HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Hampshire Pension Fund Panel and Board
Date:	16 December 2016
Title:	Governance: Investment strategies for employers
Reference:	8001
Report From:	Director of Corporate Resources – Corporate Services

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1. Executive Summary

1.1. This paper follows the review of the Pension Fund’s grouped funding arrangements and decision by the Pension Fund Panel and Board in order to strengthen the Fund's risk management framework and to introduce two intermediate funding targets for specific types of employers in the Fund.

1.2. In anticipation of possible queries from employers following changes to their funding targets, the Actuary was asked to comment on the options for implementing different strategies and confirm whether adoption of a single investment strategy remains compatible with differential investment return assumptions being adopted for employers.

1.3. This paper summarises the Actuary's advice in relation to employer investment strategies and seeks the Panel and Board's approval for maintaining the current policy of operating a single investment strategy for the Fund.

2. Background

2.1. The key strategic aim of the Hampshire Pension Fund is to ensure there are sufficient assets available to meet the benefits promised to members of the Fund. The Fund's assets are built up from contributions (less outflows) and investment returns and achieving an appropriate balance between the two is a fundamental element of the Administering Authority's funding strategy. Whilst the Administering Authority must develop, publish and review a single Funding Strategy Statement under the LGPS Regulations, its strategy has evolved over time in recognition of the changing mix and profile of participating employers.

2.2. For a number of years the Administering Authority has operated two funding targets:

- a long-term target for scheduled bodies, and any admission bodies whose assets and liabilities would be subsumed by a scheduled body after the admission body's exit, which assumes the indefinite participation of the employer in the Fund, and

- a more prudent target for admission bodies with no subsumption commitment which is intended to enable the Administering Authority to invest in government bonds after the employer's exit so as to reduce the risk of the remaining employers having to fund a deficit arising on the orphaned liabilities after the admission body's exit

2.3. Following a review of the grouped funding arrangements, and in order to strengthen the Fund's risk management framework, at the 2016 valuation the Administering Authority has introduced two intermediate funding targets. These targets apply to the Higher Education (HE) and Further Education (FE) sector bodies whose participation cannot be assumed to be permanent on the grounds of their having no government guarantee and having been assessed as having a weaker covenant than the local authorities. The intermediate funding target which applies is determined according to the financial risk assessment carried out by the Fund Actuary. The Administering Authority is one of the first to explicitly recognise that not all scheduled bodies can be considered permanent and its focus on the HE and FE sector has been vindicated by a recent decision by the Scheme Advisory Board to commission advice specifically relating to the sector, including reviewing their status as Part 1 Schedule 2 employers[1].

2.4. A further consequence of the review of the grouping arrangements is that the pre-1992 university and housing companies which are closed to new members but don't have a subsumption commitment have been removed from the admission body group and are now subject to the orphan funding target. This is consistent with the Administering Authority's intention to apply a low risk funding target on their exit from the Fund.

2.5. The demographic, pay and pension increase assumptions are identical across all funding targets and are set by the Actuary to be best estimate. What differentiates the funding targets is the discount rate (investment return) assumption adopted. The orphan funding target is set to broadly ensure that there is sufficient funding to enable the Administering Authority to invest in government bonds (as a low risk strategy which broadly matches the liabilities) at the point of exit[2]. The intermediate funding targets do not anticipate employer exit as such, but are more prudent (i.e. allow for a lower discount rate so less funding risk) in recognition of the higher risk of the employer leaving the Fund with an unmet exit debt compared to the employers in the Scheduled Body Group.

[1] http://www.lgpsboard.org/index.php/sub-comms/deficits-working-group

[2] In practice an exit payment may still be due depending upon actual experience and the timing of the employer's exit but this approach materially reduces the risk of an employer leaving with a large deficit on exit which they cannot afford to meet

2.6. Whilst the funding strategy has evolved over time, the Administering Authority has continued to operate a single investment strategy. In particular, when an employer exits the Fund the Administering Authority does not amend the investment strategy to explicitly match any orphan liabilities with bond investments. This approach is common amongst LGPS funds. The rationale is that the orphan liabilities are very small relative to the size of the Fund as a whole (estimated to be £125m or 2.4% of the Fund's assets as at 31 March 2016) and the administrative work and costs associated with amending the strategy on exit has been considered to be disproportionate to the potential benefits. The Fund does however have an allocation to government bonds within its investment strategy, the primary aim for which is to be a matching asset for the whole Pension Fund’s liabilities.

3. Implementing employer-specific funding targets

3.1. A few administering authorities do operate different investment strategies for employers, although the options are generally limited to a small number of alternative strategies, perhaps two or three, with quite material differences in the level of investment risk (e.g. low risk/allocation to growth assets, medium risk/allocation to growth assets and high risk/allocation to growth assets). The Actuary advises that there are two principal mechanisms of which they are aware which are used by LGPS funds to implement different investment strategies for employers:

- use of a unitisation model, which has the added advantage of improving the process by which employers' notional asset shares are tracked over time
- a notional approach where different strategies are operated without changing the overall strategy of the Fund.

3.2. In the case of the former, given that notional asset shares are not required for employers in the Scheduled Body Group it is not immediately obvious that the additional benefits of unitisation would justify the cost for the Hampshire Fund. The latter is generally only a viable option where a small proportion of the Fund assets are subject to an alternative strategy to ensure that this doesn't unintentionally alter the overall risk and return profile for the remaining employers. It would also require further advice and calculations to determine the return for notional investment strategies and the balance of returns for the other employers in the Fund.

3.3. The other administrative and cost implications of implementing different investment strategies for employers include:

- investment and actuarial advice on the investment options to be offered and the consequential review of the Statement of Investment Principles (soon to be replaced by the Investment Strategy Statement) and consultation with employers
- all cashflows – contributions, pensions paid, lump sum retirement payments, death-in-service payments, transfers in and out, expenses and even "notional" cashflows within the fund such as

transfers between employers etc – must be identified separately for all employers subject to a different investment strategy. This information is already required for ungrouped employers but arguably should be recorded more frequently (e.g. monthly rather than annually) where different investment strategies are being adopted

- employers' notional assets must be tracked and investment returns calculated for each investment option at least triennially to coincide with the actuarial valuation but ideally more frequently, e.g. for the purpose of employer accounting for pension costs or other inter-valuation calculations such as an employer exit

3.4. The Panel and Board is asked to note the additional costs of offering different investment strategies for employers and the fact that it is possible that the new pooling arrangements for LGPS investments may facilitate different employer investment strategies more cost effectively.

4. Compatibility of maintaining a single investment strategy

Employers subject to the intermediate funding targets

4.1. The discount rates adopted for the intermediate funding targets are 4.3% p.a. (medium risk) and 4.1% p.a. (higher risk) compared to 4.5% p.a. for the Scheduled Body Group. The Actuary has advised that:

- For the investments to deliver long-term returns at or above the intermediate discount rates would still require a material allocation to growth (i.e. equity-type) assets. It is not obvious that the benefits to the Fund of offering an investment strategy for employers subject to the intermediate funding targets which has only a slightly lower allocation to growth assets than the existing strategy would justify the costs of doing so.
- The effect of adopting a lower investment return assumption within the funding target for the HE and FE sector employers is to alter the balance between the reliance on investment returns and employer contributions in funding the liabilities (reducing the former and increasing the latter). To the extent that the investment returns actually achieved by the Fund exceed the discount rate, this will improve the funding position of these employers faster than for the Scheduled Body Group, so contributing to a further reduction in risk for the Fund. Conversely, if investments perform less well than assumed, the reduction in the funding position will be less than for the Scheduled Body Group, i.e. the stronger funding target will provide a buffer against such adverse experience. Thus the Actuary believes that the reduction in funding risk on its own is sufficient and there is no imperative, from the Fund's perspective, to reduce the investment risk for employers subject to the intermediate funding target at this time.
- The funding ratios of the employers subject to the intermediate funding target are all less than 80% as at 31 March 2016. These

employers currently admit new members and a 19 year deficit recovery period has been adopted for them at the 2016 valuation. As a result, the Actuary does not consider that the employers could argue that they are exposed to investment risk from which they cannot benefit them since if investment returns were materially higher than expected such that the funding position exceeded 100%, this could be used to reduce employer contributions in future if considered appropriate.

- If the Administering Authority wished to adopt an investment strategy with a materially lower allocation to growth assets for these employers, this would need to be accompanied by a further review of, and most likely reduction to, the discount rate (investment return assumption) and hence higher employer contributions. It is not obvious that this would be attractive to any of the employers concerned.

4.2. The Actuary's view is therefore that there is no imperative for the Administering Authority to consider alternative investment strategies for the employers subject to the intermediate funding targets unless or until:

- the funding targets have strengthened further relative to the Scheduled Body Group target (which will depend upon a number of factors including experience over the next 3 years within the Fund and within the sector), or
- the funding levels of the employers have improved to such an extent that a lower risk investment strategy (and use of a commensurately lower discount rate) is affordable and in the interests of both the Fund and the employers.

4.3. It should also be noted that none of the employers subject to the intermediate funding targets has asked the Administering Authority whether it would be possible to alter the investment strategy for their notional share of the Fund, despite having had ample opportunity to do so both at the de-grouping workshops and the Annual Employers Meeting.

4.4. The Panel is asked to note the Actuary's advice and confirm that it does not wish to facilitate different investment strategies for employers subject to the intermediate funding target at this time.

5. Employers subject to the orphan funding target

5.1. The discount rates adopted for the orphan funding target at the 2016 valuation are 4.1% p.a. for the period when active members are assumed to be in service and 2.5% p.a. otherwise. These rates have been set relative to the yield on long-dated government bonds at the valuation date, with an allowance for expected additional returns on the assets above gilt yields of 2% p.a. in the period before active members leave or retire. In addition, on affordability grounds an allowance for future increases in gilt yields of 0.4% p.a. has been incorporated in the left service discount rate (although to date real gilt yields have actually fallen since 31 March 2016).

5.2. In effect the orphan funding target has been set to anticipate a low risk (gilts-based) valuation on exit. This is a materially more robust and lower risk approach than taken by some other administering authorities where ongoing employer contributions are set using a single funding target and there is a step change to a gilts-based target on exit, and so a high risk of a material exit debt building up.

5.3. However, employers may question why they are exposed to the investment risk associated with the current investment strategy whilst paying contributions on a gilts-based funding target.

5.4. The Actuary advises that in light of the fact that the orphan funding target does require some allowance for growth assets given the 4.1% in service discount rate and recognises that gilt yields may rise in future, investment in gilts at prevailing prices would not deliver returns at the rates assumed in the orphan funding target. In addition, the funding positions for the housing associations and other employers removed from the admission body group and moved to the orphan funding target are all around 60% as at 31 March 2016.

5.5. The Actuary believes that it is justifiable for the Administering Authority to permit continued investment in growth assets as a means of meeting part of this funding gap noting that in most cases the deficit recovery period adopted is more than 5 years. This approach will be easier to maintain if DCLG's recent proposals in relation to the return of any surplus on exit[3] are confirmed in Regulations. Unfortunately given resource constraints within the Department and adverse responses in relation to the Fair Deal elements of the draft regulations it is not clear if and when any changes will be implemented.

5.6. It should also be noted that none of the employers now subject to the orphan funding target has asked the Administering Authority whether it would be possible to alter the investment strategy for their notional share of the Fund, despite having had ample opportunity to do so both at the de-grouping workshops and the AEM. Indeed, conversations with a representative of one of the housing associations whom it is understood is working with the other associations, indicated that they believe gilt yields will rise in future which would suggest that they do not consider it beneficial to invest more in government bonds at current prices.

5.7. However, the Actuary has indicated that it may be more difficult to turn down a request from an employer subject to the orphan funding target to apply a lower risk investment strategy in future if the employer is willing to meet the costs of doing so (both any advisory costs and any additional contributions by virtue of any reduction being required to the discount rate). In addition, the Administering Authority may wish to keep its approach to the investment strategy for orphan liabilities after the employer's exit under review as the value of those liabilities increases over time.

[3] Consultation: Local Government Pension Scheme Regulations issued in May 2016, here: http://www.lgpsregs.org/images/Drafts/2016-05LGPSAmendsCons.pdf

6. Recommendations

6.1. That the Panel and Board confirm the continuation of its current policy of operating a single investment strategy across the Fund, whilst noting that this may need to be revisited in future should any employers subject to the orphan funding target request a lower risk strategy and be prepared to meet the costs of its implementation.

CORPORATE OR LEGAL INFORMATION:

Links to the Corporate Strategy

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the Pension Fund's cash balance needs to be decided.

Other Significant Links

Links to previous Member decisions:		
Title	Reference	Date
Direct links to specific legislation or Government Directives		
Title		Date

Section 100 D - Local Government Act 1972 - background documents
The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.2. **Equalities Impact Assessment:**

1.3. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.