Funding issues update June 2021

Purpose and Scope

This paper has been commissioned by and is addressed to London Borough of Hackney in its capacity as Administering Authority to the London Borough of Hackney Pension Fund ("the Fund"). Its purpose is to summarise and update the London Borough of Hackney Pensions Committee on:

A. an introduction to funding and some history of how the funding plan has evolved in the Fund;

B. important funding issues which have arisen since the formal valuation, such as COVID-19, legislative changes, and GAD Section 13 "like for like" analysis of the LGPS;

C. some key funding topics for the Committee to be aware of in the remainder of the Fund year 2021/22, such as climate risk, the national Cost Management process, and planning for the 2022 valuation.

There is a glossary at the end of this paper which defines in plain English some of the funding terms used in this paper and throughout other funding communications, for reference.

A. An introduction to pension scheme funding

The Fund is part of the national Local Government Pension Scheme (LGPS). The LGPS was set up by the UK Government to provide retirement and death benefits for employees of local government authorities, and similar or related bodies, across the whole of the UK. London Borough of Hackney as the Administering Authority runs the London Borough of Hackney Pension Fund, in effect the LGPS for the Hackney area.

The majority of the Fund relates to London Borough of Hackney, but there are a range of different employers who can participate in an LGPS Fund, such as: Colleges and universities; Charities and housing associations; Contractors, for the length of time they carry out a contract for (say) the Council; and Academy schools.

There are currently around 40 employers in the Fund.

The Pensions Committee is responsible for setting the funding and investment strategy for the Fund. For the purpose of this paper we will consider only the funding strategy. That is; how the Fund agrees the contributions that will be collected from all employers in the Fund. The investment strategy sets out how those contributions and the accumulated assets will be invested to meet future benefit payments.

The Pension Committee is also responsible for ensuring that the Fund is administered correctly; such that the correct benefits are paid to members, in a timely fashion and that employee contributions are correctly collected.

Employer contribution rates

Employer contributions are set by the Fund Actuary (Gemma Sefton of Hymans Robertson LLP). The Fund has an obligation to ensure each employer meets the cost of the benefits earned by their own employees, and that cross-subsidy is limited.

Each employer has its own asset share within the Fund which grows with contributions paid from the employer and its employees, and the investment returns earned on those assets. Benefits are then paid out to ex-employees (and their dependants) from that asset share.

Each employer will meet the cost of promised benefit payments that are not met by employee contributions (which are set by the LGPS Regulations) and investment returns: this is known as the "balance of the cost". The Actuary calculates how much each employer's contributions need to be to ensure that that employer's asset share is likely to be sufficient to meet the promised benefits. This means that contribution rates can vary greatly between employers, because each is paying its own way, not the way of other employers.

Employer contribution rates are reassessed as part of the actuarial valuation, which is carried out every three years (the last one being as at 31 March 2019, setting contributions for the three years beginning 1 April 2020). Contribution rates can stay the same, or go up or down, depending how investment markets, the employer's membership and the employer's circumstances have changed.

The Fund is required by LGPS Regulations to have a Funding Strategy Statement ("FSS"). The FSS sets out how contributions are calculated for each of the Fund's employers.

The Fund's current FSS is available upon request. The first two sections of the FSS in particular give an expanded description of the above points.

How the Funding Strategy has evolved

The Fund Actuary carries out a formal valuation every three years where the Funding Strategy is reviewed. Typically the Funding Strategy will vary for different types of employers.

London Borough of Hackney

As a long-term secure employer, contributions for London Borough of Hackney are set with stability as a key objective.

Since 2010, the Fund has adopted a "stabilisation" mechanism for setting contributions, which means contributions do not change by more than an agreed amount or percentage of pay each year. This approach is tested by considering thousands of future economic scenarios, and ensuring that in the majority of scenarios there are sufficient assets to meet benefit payments.

Prior to 2010 contributions were set considering a single future economic scenario (or set of assumptions). This meant that contributions could vary significantly from one valuation to the next.

General approach for non-Council employers

Contributions for this group are set such that:

- there are projected to be sufficient assets ("the funding target")
- in a set proportion of future scenarios ("the likelihood of success")
- at the end of an appropriate time period ("the time horizon")

The FSS sets out the funding target, likelihood of success and the time horizon for all types of employers. This approach allows contributions to be set which reflect the risk of each employer and their own circumstances.

A brief summary of the approach for groups of employers is set out below:

Academies

Academies are assumed to be long-term secure employers in the Fund, however do not benefit from the "stabilisation" mechanism for setting contribution rates. Their contribution rates are set by targeting full funding on the Fund's ongoing participation basis over a maximum time horizon of 15 years with a 70% likelihood of success.

Colleges

Colleges are assumed to be long-term secure employers in the Fund, however do not benefit from the "stabilisation" mechanism for setting contribution rates. Historically, colleges have been seen as financially strong employers, however over recent years various changes to their funding arrangements have weakened their financial strength to the point where some may be in financial difficulties. Their contribution rates are set by targeting full funding on the Fund's ongoing participation basis over a maximum time horizon of 15 years with a 70% likelihood of success.

Charities/housing associations etc

Charities/housing associations may participate in the Fund in the short, medium or long-term and may either be open or closed to new members joining the LGPS. They will initially begin targeting full funding on the Fund's ongoing participation basis, however may eventually move to targeting full funding on the Fund's low risk exit basis as they approach their exit of the Fund. Their contribution rates are set over a maximum time horizon of 15 years (or average future working lifetime if less) with a 78% likelihood of success.

Contractors

Contractors may participate in the Fund in the short, medium or long-term and may either be open or closed to new entrants joining the LGPS. Under LGPS regulations, contractors are automatically provided with a guarantee from their letting employer who will ultimately be liable for all future deficits and contributions arising should the contractor exit the fund. Their contribution rates are set by targeting full funding on the Fund's ongoing participation basis over the same time horizon as their letting employer with a 73% likelihood of success.

Recent employer funding issues

At the conclusion of the last actuarial valuation (effective 31 March 2019) the Actuary signed a valuation report in March 2020 which included a legally required document called a "Rates & Adjustments Certificate"; this R&A lists all the employers in Fund, and for each of them confirms the employer contribution payable in each of the three years beginning 1 April 2020.

The actuarial valuation report including R&A is available on request.

B. Hot topics in LGPS funding

Impact of Covid-19

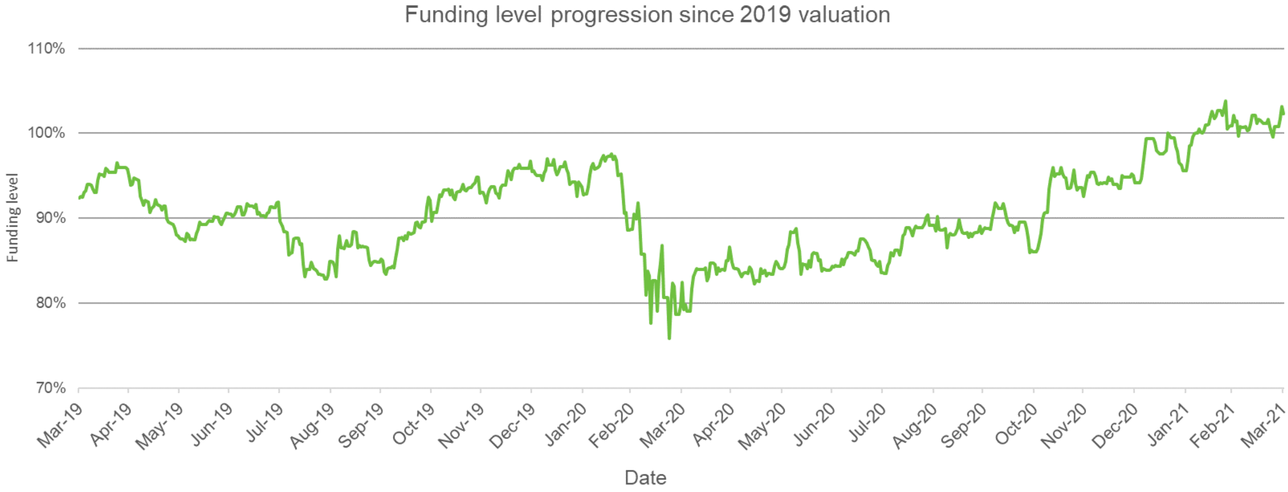
In general terms, the COVID-19 pandemic and lockdown has affected funding in three material ways:

- Market fluctuations
- Employer covenant risk
- Potential life expectancy changes

Market fluctuations

Markets across the globe reacted very strongly to the pandemic and consequent lockdowns, reflecting the much reduced prospect of economic and other activity. In particular, market falls in Spring 2020 were very severe, so that the Fund's own funding level fell from 92% at 31 March 2019 to an estimated 76% at 23 March 2020.

However, throughout the remainder of 2020 the markets strongly bounced back, so that at 31 March 2021 the funding level had improved to 102%.



Therefore, whilst market uncertainty is still clearly present, and funding levels will understandably continue to be as volatile as before 2020, it does appear that Spring 2020 did not represent a "re-setting" of markets at a reduced level.

Employer covenant risk

The Fund relies on its employers to continue making contributions to their asset shares to provide the funding for members' future benefits. It is possible that an employer's business is so severely harmed by the impact of the pandemic and lockdown that it may struggle to afford its contributions or even that its continued operation is in doubt.

The Fund's experience of this to date is cautiously positive, namely that there have been few if any instances of employers struggling as a result. This remains to be monitored as the country emerges from lockdown measures, the furlough scheme is wound down, and the spread of the virus is contained or mutates.

Potential life expectancy changes

As we are all too sadly aware, the COVID-19 pandemic has resulted in a significant rise in mortality during 2020.

At the next formal valuation, we will be able to assess the impact on the Fund of its pensioner (and other beneficiaries) deaths being greater than expected.

There is also a potential impact on future life expectancy and this won't be known for some time. There are two potential future directions:

(a) the impact of COVID-19 causes a long-term decrease in life expectancy as a result of the virus continuing to circulate and other long-term health impacts (for example, long COVID or delayed hospital treatment).

(b) life expectancy will improve as a result of, for example, improved hygiene measures or the health benefits from more flexible working patterns.

Realistically it is likely that both will apply to some extent, and it is a matter of whether one outweighs the other (or they broadly balance out).

The Fund's own longevity assumptions are derived by the Actuary on the basis of analysis carried out by Club Vita. The Actuary will work with Club Vita in the approach to the next actuarial valuation, and will agree with you appropriate life expectancy assumptions which bear in mind the impact of COVID-19 nationally and for your Fund.

Recent legislation on employer flexibilities and exit credits

When an employer leaves the Fund, typically a "cessation valuation" is carried out to determine the employer's position in the Fund. The employer's asset share is compared to the value of the benefits promised to employees and ex-employees ("the liabilities"). Any shortfall is known as the "deficit" and any excess is known as the "surplus."

Exit credits

Prior to 2018, any employer leaving with a surplus had no entitlement to have this paid back to them. Legislation changed in May 2018 so that Funds had to pay employers any surplus when they leave the Fund. The surplus payment is known as an "exit credit".

In England & Wales, further legislation was added in 2020 to clarify that the surplus was at the Fund's discretion, and it had to consider whether there were other factors (eg business agreements between the contractor and Letting Employer) which might mean the surplus was not payable after all. These factors need to be brought out in the Fund's FSS or a separate policy.

Employer flexibilities

If an employer has a deficit on exit, the Fund will normally request payment in a single lump sum. For some exiting employers, this lump sum payment is unaffordable.

Legislation was brought in for the English & Welsh LGPS Funds on 23 September 2020, to allow Funds to treat employers flexibly where they considered it appropriate. The following two options are now permitted:

1. The Fund can permit the employer to pay the deficit in instalments.

2. The employer can exit the Fund without having to pay any deficit immediately, by entering into a Deferred Debt Agreement (DDA). A DDA is where the employer remains in the Fund and pays contributions towards their deficit, but no further benefits are earned by the employees. The important point to note is that the employer retains the benefit (or otherwise) of investment returns on the assets.

The same update to the Regulations also allows for the employer or the Fund to request an update to the employer's contribution rate between formal actuarial valuations in some circumstances.

There is additional guidance provided to LGPS Funds around these new flexibilities, and in broad terms the Fund should reflect its policies in these areas in its FSS.

Early retirement factors

If a member retires early with a full pension, this means there is a "strain" on the funding costs for his/her employer, because the pension is being paid for more years than anticipated. The cost of the early provision of this pension is calculated using early retirement factors calculated by the Actuary.

The £95,000 cap

In November 2020 the UK Government brought in legislation to limit the size of exit package for people leaving the public sector by capping these at £95,000. The package was defined to include any early retirement strain cost for English LGPS cases, but in effect this did not apply to Scotland or Wales.

The English situation gave rise to a clash of regulations, if a member's strain cost brought their package value above £95,000: the new legislation required the benefits to be restricted, but the existing LGPS Regulations required the benefit to be paid in full.

In February 2021 the UK Government revoked this new legislation, so that in effect the £95,000 cap is treated as if it had never been brought into place. However a Judicial Review is underway, and we expect to hear later in 2021 whether and how the cap will apply in future.

One of the implications of the £95,000 cap was that early retirement factors needed to be made unisex to avoid male and female early retirements potentially resulting in different benefits. The Fund's existing factors were sex-specific as they were only intended to calculate funding costs for the employer; as men and women have different life expectancies, these funding costs differ between the sexes. Therefore the Fund decided to adopt new (unisex) factors on the advice of the Actuary.

GAD Section 13 "like for like" analysis of LGPS Funds

After each formal valuation, the Government Actuary's Department (GAD) carries out an analysis of all English & Welsh LGPS Funds, to help comparison of their actuarial valuation results. This is known as the "Section 13" valuation.

This GAD analysis presents metrics on a "like-for-like" fashion, so that reasonable comparisons can be made. Their analysis for the 2019 actuarial valuations was recently produced, albeit the final figures are not yet public and have not yet been fully verified. However, we understand that GAD have no concerns on the Fund's funding plans based on their most recent analysis.

C. Looking forward: Key funding issues to watch out for in 2021/22

Considering climate change risk as part of setting the funding strategy

Setting the contributions or investment strategy for the Fund involves looking to the future and considering risks. The Fund, taking advice from its Actuary, needs to decide what to do today, based on what could happen to life expectancy, inflation, and investment returns in years to come.

No one would argue that Funds should ignore a material risk, and it is broadly accepted that climate change falls into that category. With climate risk disclosures expected to be mandatory in the LGPS by 2023 there will soon be a regulatory requirement too.

Within the past couple of years Hymans Robertson has carried out some climate risk analysis for several LGPS funds, illustrating what the high-level funding impact could be under different future climate scenarios.

Building on that experience, climate risk is now becoming an integral part of the Actuary's advice. This is clearly important in the LGPS where open-ended time horizons mean that the potential impact of climate change is more significant than for a closed private sector scheme. Starting later this year, Hymans Robertson will be "stress testing" modelling results under climate scenarios and (crucially) building the results into decision-making.

The Fund officers are currently in discussion with the Actuary regarding this modelling and modelling under various climate scenarios will be carried out alongside the contribution rate modelling for London Borough of Hackney as part of the 2022 valuation.

The national Cost Management process

Benefits earned by members of the LGPS are set in LGPS Regulations. Other public sector pension schemes, such as NHS and Teachers, have their benefits set in their own regulations. All public sector benefit structures are subject to periodic review by the Government on the basis of analysis carried out by the Government Actuary's Department (GAD): this is known as the Cost Management process.

The intention of the process is that:

- should the package **increase** in value due to certain factors (e.g. members living longer than previously expected), then future benefits should reduce and/or member contributions increase;
- should the package **decrease** in value due to certain factors (e.g. members not living as long as previously expected), then future benefits should increase and/or member contributions reduce.

The principle is that the benefit structure should be managed so that the overall cost to the public purse remains broadly consistent over time.

In brief, GAD have carried out their analysis in the latest Cost Management process, but details are not yet available: when these are published they will result in one of the following scenarios:

a) the cost is deemed to have materially risen, so member benefits will reduce and/or employee contributions increase, which (all other things being equal) will cause a decrease in employer contributions;

b) the cost is deemed to have remained broadly unchanged, so there will be no change to the benefit structure or contributions by employees or employers;

c) the cost is deemed to have materially fallen, so member benefits will increase and/or employee contributions reduce, which (all other things being equal) will cause an increase in employer contributions.

We will advise when further details are available, and the results will be factored into the next actuarial valuation and setting of employer contributions.

Planning for the 2022 actuarial valuation

The next formal valuation will take place as at 31 March 2022, with employer contributions being set for the period 1 April 2023 to 31 March 2026.

An actuarial valuation has many aspects, and therefore advance planning and work in this financial year can help spread the burden on officers and the Committee. This could involve work on some or all of the following areas:

- **modelling of Council contribution rates in 2021**, to provide London Borough of Hackney with more time in planning for resource and budgeting from 1 April 2023: due to London Borough of Hackney being a long term secure employer, the Actuary is able to conduct the modelling in advance of the valuation effective date. The ability to carry out the modelling within the 2021/22 financial year ahead of the 31 March 2022 valuation date is dependent on the availability of membership data of an appropriate standard;
- **climate risk modelling** as mentioned earlier. Climate risk modelling will be carried out by the Actuary alongside the modelling of Council contribution rates as part of the valuation process.
- **individual member data cleansing**: accurate data is the bedrock of the Actuary's calculations, so it is crucial that the Fund is comfortable with this before the Actuary begins their work. In conjunction with their data administrators, the Fund are planning to carry out a data cleansing exercise as at 31 March 2021 in preparation for the upcoming valuation;

- **cashflow data cleansing**: knowing how the Fund's cash receipts and payments are divided among the various employers is essential to establishing each employer's correct asset share. The Fund currently use Hymans Robertson's Employer Asset Tracking system to apportion assets to individual employers on a monthly basis by allowing for employer cashflows and investment returns. Cashflow data has been provided monthly by the Fund's data administrator since 31 March 2019 and will continue to be provided up to the valuation date.

- **employer database**: one of the key outputs of the actuarial valuation is the setting of employer contribution rates for the following three years. With c.40 employers in the Fund, and employers starting and ceasing on a regular basis, it is important to have an accurate record of each employer's status in the Fund. Alongside the Actuary, the Fund is planning to review the information contained in the employer database ahead of the 2022 valuation date;

- **training for Committee Members** to ensure they are equipped with the knowledge and skills to appreciate the papers being brought to them and decisions which they will need to make. In conjunction with the Actuary, the Fund are currently compiling a training timetable for the delivery of relevant training to all Committee Members ahead of the valuation process.

Next steps

Taking account of all the above issues, we would recommend that:

- Committee members should be aware of the key funding topics outlined in this paper ahead of the 2022 valuation of the Fund;

- The Committee should consider the updates made to the Funding Strategy in respect of the exit credit legislation and employer flexibility regulations; and

- The Fund and their Actuary begin preparing for the 2022 funding valuation by carrying out as many of the above areas of work as possible, including delivering relevant training for Committee members ahead of the decisions required to be made as part of the valuation process.

Reliances and limitations

This paper has been prepared for the Fund for the purpose described at the start. It has not been prepared for use for any other purpose and should not be so used. We accept no liability where the paper is used for any other purpose.

The paper is not addressed to any third party. We accept no liability where the paper is used by a third party unless we have expressly accepted such liability in writing.

This paper complies with Technical Actuarial Standard TAS 100 (Principles for Technical Actuarial Work) to a proportionate and relevant degree.

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For and on behalf of Hymans Robertson LLP, Actuary to the London Borough of Hackney Pension Fund

Glossary

Actuarial Valuation	A risk management exercise to review the **Primary** and **Secondary contribution rates**, and other statutory information. This is carried out for the whole Fund, and for each individual **Employer** too.
Administering Authority	The council with statutory responsibility for running the Fund, in effect the Fund's "trustees".
Admission Bodies	Employers where there is an Admission Agreement setting out the employer's obligations. These can be Community Admission Bodies (such as charities or housing associations) or Transferee Admission Bodies (i.e. contractors where a **Letting Employer** outsources some services).
Covenant	The assessed financial strength of the employer. A strong covenant indicates a greater ability (and willingness) to pay for pension obligations in the long run. A weaker covenant means that it appears that the employer may have difficulties meeting its pension obligations in full over the longer term.
Designating Employer	Employers that are able to participate in the LGPS via resolution. These employers can designate which of their employees are eligible to join the Fund.
Employer	An individual participating body in the Fund, which employs (or used to employ) **members** of the Fund. Normally the assets and **funding target** values for each employer are individually tracked, together with its **Primary rate** at each **valuation**.
Funding basis	The combined set of assumptions made by the actuary, regarding the future, to calculate the value of the funding target at the end of the employer's time horizon. The main assumptions will relate to the level of future investment returns, salary growth, pension increases and longevity. More prudent assumptions will give a higher funding target, whereas more optimistic assumptions will give a lower funding target.
Guarantee / guarantor	A formal promise by a third party (the guarantor) that it will meet any pension obligations not met by a specified employer. The presence of a guarantor will mean, for instance, that the Fund can consider the employer's **covenant** to be as strong as its guarantor's.
Letting Employer	An employer which outsources or transfers a part of its services and workforce to another employer (usually a contractor). The contractor will pay towards the LGPS benefits accrued by the transferring members, but ultimately the obligation to pay for these benefits will revert to the letting employer. A letting employer will usually be a local authority but can sometimes be another type of employer such as an Academy.
LGPS	The Local Government Pension Scheme, a public sector pension arrangement put in place via Government Regulations, for workers in local government. These Regulations also dictate eligibility (particularly for Scheduled Bodies), members' contribution rates, benefit calculations and certain governance requirements. The LGPS is divided into 100 Funds which map the UK. Each LGPS Fund is

	autonomous to the extent not dictated by Regulations, e.g. regarding investment strategy, employer contributions and choice of advisers.
Maturity	A general term to describe a Fund (or an employer's position within a Fund) where the members are closer to retirement (or more of them already retired) and the investment time horizon is shorter. This has implications for investment strategy and, consequently, funding strategy.
Members	The individuals who have built up (and may still be building up) entitlement in the Fund. They are divided into actives (current employee members), deferreds (ex-employees who have not yet retired) and pensioners (ex-employees who have now retired, and dependants of deceased ex-employees).
Primary contribution rate	The employer contribution rate required to pay for ongoing accrual of active members' benefits (including an allowance for administrative expenses).
Profile	The profile of an employer's membership or liability reflects various measurements of that employer's **members**, ie current and former employees. This includes: the proportions which are active, deferred or pensioner; the average ages of each category; the varying salary or pension levels; the lengths of service of active members vs their salary levels, etc. A membership (or liability) profile might be measured for its **maturity** also.
Rates and Adjustments Certificate	A formal document required by the LGPS Regulations, which must be updated at the conclusion of the formal **valuation**. This is completed by the actuary and confirms the contributions to be paid by each employer (or pool of employers) in the Fund for the period until the next valuation is completed.
Scheduled Bodies	Types of employer explicitly defined in the LGPS Regulations, whose employees must be offered membership of their local LGPS Fund. These include Councils, colleges, universities, academies, police and fire authorities etc, other than employees who have entitlement to a different public sector pension scheme (e.g. teachers, police and fire officers, university lecturers).
Secondary contribution rate	The difference between the employer's actual and **Primary contribution rates**.
Stabilisation	Any method used to smooth out changes in employer contributions from one year to the next. This is very broadly required by the LGPS Regulations, but in practice is particularly employed for large stable employers in the Fund.