any shortfall if they leave the Fund or become insolvent.
- Asset shock – this measures the change in the average employer pension costs as a percentage of what is called "core spending" if there was a fall in markets and the Fund's "growth" assets– essentially non bonds - fell by 15% and never recovered. A lower percentage is regarded as good here as it indicates that employer contributions are more resilient to market volatility.
- Employer default – 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 2016 valuation. A low percentage means the Fund is less exposed to default of more risky employers and the impact on employer contribution rates would be low.

The data for the Fund are set out below:

Non-Statutory Employees	10.6%
Asset shock	3.6%
Employer default	1.1%

The asset shock test, and in particular the use of "core spending", did give GAD some problems due to the unique way the Corporation is funded. However, eventually GAD amended the test for the Corporation and a couple of other Funds to accommodate this, resulting in a green flag for the Fund.

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.

Most Funds demonstrated they met the objective of long term cost efficiency, with 83 out of 91 Funds achieving a green flag. This is a material improvement on the 2013 position, when only 72 Funds achieved a green flag.

GAD's interpretation of the CIPFA guidance on deficit recovery plans and resulting expectation is that Funds should stick with the same deficit recovery end point at each valuation rather than "roll over" the same recovery period. So if at a valuation the recovery period is set at say 20 years then in 3 years' time the recovery period should be 17 years and in 6 years' time it should be 14 years etc.

The LGPS actuarial firms, however, have raised concerns about GAD's interpretation. A rigid objective to reduce the deficit recovery period at each valuation is not in itself a desirable aim, and it not realistic to expect that a deficit, and deficit recovery period, would not arise again in future. Pension funding is very long term, the LGPS is an open scheme with backing from tax-raising employers and many Funding Strategy Statements require overall contribution stability. A more sensible approach is to try to reduce the recovery period if affordable and if in line with the funding objectives set out in the Funding Strategy Statement. Otherwise, employers in the Funds could end up paying very high levels of contribution during the recovery period and then coming to a cliff edge as the deficit in theory is finally paid off.

A number of measures were calculated to check if the objective was met. Some of these are defined below.
The Fund achieved green flags for all measures.

- Implied deficit recovery period – this measures the time it will take to pay off the Section 13 best estimate deficit at the current level of deficit contributions. A low number is good as this indicates the employers in the Fund are paying sufficient deficit contributions to clear the deficit more quickly. Note that this implied recovery period will be shorter than the recovery period used in the actual funding valuation.
- Required return – this shows the return the Fund's assets need to achieve to be fully funded in 20 years' time on the Section 13 best estimate basis. A lower required return means a lower bar for the Fund to exceed and so a greater chance of doing so.
- 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 reconciliation – a check on whether the current deficit recovery period is a continuation of the previous deficit recovery period. This is an amber flag if deficit recovery contributions have decreased and the deficit recovery period has not been reduced.
- Interest cover – whether the implied deficit contributions cover the interest on the deficit.

The results for the Fund are as follows:

Implied deficit recovery period	6 years
Required return	4.0%
Return scope	1.8%
Deficit recovery plan	Green
Interest cover	Yes

Conclusions

The key point for the Corporation is that the Fund has met all the criteria of the Section 13 valuation, except the standardised funding level which has received an amber flag

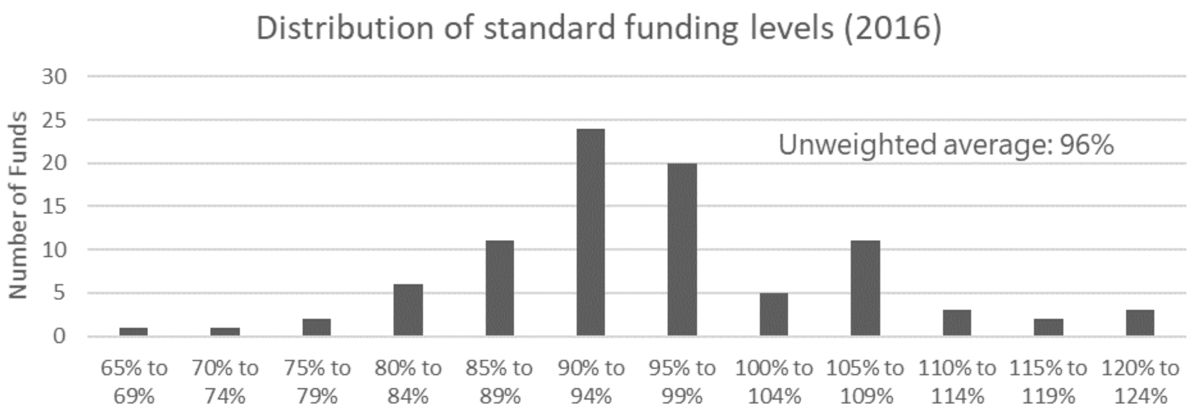
There is an increasing amount of scrutiny on the LGPS from external parties and it is becoming increasingly important to ensure the Fund is well governed and takes a balanced, sensible approach to funding and investment strategy, which the Fund has of course been doing. .

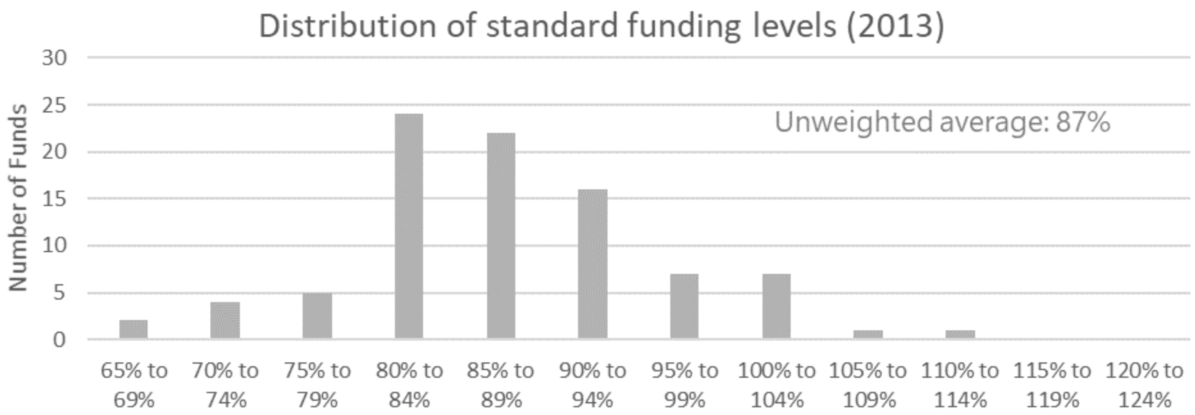
It is important to note that the solvency objective does not require the pension fund to be 100% funded at all times, or even as quickly as possible. The key aim is to ensure that the contributions have been set at a suitable level to target 100% funding over an appropriate period and GAD's report makes it clear that the amber flag for solvency is simply an advisory signal which is automatically triggered at an arbitrary funding level.

It is equally important to ensure that decisions taken by the Fund are taken for the right reasons and meet the Fund's objectives, Funding Strategy Statement and Investment Strategy statement. Although the Section 13 valuation is a useful check on the health of the LGPS and its Funds, it would not be beneficial to allow this to influence decisions.

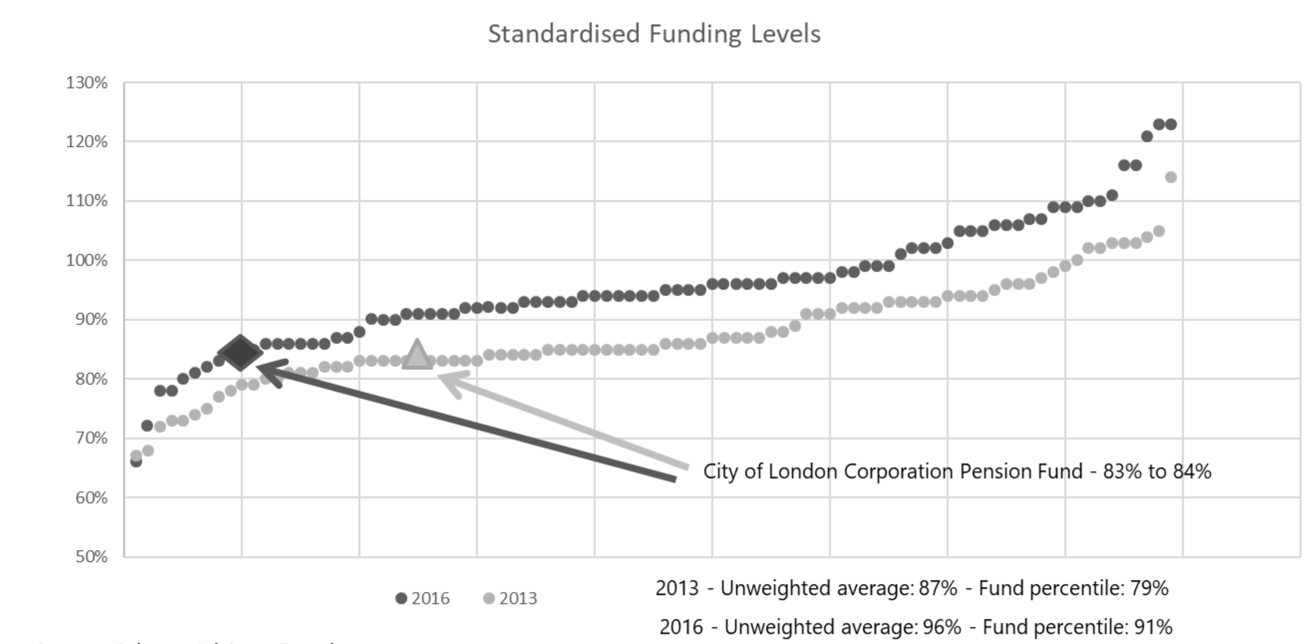
Appendix

The charts below show the distribution of the standard funding levels at 2016 and 2013 respectively. There has been an increase in the average unweighted funding level from 87% in 2013 to 96% in 2016.





The chart below shows the distribution of the funding levels at 2013 and 2016 for the LGPS Funds on the standardised basis. The Fund's funding level has increased from 83% to 84%, although this is smaller increase relative to most other Funds.



Source : Scheme Advisory Board