Croydon Council

REPORT TO:	**PENSION COMMITTEE** **6 December 2016**
AGENDA ITEM:	**6**
SUBJECT:	**Funding Strategy Statement**
LEAD OFFICER:	**Richard Simpson** **Executive Director of Resources**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: the Pensions Committee is responsible to other Scheme Employers for the sound management of the Local Government Pension Scheme.	
FINANCIAL SUMMARY: The Strategy determines the underlying principles for the triennial valuation. The valuation determines the contribution rate for the Council and for all other Scheme employers.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1 RECOMMENDATIONS

1.1 The Committee is asked to endorse the proposed consultation exercise on the Strategy Statement.

2 EXECUTIVE SUMMARY

2.1 The Funding Strategy Statement summarises the Croydon Fund's approach to funding its liabilities. The key components of the Strategy are set out in this report which also provides some context by briefly describing how stakeholders are impacted by the processes described in the Strategy and how the Council will consult these stakeholders.

3 DETAIL

3.1 This report sets out the reason why this authority needs a Funding Strategy Statement and provides the context for the strategy. In providing that context it discusses how the strategy relates to key stakeholders and the financial strategy for the Fund. Finally the report presents the approach to be adopted for consultation on the strategy. The statement has been drafted by the Pension Fund's actuary. It is attached to this report as Appendix A.

3.2 Local Government Pension Scheme members' benefits are set out and guaranteed by the Scheme regulations. These current and future outflows from the Fund represent a liability to the Scheme. In the same way employees' tiered contributions are defined by regulation. A proportion of this liability will be met from the returns generated from the investment of the assets that comprise the Fund with the balance coming from employer contributions. The Funding Strategy Statement addresses three critical issues:

- How those employer liabilities are measured;
- The pace at which these liabilities are funded; and
- How employers pay for their own liabilities.

3.3 It will be apparent that in addressing these issues, there will be conflict, because of the different characteristics of Scheme employers and because of the different goals of stakeholders. The Strategy directly addresses the conflicting aims of:

- Affordability for all employers;
- Transparency;
- Stability; and
- Prudence.

3.4 There is a statutory requirement to produce this statement.

3.5 The Strategy is aimed at four groups of stakeholders, each with distinct and often conflicting interests.

3.5.1 **Scheme members** will look for assurance that there is sufficient liquidity to meet the requirements to pay their benefits.

3.5.2 **Employers** will have an interest in ensuring that equality underpins the basis for the calculation of contributions and liabilities.

3.5.3 **Elected Members** need to balance the level of contributions against other demands for scarce resources.

3.5.4 Finally, **Council Tax payers** will be interested in cross-subsidising between different generations. The Council will consult directly with all Scheme employers by circulating a copy of the Strategy for comment. This report will also be considered by the Croydon Pension Board. Any responses to this exercise will be reported back to this Committee. Members are invited to suggest any methods to widen the scope of the consultation or to make the process more open. Once finalised the Strategy will be published on the Croydon Scheme website.

3.6 The Strategy provides an overview to the main principles behind the funding of the Scheme, covering the calculation of the contribution rate for the different categories of employer. To provide a more complete and rounded picture the Strategy discusses in detail the regulatory framework, key responsibilities, risk monitoring and an explanation of assumptions and technical terms.

3.7 Under LGPS Regulations, all funds have a statutory obligation to produce a FSS. The Draft FSS, appended to this report, has been prepared in collaboration with the Administering Authority and forms an integral part of the framework within which the Scheme Actuary carries out the triennial valuation to set employers' contributions and to provide recommendations on funding decisions. The FSS also outlines how the funding strategy fits in with the investment strategy. Once approved, a draft version of the FSS will be issued to all participating employers with any comments to be submitted within 30 calendar days. Following the end of the consultation period, any comments received may lead to amendments to the document. The final version of the FSS should be approved by the Pensions Committee and published during March 2017.

3.8 The current FSS was approved by this Committee on 8 July 2014. Although essentially a refresh, each version is adapted to fit in with the changing environment and circumstance within which the Fund operates over time. A key change to this version of the FSS is the application of a risk based framework for setting contributions. This has been applied across all employers. This change has been made to recognise the importance of taking employer risk profiles and covenant into account when setting employer contributions, ensuring a clear auditable process which is visible to scrutineers.

3.9 New guidance from the Chartered Institute of Public Finance and Accountancy (CIPFA), "Preparing and maintaining a funding strategy statement in the Local Government Pension Scheme 2016", moves the FSS into the modern pensions landscape and requires a number of changes to be incorporated. This new guidance reflects the changed context in which the LGPS operates. The main changes relate to the following areas:

- Introduction of the Public Service Pensions Act 2013 (under Section 13 of this Act, the Government Actuary's Department (GAD) must, following an actuarial valuation, report on whether the rate of employer contributions to the pension fund are set at an appropriate level to ensure the solvency of the pension fund and long term cost efficiency of the LGPS so far as relating to the pension fund. The new guidance seeks to define these terms.
- The new 2014 scheme and associated regulations;
- Changes to the LGPS investment regulations, and

- How the fund handles the growth in the number of its employers and the evolving nature of the provision of public services.

3.10 A key change to the funding strategy is the use of a risk based framework for setting all employer contributions. At the 2013 valuation the Scheme Actuary introduced a risk based approach to setting contribution rates for the "Croydon Council pool" - this approach leads to a stable contribution rate which achieves the employer's funding target over the longer term with a prudent likelihood of success (or "level of risk"). For the remaining employers in the Fund, the traditional method continued to be used. However, for the 2016 valuation, contribution rates for every employer will be set using a risk based approach.

3.11 The next section of this report compares the traditional against risk based approaches.

Traditional approach to setting employer contributions

3.12 Historically, actuaries have set employer contribution rates by using a single set of funding assumptions. The single set of assumptions reflects market conditions at the valuation date only. By using this method, there is an implicit assumption that the future will exactly follow expectations (i.e. the assumptions used in the calculation). However, in reality pension funding is uncertain. Changes in investment markets cannot be predicted, and do not follow a "straight line". This uncertainty could take the form of higher than expected investment returns (increasing the value of the assets by more than assumed) or higher than expected inflation (increasing the value of the liabilities by more than assumed), for example.

Risk based approach to setting employer contribution rates

3.13 The actual progression of the funding level could take one of many different paths. Whilst it is not possible to know which path will ultimately happen in practice, it is possible to assume that market uncertainty means that there is a risk that the employer may not reach its long term funding target. This risk can never be fully mitigated. However the main disadvantage of the traditional approach is that it does not allow the Fund, employer or actuary to assess and understand the risk associated with a proposed contribution strategy and the likelihood of its success, or otherwise.

3.14 The Fund's new risk based approach requires thousands of simulations to be projected of how an employer's assets and liabilities may evolve over the future to form a distribution of future funding levels. Each simulation represents a different possible economic scenario and varies due to different future investment returns, inflation and other financial factors. Once the model has generated a sufficient number of outcomes to form a statistically credible distribution (say 5,000 outcomes), it is possible to examine what level of contribution rate gives an appropriate likelihood of meeting the employer's funding target within the agreed timeframe (i.e. a sufficient number of successful outcomes).

3.15 Having this 'range of potential outcomes allows an understanding of the likelihood of the actual outcome being higher or lower than a certain level. Using these results, a contribution rate can be set that leads to an agreed number of funding outcomes being successful (e.g. with a likelihood of say 75%).

Considerations when setting risk based contribution rates

3.16 Setting contribution rates using a risk based approach requires the Fund to consider 3 steps for each employer:

1 The employer's funding target;
2 How long the employer has to reach the funding target (the time horizon previously known as the deficit recovery period); and
3 A prudent likelihood of meeting the funding target at the end of the time horizon (e.g. 2/3rds, or 75%).

The way that the Fund is tackling the first two steps for each employer group is outlined in Appendix A (in the "Funding Target Basis used" and 'Maximum time horizon' rows; this table appears in section 3.3, page 10 of the draft FSS), and depends on:

- Employer type, and
- Approach to new entrants i.e. open or closed.

3.17 Setting an appropriate likelihood under step 3 for each employer requires further analysis by the Administering Authority. For example, the Fund may be willing to accept a lower likelihood of success for an employer which has a strong funding position and is financially secure, compared to an employer with a weak funding position and poor business outlook. The Fund Actuary analysed a number of metrics to understand the funding profile of employers, including:

- Funding level
- Net cash flow position
- Maturity/demographic profile
- "Gearing" of funding deficit/surplus vs payroll.

The Actuary has also discussed the financial strength of each employer with the Fund's Officers with a focus on:

- Inspection of company accounts/financial statements, and information gleaned from employer questionnaires;
- Funding sources and agreements (including guarantor arrangements);
- Understanding the business outlook; and
- Any changes for the sector the employer participates in.

3.18 Combining these sources of information allows the Fund to understand the risk profile of each employer. Risk in this context means the likelihood that the employer is unable to meet its future obligations to the Fund and is then in turn unable to meet its funding target. Any such failure has an impact on other employers in the Fund (who will need to make good any funding deficit that cannot be met by the employer).

Other important changes made to the funding strategy at 2016

3.19 In addition to moving to a risk based approach for all employers (and allowing for the previously agreed changes to the way that Academies are funded), two other important changes have been made to the draft funding strategy at this valuation. The three Colleges that were in the "Croydon Council pool" at the 2013 valuation have been removed from that pool. Each College now has its own individual funding level and contribution rate. The reasons for this change are two-fold. Firstly, there is no direct financial link between the Council and the Colleges.

Secondly, all Colleges in the UK have been recently subject to "area reviews" by central Government and are now formally classified as private (rather than public) sector bodies with responsibility for generating their own revenue streams.

3.20 The former "Other Grouped Bodies" pool that existed at the 2013 valuation has been disbanded. This pool contained a small number of "third sector" bodies, with the liabilities dominated by one employer, Cabrini Children's Society. Following Cabrini's cessation, the Fund believes that now is the time to create individual funding positions and contribution rates for the remaining employers that reflect their own unique risk profiles.

Impact on Academy employer's contribution rates

3.21 The updated funding strategy approach contained in Appendix A incorporates the outcome of the Academies' funding strategy consultation, as approved by the Pensions Committee at its 8 December 2015 meeting. As part of the consultation the following changes were approved:

- A risk-adjusted approach is adopted for setting contributions;
- Extension of the deficit recovery period or time horizon for Academies to 22 years (in line with the Council).

Following discussion between Fund officers and the Actuary, the likelihood of reaching full funding at the end of 22 years under the new risk based approach has been set at 73%. This is the same level of risk that underpins the contribution payable by the Council and its pooled employers under the stabilised approach outlined in the draft 2016 FSS. The contributions required by the Academy employers have been calculated applying the above approach.

4 CONSULTATION

4.1 Officers have fully consulted with the Pension Fund's advisers in preparing this report. Other scheme employers will be consulted on the approach set out in the FSS. Following this Committee's consideration of the draft the FSS will be circulated to all Scheme employers for their consideration and comments.

5 FINANCIAL CONSIDERATIONS

5.1 This report contributes to the process whereby the employer contribution rates are set and therefore has a direct impact of the Council's General Fund.

6 COMMENTS OF THE COUNCIL SOLICITOR AND MONITORING OFFICER

6.1 The Council Solicitor comments there are no specific legal comments arising from this report.

(Approved for and on behalf of Jacqueline Harris-Baker, Acting Council Solicitor and Acting Monitoring Officer)

7 FREEDOM OF INFORMATION/DATA PROTECTION CONSIDERATIONS

7.1 This report does not contain any information which will not be made publically available by being published on the Council's Pension Fund website.

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APPENDIX A: Draft Funding Strategy Statement

BACKGROUND DOCUMENTS: None