Dear Sirs

Local Government Pension Scheme 2016 Section 13 Valuation

We are writing to you as the responsible authority for the LGPS and Chair of the Local Government Pension Scheme Advisory Board (England and Wales) on behalf of the four firms who provide actuarial advice to LGPS funds regarding the Section 13 review carried out by the Government Actuary's Department (GAD).

We recognise that the initial headline messages in the report are positive about the overall progress being made by the LGPS, and this has been identified in the initial press reports which have emerged since the report's publication. Clearly this is something which we are pleased to see. However, on reading the detail of the report we have some material concerns over its content. We believe that it is important to highlight these, as we do below, and that it is not in the interests of the LGPS for some of GAD's recommendations to be taken forward.

Our concerns relate to GAD's:

- lack of recognition of the LGPS's updated financial position and outlook;
- approach to engagement during the process;
- interpretation of consistency as applied to LGPS funding plans; and
- understanding of LGPS funding plans and expectation of how deficit recovery plans should be set.

We consider each of these areas in turn.

The LGPS Funding Position and Outlook

We believe that the LGPS's financial position has improved significantly over the last few years and, for most local authorities, we do not currently expect that monetary contributions will need to rise following the 2019 valuations (albeit the valuation date is still six months away so that cannot be guaranteed).

The Section 13 report is based on the position as at 31 March 2016. It does acknowledge the significant improvement in funding since 31 March 2013 (from 79% to 85% on average on prudent local bases and from 92% to 106% on average on GAD's best estimate market basis). However, despite being published 18 months after the 2016 valuations were signed off, the report does not acknowledge that the funding position would have been expected to increase further due to continuation of deficit contributions and due to the funds' strong asset performance since 2016. Instead, the report is largely focussed on highlighting perceived failures by Funds against a series of arguably rather arbitrary actuarial metrics, many of which focus on a single point when in fact there are a number of interrelated issues at play.

Our concerns are that readers (particularly lay readers) may conclude that:

- The LGPS is not being well managed from a funding perspective, with more than 20 amber or red flags being allocated.
- There will be significant employer contribution increases at the 2019 valuation based on GAD's asset liability modelling work (work which we believe goes beyond the remit and requirements of Section 13). Based on current financial conditions, this does not reflect what we expect will happen in reality and seems to emanate from GAD's assumption that contributions are set solely based on prevailing market conditions and gilt yields.

Engagement

We recognise that GAD do not carry out valuations of LGPS funds for funding purposes, so all four firms of actuarial advisers have invested considerable time and effort assisting GAD in their work preparing this report.

Our concerns are that:

- Very little of the extensive feedback that we provided has been reflected in the final approach and published report, and similarly for the feedback which has been provided by those clients consulted directly by GAD. It therefore seems to us that GAD have not taken fully into account how the LGPS is funded and how this differs from private sector schemes.
- The metrics are in our view too simplistic and could lead to incorrect/invalid conclusions. Whilst it is accepted that there is a balance to be struck between simplicity by applying metrics (where there is a risk of applying them rigidly despite them potentially offering limited insight) and a detailed bespoke analysis which would offer a more rounded view, in many cases, in our view, there hasn't been sufficient detailed engagement with the administering authority and Fund Actuary to understand local circumstances or the risk management measures already in place to mitigate the identified risks. Readers of the report will see the metrics used as a valid test (especially with the Red/Amber/Green classification used). This could influence funding behaviours in an effort to avoid a future red or amber flag and lead to lay readers drawing incorrect conclusions about the performance of a fund and its officers and committee. Ultimately this could result in actions being taken which are not in the best interests of the LGPS and/or individual funds.

We believe GAD should recognise more explicitly that these metrics are limited in nature and instead undertake a more holistic review of, and commentary on, funding plans with considerably more engagement with key stakeholders at individual funds.

Interpretation of consistency

We have no objection to GAD's recommendation in relation to presentational consistency (Recommendation 1) as long as any "template" reporting is provided in good time to be implemented and is mandatory (since some administering authorities may otherwise refuse to agree to any changes).

However, we fundamentally disagree with how GAD has approached what they call "evidential consistency": the wording in the Public Service Pensions Act is “not inconsistent” implying a focus on identifying outliers which is entirely logical for a review analysing and comparing local LGPS valuations. GAD has instead interpreted their role as requiring a comparison of individual assumptions (focusing on those used to calculate the past service funding level) and commenting on whether or not they are identical. Our concern is that readers will be given a completely false impression of what we understood to be the intentions of Section 13.

In addition, our concerns are that:

- There is very little commentary on the main output from a local LGPS funding valuation, i.e. the employer contributions payable. Given LGPS funds are open, ongoing and long term statutory schemes, the contributions payable are far more relevant and important than the assessment of the past service funding position (on which GAD has focused). We believe that there is far greater consistency in relation to employer contributions and the report as drafted will give readers a false impression of what is most important in the overall funding plan.
- GAD does not acknowledge that different assumptions and funding mechanisms are valid when setting employer contribution rates nor that this diversity in approach allows administering authorities to adopt the approach which maximises the chance that they meet their objectives in light of their appetite for risk and the specific circumstances of the Fund. Equally important, the Fund Actuary is required to have regard to the Funding Strategy Statement when carrying out the valuation. This is an administering authority document and administering authorities may appoint an adviser on the basis of the funding approach adopted. Our concern is that GAD's assertion that house views are responsible for the assumptions adopted for local valuations is misleading, ignores the administering authorities’ (and employers') key role within the valuation process and does not provide an appropriately balanced view.

In putting forward Recommendation 2, GAD has neither outlined what the benefits for the LGPS and its stakeholders would be, nor has it considered the potential downsides in terms of the reduced input from the administering authority into the funding process and the fundamental change in governance arrangements which would be involved. A change of this nature needs to be considered from a policy point of view with consultation with all stakeholders, rather than being introduced by the back door. We therefore do not agree with Recommendation 2 and believe that the Scheme Advisory Board should consider the feedback we provided to GAD before taking this recommendation forward.

In particular, we believe that a better focus for the Section 13 review would have been:

- consideration of the consistency of output of the valuation, i.e. employer contribution rates rather than focusing on certain individual assumptions used to calculate funding levels;
- commentary and analysis of the overall funding strategy and assumptions, including level of prudence, rather than a focus on individual assumptions in isolation; and

- a comparison of employer contribution rates against funding levels (assessed on a standardised funding basis), which would give a visual representation of the above two points and some insight into relative prudence of the overall funding approach for each fund.

How deficit recovery periods should be set

Deficit recovery periods can form an important part of the funding strategy, particularly where funding levels are low, but in practice are often not key drivers of the contribution plan. Our concern is that the application of a strict "rules-based" approach could potentially inadvertently lead to the wrong conclusions in cases where the funding plan overall is robust and meets the cost-efficiency requirements. In particular:

- A fund wishing to adopt a more prudent actuarial valuation basis may be reluctant to do so if the result is an increased deficit recovery period and hence a risk of triggering on this measure.
- A fund which feels it can sensibly afford to adopt a more risk-averse investment strategy may decide against doing so if it will give rise to a longer deficit recovery period.
- When deficit recovery periods are relatively short, there comes a point where seeking to shorten them further at every actuarial valuation may lead to increased volatility of contributions and therefore come into conflict with cost-efficiency.
- Funds/employers may fall foul of this trigger simply due to seeking to manage their budgets prudently within their financial constraints (e.g. paying increased contributions whilst it can afford them with a view to reducing them in future years when its financial position is tighter).
- GAD has interpreted CIPFA's guidance on deficit recovery periods to mean that these should have a fixed end date. However, as GAD has acknowledged, they were not part of discussions when the guidance was drawn up. During these discussions, we have already confirmed to GAD that a deficit recovery period was used to mean a number of years e.g. 20 years, so the intention was for funds to operate with a rolling recovery period which does not extend in the number of years. We are concerned that because GAD has a different interpretation of CIPFA's guidance, even if funds follow that guidance on our advice, they may still be flagged on this metric.

We think it would make more sense for the deficit recovery period not to be flagged in isolation, but for a more rounded view of the funding plan to be taken in the context of viewing whether a fund meets the cost-efficiency requirement. Rather than Recommendation 5, of the report, we would have preferred to have seen:

- the deficit recovery period at this and the previous valuation being noted; and
- a flag being raised only if it were felt that the cost-efficiency requirement was not being met overall.

We are disappointed that after so many months of discussions we are in a position to have to write this letter to you. However, we feel very strongly that it is important to ensure that the requirements of Section 13 can be met whilst recognising the positive steps taken by local authorities to date so it does not become the driver of LGPS funding plans to the detriment of the vast majority of well-managed LGPS Funds and the public perception of the LGPS. One of the great strengths of the LGPS is that it is funded, giving it a far greater degree of transparency and accountability particularly when compared with the other public service schemes.   We would be more than happy to provide further input and gather further feedback from our administering authority clients if that would assist you in determining how best to respond to GAD's review.

Yours faithfully

Alison Murray FFA
Partner
For and on behalf of Aon

Graeme Muir FFA
Partner
For and on behalf of Barnett Waddingham

Catherine McFadyen FFA
Partner
For and on behalf of Hymans Robertson

Paul Middleman FIA
Partner
For and on behalf of Mercer