

# Nottinghamshire Pension Fund Funding Strategy Statement

## Introduction

This is the Funding Strategy Statement (FSS) for the Nottinghamshire County Council Pension Fund. It has been prepared in accordance with Regulation 58 of the Local Government Pension Scheme Regulations 2013 ("the Regulations") and describes Nottinghamshire County Council's strategy, in its capacity as Administering Authority, for the funding of the Nottinghamshire County Council Pension Fund ("the Fund").

This statement has regard to the guidance set out in the document "Preparing and Maintaining a Funding Strategy Statement" published by CIPFA in February 2016. The statement also has regard to the Investment Strategy Statement published by the Administering Authority.

The Statement describes a single strategy for the Fund as a whole. The Fund Actuary, Barnett Waddingham LLP, has been consulted on the contents of this Statement.

## Purpose of the Funding Strategy Statement

The purpose of this Funding Strategy Statement is to explain the funding objectives of the Fund and in particular:

- Establish a clear and transparent fund-specific strategy that will identify how employers' pension liabilities are best met going forward;
- Support the desirability of maintaining as nearly constant a primary contribution rate as possible, as defined in Regulation 62(6) of the Regulations;
- Ensure that the regulatory requirements to set contributions to meet the future liability to provide Scheme member benefits in a way that ensures the solvency and long-term cost efficiency of the Fund are met; and
- Take a prudent longer-term view of funding those liabilities.

## Aims and purpose of the Fund

The aims of the Fund are to:

- Manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due
- Achieve and maintain Fund solvency and long-term cost efficiency at reasonable cost to taxpayers, scheduled, resolution and admitted bodies, and enable contribution rates to be kept as nearly constant as possible where practical
- Seek returns on investment within reasonable risk parameters

The purpose of the Fund is to:

- Pay pensions, lump sums and other benefits provided under the Regulations
- Meet the costs associated in administering the Fund
- Receive contributions, transfer values and investment income.

## Funding objectives

Contributions are paid to the Fund by Scheme members and the employing bodies to provide for the benefits which will become payable to Scheme members when they fall due.

The funding objectives are to:

- Ensure that pension benefits can be met as and when they fall due over the lifetime of the Fund;
- Ensure the long-term solvency of the Fund;
- Set levels of employer contribution rates to target a 100% funding level over an appropriate time period and using appropriate actuarial assumptions, while taking into account the different characteristics of participating employers;
- Build up the required assets in such a way that employer contribution rates are kept as stable as possible, with consideration of the long-term cost efficiency objective; and
- Adopt appropriate measures/approaches to reduce the risk, as far as possible, to the Fund, other employers and ultimately the taxpayer from an employer defaulting on its pension obligations
- In developing the funding strategy, the administering authority should also have regard to the likely outcomes of the review carried out under Section 13(4)(c) of the Public Service Pensions Act 2013. Section 13(4)(c) requires an independent review of the actuarial valuations of the LGPS funds; this involves reporting on whether the rate of employer contributions set as part of the actuarial valuations are set at an appropriate level to ensure the solvency of the fund and the long-term cost efficiency of the scheme so far as relating to the pension fund. The review also looks at compliance and consistency of the actuarial valuations.

## Key Parties

The key parties involved in the funding process and their responsibilities are as follows.

### The Administering Authority

The Administering Authority for the Pension Fund is Nottinghamshire County Council. The main responsibilities of the Administering Authority are to:

- Collect employee and employer contributions
- Invest the Fund's assets, while ensuring cash is available to meet liabilities as and when they fall due
- Pay the benefits due to Scheme members
- Take measures to safeguard the Fund against the consequences of employer default
- Manage the actuarial valuation process in conjunction with the Fund Actuary, and enable the Local Pensions Board to review the valuation process as they see fit
- Prepare and maintain this FSS and the Investment Strategy Statement (ISS) after consultation with other interested parties as appropriate
- Monitor all aspects of the Fund's performance and funding
- Effectively manage any potential conflicts of interest arising from its dual role as both Administering Authority and Scheme employer; and
- Enable the Local Pension Board to review the valuation process as they see fit.

## Scheme Employers

In addition to the Administering Authority, a number of other Scheme Employers, including Admission Bodies, participate in the Fund. The responsibilities of each Scheme Employer that participates in the Fund, including the Administering Authority, are to:

- Collect employee contributions and pay these together with their own employer contributions certified by the Fund Actuary to the Administering Authority within the statutory timescales, including any exit payments on ceasing participation in the Fund
- Notify the Administering Authority of any new Scheme members and any other membership changes promptly
- Develop a policy on certain discretions and exercise those discretions as permitted under the Regulations
- Meet the costs of any augmentations or other additional costs in accordance with agreed policies and procedures
- Notify the Administering Authority of significant changes in the employer's structure or membership; and

## Fund Actuary

The Fund Actuary for the Pension Fund is Barnett Waddingham LLP. The main responsibilities of the Fund Actuary are to:

- Prepare valuations including the setting of employers' contribution rates at a level to ensure Fund solvency and long-term cost efficiency after agreeing assumptions with the administering authority and having regard to the FSS and the Regulations;
- Prepare advice and calculations in connection with bulk transfers and the funding aspects of individual benefit-related matters such as pension strain costs, ill health retirement costs, compensatory added years costs, etc;
- Provide advice and valuations on the exiting of employers from the Fund;
- Provide advice and valuations relating to new employers, including recommending the level of bonds or other forms of security required to protect the Fund against the financial effect of employer default;
- Assist the administering authority in assessing whether employer contributions need to be revised between valuations as permitted or required by the Regulations;
- Ensure that the administering authority is aware of any professional guidance or other professional requirements which may be of relevance to their role in advising the Fund; and
- Advise on other actuarial matters affecting the financial position of the Fund.

## Solvency Issues, Target Funding Levels and Long-term Cost Efficiency

### Funding Strategy

The factors affecting the Fund's finances are constantly changing, so it is necessary for its financial position and the contributions payable to be reviewed from time to time by means of an actuarial valuation to check that the funding objectives are being met.

The actuarial valuation involves a projection of future cash flows to and from the Fund. The main purpose of the valuation is to determine the level of employers' contributions that should be paid to ensure that the existing assets and future contributions will be sufficient to meet all future benefit payments from the Fund.

The last actuarial valuation was carried out as at 31 March 2019 with the assets of the Fund found to be 93% of the accrued liabilities of the Fund.

## Funding Method

The key objective in determining employer's contribution rates is to establish a funding target and then set levels of employer contribution to meet that target over an agreed period.

The funding target is to have sufficient assets in the Fund to meet the accrued liabilities for each employer in the Fund. The funding target may, however, depend on certain employer circumstances and in particular, whether an employer is an "open" employer – one which allows new staff access to the Fund, or a "closed" employer which no longer permits new staff access to the Fund. The expected period of participation by an employer in the Fund may also affect the chosen funding target.

For open employers, the actuarial funding method that is adopted is known as the Projected Unit Funding Method which considers separately the benefits in respect of service completed before the valuation date ("past service") and benefits in respect of service expected to be completed after the valuation date ("future service"). This approach focuses on:

- The past service funding level of the Fund. This is the ratio of accumulated assets to liabilities in respect of past service. It makes allowance for future increases to members' pay for pensions in payment. A funding level in excess of 100 per cent indicates a surplus of assets over liabilities; while a funding level of less than 100 per cent indicates a deficit
- The primary rate which is the level of contributions required from the individual employers which, in combination with employee contributions, is expected to support the cost of benefits accruing in future.

The key feature of this method is that, in assessing the future service cost, the contribution rate represents the cost of one year's benefit accrual.

For closed employers, the funding method adopted is known as the Attained Age Method. The key difference between this method and the Projected Unit Method is that the Attained Age Method assesses the average cost of the benefits that will accrue over the remaining expected working lifetime of active members.

## Valuation Assumptions and Funding Model

The value of accrued or past service benefits (allowing for future salary and pension increases) are referred to as the past service liabilities, or simply the liabilities.

Using the valuation assumptions set out below, an estimate is made of the future cash flows which will be made to and from the Fund throughout the future lifetime of existing members. These projected cashflows are then discounted using the discount rate which is essentially a calculation of the amount of money which, if invested now, would be sufficient together with the income and growth in the accumulating assets to make these payments in future, using our assumption about investment returns.

This amount is called the present value (or, more simply, the value) of members' benefits. Separate calculations are made in respect of benefits arising in relation to membership before the valuation date (past service) and for membership after the valuation date (future service).

To produce the future cashflows and therefore an estimate of the value of the liabilities, the fund actuary needs to make assumptions about the factors affecting the Fund's future finances such as inflation, salary increases, investment returns, life expectancy and retirements.

The assumptions adopted at the valuation can therefore be considered as:

- The demographic assumptions which are essentially estimates of the likelihood of benefits and contributions being paid
- The financial assumptions which will determine the estimates of the amount of benefits and contributions payable and their current or present value. The base market statistics used for the financial assumptions are smoothed around the valuation date so that the market conditions used are the average of the daily observations over the three months before and the three months after the valuation date.

A summary of the key assumptions is included in the following table and can be found in the actuarial valuation report as at 31 March 2019. Further details regarding the derivation of these assumptions can be found in the Fund Actuary's initial results and assumptions advice to the Fund dated 7 October 2019.

| Assumption                   | Derivation  | Value at 31 March 2019 |
|------------------------------|---|------------------------|
| Future Price Inflation (RPI) | Smoothed 20 year point on the Bank of England implied Retail Price Index inflation curve as at 31 March 2019  | 3.6% p.a.              |
| Future Price Inflation (CPI) | RPI less 1.0% per annum to reflect the differences in the indices   | 2.6% p.a.              |
| Salary increases             | Assumed to be in line with CPI plus 1.0% p.a.   | 3.6% p.a.              |
| Discount rate                | Based on the long-term investment strategy of the Fund, with deductions for expenses and prudence   | 4.8% p.a.              |
| Post-retirement mortality    | S3PA tables with a multiplier of 110% for males and 105% for females, projected into the future with the 2018 CMI Model with a long-term rate of improvement of 1.25% p.a. and initial addition parameter of 0.5% | n/a                    |

### Future Investment Returns/Discount Rate

To determine the value of accrued liabilities and derive future contribution requirements it is necessary to discount future payments to and from the Fund to present day values. The discount rate that is adopted will depend on the funding target adopted for each employer.

For open employers, the discount rate that is applied to all projected liabilities reflects a prudent estimate of the rate of investment return that is expected to be earned from the underlying investment strategy by considering average market yields in the six months straddling the valuation date. The discount rate so determined may be referred to as the "ongoing" discount rate.

For closed employers, an adjustment may be made to the discount rate in relation to the remaining liabilities, once all active members are assumed to have retired if at that time (the projected "termination date"), the

employer becomes an exiting employer under Regulation 64. The Fund Actuary may incorporate such an adjustment after consultation with the Administering Authority.

The adjustment to the discount rate for closed employers is to set a higher funding target at the projected termination date, so that there are sufficient assets to fund the remaining liabilities on a "minimum risk" rather than on an ongoing basis. The aim is to minimise the risk of deficits arising after the termination date.

Further details of the assumptions adopted are included in the Fund's 2019 valuation report.

### Asset Valuation

- For the purposes of the valuation, the asset value used is the market value of the accumulated Fund at the valuation date adjusted to reflect average market conditions during the six months straddling the valuation date. This is referred to as the smoothed asset value and is calculated as a consistent approach to the valuation of the liabilities.
- The Fund's assets are allocated to employers at an individual level by allowing for actual Fund returns achieved on the assets and cashflows paid into and out of the Fund in respect of each employer (e.g. contributions received and benefits paid).

### McCloud/Sargeant judgement and cost cap

The 2016 national Scheme valuation was used to determine the results of HM Treasury's (HMT) employer cost cap mechanism for the first time. The HMT cost cap mechanism was brought in after Lord Hutton's review of public service pensions with the aim of providing protection to taxpayers and employees against unexpected changes (expected to be increases) in pension costs. The cost control mechanism only considers "member costs". These are the costs relating to changes in assumptions made to carry out valuations relating to the profile of the Scheme members; e.g. costs relating to how long members are expected to live for and draw their pension. Therefore, assumptions such as future expected levels of investment returns and levels of inflation are not included in the calculation, so have no impact on the cost management outcome.

The 2016 HMT cost cap valuation revealed a fall in these costs and therefore a requirement to enhance Scheme benefits from 1 April 2019. However, as a funded Scheme, the LGPS also had a cost cap mechanism controlled by the Scheme Advisory Board (SAB) in place and HMT allowed SAB to put together a package of proposed benefit changes in order for the LGPS to no longer breach the HMT cost cap. These benefit changes were due to be consulted on with all stakeholders and implemented from 1 April 2019.

However, on 20 December 2018 there was a judgement made by the Court of Appeal which resulted in the Government announcing their decision to pause the cost cap process across all public service schemes. This was in relation to two employment tribunal cases which were brought against the Government in relation to possible discrimination in the implementation of transitional protection following the introduction of the reformed 2015 public service pension schemes from 1 April 2015. Transitional protection enabled some members to remain in their pre-2015 schemes after 1 April 2015 until retirement or the end of a pre-determined tapered protection period. The claimants challenged the transitional protection arrangements on the grounds of direct age discrimination, equal pay and indirect gender and race discrimination.

The first case (McCloud) relating to the Judicial Pension Scheme was ruled in favour of the claimants, while the second case (Sargeant) in relation to the Fire scheme was ruled against the claimants. Both rulings were appealed and as the two cases were closely linked, the Court of Appeal decided to combine the two cases. In December 2018, the Court of Appeal ruled that the transitional protection offered to some members as part of the reforms amounts to unlawful discrimination. On 27 June 2019 the Supreme Court denied the Government's request for an appeal in the case. A remedy is still to be either imposed by the Employment Tribunal or negotiated and applied to all public service schemes, so it is not yet clear how this judgement may affect LGPS members'

past or future service benefits. It has, however, been noted by Government in its 15 July 2019 statement that it expects to have to amend all public service schemes, including the LGPS.

At the time of drafting this FSS, it is still unclear how this will affect current and future LGPS benefits. As part of the Fund's 2019 valuation, in order to mitigate the risk of member benefits being uplifted and becoming more expensive, the potential impact of McCloud was covered by the prudence allowance in the discount rate assumption. As the remedy is still to be agreed the cost cannot be calculated with certainty, however, the Fund Actuary expects it is likely to be less than the impact of reducing the discount rate assumption by 0.1% p.a.

### **Guaranteed Minimum Pension (GMP) indexation and equalisation**

As part of the restructuring of the state pension provision, the government needs to consider how public service pension payments should be increased in future for members who accrued a guaranteed minimum pension (GMP) from their public service pension scheme and expect to reach State Pension Age (SPA) post-December 2018. In addition, a resulting potential inequality in the payment of public service pensions between men and women needs to be addressed. Information on the current method of indexation and equalisation of public service pension schemes can be found [at https://www.gov.uk/government/consultations/indexation-and-equalisation-of-gmp-in-public-service-pension-schemes/consultation-on-indexation-and-equalisation-of-gmp-in-public-service-pension-schemes](https://www.gov.uk/government/consultations/indexation-and-equalisation-of-gmp-in-public-service-pension-schemes/consultation-on-indexation-and-equalisation-of-gmp-in-public-service-pension-schemes).

On 22 January 2018, the Government published the outcome to its *Indexation and equalisation of GMP in public service pension schemes* consultation, concluding that the requirement for public service pension schemes to fully price protect the GMP element of individuals' public service pension would be extended to those individuals reaching SPA before 6 April 2021. HMT published a Ministerial Direction on 4 December 2018 to implement this outcome, with effect from 6 April 2016. Details of this outcome and the Ministerial Direction can be found [here https://www.gov.uk/government/publications/indexation-of-public-service-pensions](https://www.gov.uk/government/publications/indexation-of-public-service-pensions).

The 2019 valuation assumption for GMP is that the Fund will pay limited increases for members that have reached SPA by 6 April 2016, with the Government providing the remainder of the inflationary increase. For members that reach SPA after this date, it is assumed that the Fund will be required to pay the entire inflationary increase.

### **Deficit Recovery/Surplus Amortisation Periods**

Whilst one of the funding objectives is to build up sufficient assets to meet the cost of benefits as they accrue, it is recognised that at any particular point in time, the value of the accumulated assets will be different from the value of accrued liabilities, depending on how the actual experience of the Fund differs from the actuarial assumptions. Accordingly the Fund will normally either be in surplus or in deficit.

Where the actuarial valuation reveals a deficit in respect to a particular employer then the levels of required employer contributions will include an adjustment to fund the deficit over a specified period. Each employer's recovery period is considered individually, unless they are part of a pool (see Pooling of Individual Employers). Past service deficit contributions are generally paid as monetary amounts but may be paid as a percentage of payroll, subject to the Administering Authority agreeing this approach. The maximum deficit recovery period is 20 years.

Where an employer's funding position has improved in the inter-valuation period, but the employer is still in deficit, the employer may be required to maintain the previous total contribution level so that the expected deficit recovery period reduces.

Incremental phasing-in (stepping) of contribution increases may be considered for some employer types where proposed increases are large, with target rates to be achieved in no more than 3 years. Where stepping is agreed to, employers are instructed that the difference between the employer contributions with stepping and the employer contributions without stepping will need to be repaid later in the recovery period.



Employers in surplus on their funding method will generally pay the future service rate although the surplus may be released back to the employer through an adjustment to their contribution rate. The Fund Actuary will consider each employer separately when deciding whether surplus amortisation is appropriate.

## Pooling of Individual Employers

The general policy of the Fund is that each individual employer should be responsible for the costs of providing pensions for its own employees who participate in the Fund. Accordingly, contribution rates are set for individual employers to reflect their own particular circumstances.

However, certain groups of individual employers are pooled for the purposes of determining contribution rates to recognise common characteristics or where the number of Scheme members is small.

The main purpose of pooling is to produce more stable employer contribution levels in the longer term whilst recognising that ultimately there will be some level of cross-subsidy of pension cost amongst pooled employers.

Currently, other than Scheme employers that are already legally connected, there are the following pools:

- Small Scheduled Bodies pool
- Grouped Admission Bodies pool
- Fund Academies pool

## New employers joining the Fund

When a new employer joins the Fund, the Fund Actuary is required to set the contribution rates payable by the new employer and allocate a share of Fund assets to the new employer as appropriate. The most common types of new employers joining the Fund are admission bodies and new academies. These are considered in more detail below.

### Admission bodies

New admission bodies in the Fund are commonly a result of a transfer of staff from an existing employer in the Fund to another body (for example as part of a transfer of services from a council or academy to an external provider under Schedule 2 Part 3 of the Regulations). Typically these transfers will be for a limited period (the contract length), over which the new admission body employer is required to pay contributions into the Fund in respect of the transferred members.

#### Funding at start of contract

Generally, when a new admission body joins the Fund, they will become responsible for all the pensions risk associated with the benefits accrued by transferring members and the benefits to be accrued over the contract length. This is known as a full risk transfer. In these cases, it may be appropriate that the new admission body is allocated a share of Fund assets equal to the value of the benefits transferred, i.e. the new admission body starts off on a fully funded basis. This is calculated on the relevant funding basis and the opening position may be different when calculated on an alternative basis (e.g. on an accounting basis).

However, there may be special arrangements made as part of the contract such that a full risk transfer approach is not adopted. In these cases, the initial assets allocated to the new admission body will reflect the level of risk transferred and may therefore not be on a fully funded basis or may not reflect the full value of the benefits attributable to the transferring members.



### Contribution rate

The contribution rate may be set on an open or a closed basis. Where the funding at the start of the contract is on a fully funded basis then the contribution rate will represent the primary rate only; where there is a deficit allocated to the new admission body then the contribution rate will also incorporate a secondary rate with the aim of recovering the deficit over an appropriate recovery period.

Depending on the details of the arrangement, for example if any risk sharing arrangements are in place, then additional adjustments may be made to determine the contribution rate payable by the new admission body. The approach in these cases will be bespoke to the individual arrangement.

### Security

To mitigate the risk to the Fund that a new admission body will not be able to meet its obligations to the Fund in the future, the new admission body may be required to put in place a bond in accordance with Schedule 2 Part 3 of the Regulations, if required by the letting authority and administering authority.

If, for any reason, it is not desirable for a new admission body to enter into a bond, the new admission body may provide an alternative guarantee in a form satisfactory to the administering authority.

### New academies

When a school converts to academy status, the new academy (or the sponsoring multi-academy trust) becomes a Scheme employer in its own right.

### Funding at start

On conversion to academy status, the new academy will be allocated assets based on the active cover of the relevant local authority at the conversion date. The active cover approach is based on the funding level of the local authority's active liabilities, after fully funding the local authority's deferred and pensioner liabilities.

The deficit is transferred to the Academy pool and the new academy will become part of the Academy pool and will be allocated assets based on the funding level of the pool at the conversion date.

### Contribution rate

The contribution rate payable when a new academy joins the Fund will be in line with the contribution rate certified for the Academy pool at the 2019 valuation.

### Cessation Valuations

When a Scheme employer exits the Fund and becomes an exiting employer, as required under the Regulations the Fund Actuary will be asked to carry out an actuarial valuation in order to determine the liabilities in respect of the benefits held by the exiting employer's current and former employees. The Fund Actuary is also required to determine the exit payment due from the exiting employer to the Fund or the exit credit payable from the Fund to the exiting employer.

Any deficit in the Fund in respect of the exiting employer will be due to the Fund as a single lump sum payment, unless it is agreed by the administering authority and the other parties involved that an alternative approach is permissible. For example:

- It is agreed with the administering authority that the exit payment can be spread over some agreed period;
- the assets and liabilities relating to the employer will transfer within the Fund to another participating employer; or

- the employer's exit is deferred subject to agreement with the administering authority, for example if it intends to offer Scheme membership to a new employee within the following three years.

Similarly, any surplus in the Fund in respect of the exiting employer may be treated differently to an exit credit, subject to the agreement between the relevant parties and any legal documentation.

In assessing the financial position on termination, the Fund Actuary may adopt a discount rate and adopt different assumptions from those used at the previous funding valuation in order to protect the other employers in the Fund from having to fund any future deficits which may arise from the liabilities that will remain in the Fund.

For example, if there is no guarantor in the Fund willing to accept responsibility for the residual liabilities of the exiting employer, then those liabilities are likely to be assessed on a "minimum risk" basis leading to a higher exit payment being required from (or lower exit credit being paid to) the employer, in order to extinguish their liabilities to the Fund and to reduce the risk of these liabilities needing to be met by other participating employers in future.

The cessation valuation of the liabilities attempts to ensure there are sufficient assets to meet all the liabilities over time. In the event that the assets of a ceased employer are insufficient to meet all the employer's residual liabilities then these liabilities will fall to the ceding employer who originally awarded the contract.

## Exit credits

MHCLG made an amendment to the 2018 Regulations which came into force on 20 March 2020, with effect from 14 May 2018. These regulations enable administering authorities to determine at their absolute discretion the amount of any exit credit payment due having regard to the following relevant considerations:-

- The extent to which the employer's assets are in excess of its liabilities
- The proportion of the excess of assets which has arisen because of the value of employer's contributions
- Any representations made by the exiting employer and its letting authority/guarantor
- Any other relevant factors.

Nottinghamshire County Council Pension Fund's approach aims to protect the interests of the members and employers as a whole and will apply the following approach to the payment of exit credits.

### **The extent to which the employer's assets are in excess of its liabilities**

The Fund's Actuary will calculate the assets and liabilities relevant to the exiting employer. The approach will depend on the specific details surrounding the employer's cessation scenario. Further details of the most likely approach is given in the section "Cessation Valuations"

### **The proportion of the excess of assets which has arisen because of the value of employer's contributions**

Exit credits will only be paid to employers who can demonstrate that they have been exposed to underfunding risk during their participation. The level of risk that an employer has borne will be taken into account. For example, if an employer participated in the Fund on a pass-through arrangement then no exit payment would have been requested if a deficit existed, and therefore it is not appropriate to pay an exit credit if there is a surplus.

On the other hand, if an employer commenced fully funded and was liable for any deficits arising as a result of adverse experience (for example, investment returns less than anticipated) then this employer has borne risk and so an exit debt or credit would be payable on exit.

Any exit payment will be limited to the total contributions paid over the period of participation into the Fund.

## **Any representations made by the exiting employer and its letting authority/guarantor and any other relevant factors.**

Under the Regulations, the administering authority has the discretion to take into account any other relevant factors in the calculation of any exit credit payable and will seek legal advice where appropriate.

The administering authority will pay out any exit credits within six months of the cessation date where possible. A longer time may be agreed between the administering authority and the exiting employer where necessary. If the employer does not provide all the relevant information to the administering authority within one month of the cessation date the administering authority will not be able to guarantee payment within six months of the cessation date..

## **Regulatory factors**

At the date of drafting this FSS, the government is currently consulting on potential changes to the Regulations, some of which may affect the regulations surrounding an employer's exit from the Fund. This is set out in the *Local government pension scheme: changes to the local valuation cycle and the management of employer risk* consultation document.

Further details of this can be found in the **Error! Reference source not found.** section below.

## **Links to Investment Policy**

The investment strategy and the funding strategy are linked by the strategic asset allocation of the Fund, which has been set following advice from the Fund's investment advisor and with regard, amongst other considerations, the maturity profile of the Fund.

The actuarial valuation involves a projection of future cashflows from the Fund and these cashflows are discounted to the current time, using the discount rate, to obtain a single figure for the value of the past service liabilities. This figure is the amount of money, which if invested now, would be sufficient to make those payments in future provided that the assumptions made during the valuation were borne out in practice (in particular, if the future investment return was equal to the discount rate used).

The discount rate is based on the expected long-term future investment return, using the long-term strategic allocation set out in the Investment Strategy Statement, with a deduction for expenses and for prudence. This ensures consistency between the funding strategy and investment strategy.

## **Risks and Counter Measures**

Whilst the funding strategy attempts to satisfy the funding objectives of ensuring sufficient assets to meet pension liabilities and stable levels of employer contributions, it is recognised that there are risks that may impact on the funding strategy and hence the ability of the strategy to meet the funding objectives.

The major risks to the funding strategy are financial, although there are other external factors including demographic risks, regulatory risks and governance risks.

## **Financial Risks**

The main financial risk is that the actual investment strategy fails to produce the expected rate of investment return (in real terms) that underlies the funding strategy. This could be due to a number of factors, including market returns being less than expected and/or the fund managers who are employed to implement the chosen investment strategy failing to achieve their performance targets.

The valuation results are most sensitive to the real discount rate. Broadly speaking an increase/decrease of 0.1% per annum in the real discount rate will decrease/increase the valuation of the liabilities by 2%, and decrease/increase the required employer contribution by around 0.6% of payroll p.a.

However, the Nottinghamshire Pension Fund Committee regularly monitors the investment returns achieved by the fund managers and receives advice from officers and independent advisers on investment strategy.

The Committee may also seek advice from the Fund Actuary on valuation related matters. In addition, the Fund Actuary may provide funding updates between valuations to check whether the funding strategy continues to meet the funding objectives.

## Demographic Risks

Allowance is made in the funding strategy via the actuarial assumptions for a continuing improvement in life expectancy. However, the main demographic risk to the funding strategy is that it might underestimate the continuing improvement in longevity. For example, an increase of one year to life expectancy of all members in the Fund will reduce the funding level by approximately 1%.

The actual mortality of pensioners in the Fund is monitored by the Fund Actuary at each actuarial valuation and assumptions are kept under review.

The liabilities of the Fund can also increase by more than has been planned as a result of early retirements. However, the Administering Authority monitors the incidence of early retirements and procedures are in place that require individual employers to pay additional amounts into the Fund to meet any additional costs arising from early retirements.

## Maturity risk

The maturity of a Fund (or of an employer in the Fund) is an assessment of how close on average the members are to retirement (or already retired). The more mature the Fund or employer, the greater proportion of its membership that is near or in retirement. For a mature Fund or employer, the time available to generate investment returns is shorter and therefore the level of maturity needs to be considered as part of setting funding and investment strategies.

The cashflow profile of the Fund needs to be considered alongside the level of maturity: as a Fund matures, the ratio of active to pensioner members falls, meaning the ratio of contributions being paid into the Fund to the benefits being paid out of the Fund also falls. This therefore increases the risk of the Fund having to sell assets in order to meet its benefit payments.

The government has published a consultation (*Local government pension scheme: changes to the local valuation cycle and management of employer risk*) which may affect the Fund's exposure to maturity risk. More information on this can be found in the **Error! Reference source not found.** section below.

## Regulatory Risks

The benefits provided by the Scheme and employee contribution levels are set out in Regulations determined by central Government. Regulations also place certain limitations on how the assets can be invested. The tax status of the invested assets is also determined by the Government.

The funding strategy is therefore exposed to the risks of changes in the Regulations governing the Scheme and changes to the tax regime which may affect the cost to individual employers participating in the Scheme.

However, the Administering Authority participates in any consultation process of any proposed changes in Regulations and seeks advice from the Fund Actuary on the financial implications of any proposed changes.

There are a number of general risks to the Fund and the LGPS, including:

- If the LGPS was to be discontinued in its current form it is not known what would happen to members' benefits.
- The potential effects of GMP equalisation between males and females, if implemented, are not yet known.
- More generally, as a statutory scheme the benefits provided by the LGPS or the structure of the scheme could be changed by the government.
- The State Pension Age is due to be reviewed by the government in the next few years.

At the time of preparing this FSS, specific regulatory risks of particular interest to the LGPS are in relation to the McCloud/Sargeant judgements, the cost cap mechanism and the timing of future funding valuations consultation. These are discussed in the sections below.

### **McCloud/Sargeant judgements and cost cap**

The 2016 national Scheme valuation was used to determine the results of HM Treasury's (HMT) employer cost cap mechanism for the first time. The HMT cost cap mechanism was brought in after Lord Hutton's review of public service pensions with the aim of providing protection to taxpayers and employees against unexpected changes (expected to be increases) in pension costs. The cost control mechanism only considers "member costs". These are the costs relating to changes in assumptions made to carry out valuations relating to the profile of the Scheme members; e.g. costs relating to how long members are expected to live for and draw their pension. Therefore, assumptions such as future expected levels of investment returns and levels of inflation are not included in the calculation, so have no impact on the cost management outcome.

The 2016 HMT cost cap valuation revealed a fall in these costs and therefore a requirement to enhance Scheme benefits from 1 April 2019. However, as a funded Scheme, the LGPS also had a cost cap mechanism controlled by the Scheme Advisory Board (SAB) in place and HMT allowed SAB to put together a package of proposed benefit changes in order for the LGPS to no longer breach the HMT cost cap. These benefit changes were due to be consulted on with all stakeholders and implemented from 1 April 2019.

However, on 20 December 2018 there was a judgement made by the Court of Appeal which resulted in the government announcing their decision to pause the cost cap process across all public service schemes. This was in relation to two employment tribunal cases which were brought against the government in relation to possible discrimination in the implementation of transitional protection following the introduction of the reformed 2015 public service pension schemes from 1 April 2015. Transitional protection enabled some members to remain in their pre-2015 schemes after 1 April 2015 until retirement or the end of a pre-determined tapered protection period. The claimants challenged the transitional protection arrangements on the grounds of direct age discrimination, equal pay and indirect gender and race discrimination.

The first case (McCloud) relating to the Judicial Pension Scheme was ruled in favour of the claimants, while the second case (Sargeant) in relation to the Fire scheme was ruled against the claimants. Both rulings were appealed and as the two cases were closely linked, the Court of Appeal decided to combine the two cases. In December 2018, the Court of Appeal ruled that the transitional protection offered to some members as part of the reforms amounts to unlawful discrimination. On 27 June 2019 the Supreme Court denied the government's request for an appeal in the case. A remedy is still to be either imposed by the Employment Tribunal or negotiated and applied to all public service schemes, so it is not yet clear how this judgement may affect LGPS members' past or future service benefits. It has, however, been noted by government in its 15 July 2019 statement that it expects to have to amend all public service schemes, including the LGPS.

At the time of drafting this FSS, it is not yet known what the effect on the current and future LGPS benefits will be.

## Consultation: Local government pension scheme: changes to the local valuation cycle and management of employer risk

On 8 May 2019, the government published a consultation seeking views on policy proposals to amend the rules of the LGPS in England and Wales. The consultation covered:

- amendments to the local fund valuations from the current three year (triennial) to a four year (quadrennial) cycle;
- a number of measures aimed at mitigating the risks of moving from a triennial to a quadrennial cycle;
- proposals for flexibility on exit payments;
- proposals for further policy changes to exit credits; and
- proposals for changes to the employers required to offer LGPS membership.

The consultation is currently ongoing: the consultation was closed to responses on 31 July 2019 and an outcome is now awaited. This FSS will be revisited once the outcome is known and reviewed where appropriate.

### Timing of future actuarial valuations

LGPS valuations currently take place on a triennial basis which results in employer contributions being reviewed every three years. In September 2018 it was announced by the Chief Secretary to HMT, Elizabeth Truss, that the national Scheme valuation would take place on a quadrennial basis (i.e. every four years) along with the other public sector pension schemes. The results of the national Scheme valuation are used to test the cost control cap mechanism and HMT believed that all public sector scheme should have the cost cap test happen at the same time with the next quadrennial valuation in 2020 and then 2024.

### Managing employer exits from the Fund

The consultation covers:

- Proposals for flexibility on exit payments. This includes:
  - Formally introducing into the Regulations the ability for the administering authority to allow an exiting employer to spread the required exit payment over a fixed period.
  - Allowing employers with no active employees to defer payment of an exit payment in return for an ongoing commitment to meeting their existing liabilities (deferred employer status).
- Proposals for further policy changes to exit credits. The proposed change would require the exiting employer's exposure to risk to be taken into account in calculating any exit credit due (for example a pass through employer who is not responsible for any pensions risk would likely not be due an exit credit if the amendments are made to the Regulations).

### Changes to employers required to offer LGPS membership

At the time of drafting this FSS, under the current Regulations, further education corporations, sixth form college corporations and higher education corporations in England and Wales are required to offer membership of the LGPS to their non-teaching staff.

With consideration of the nature of the LGPS and the changes in nature of the further education and higher education sectors, the government has proposed to remove the requirement for further education corporations, sixth form college corporations and higher education corporations in England to offer new employees access to the LGPS. This could impact on the level of maturity of the Fund and the cashflow profile. For example, increased risk of contribution income being insufficient to meet benefit outgo, if not in the short term then in the long term as the payroll in respect of these types of employers decreases with fewer and fewer active members participating in the Fund.



This also brings an increased risk to the Fund in relation to these employers becoming exiting employers in the Fund. Should they decide not to admit new members to the Fund, the active membership attributable to the employers will gradually reduce to zero, triggering an exit under the Regulations and a potential significant exit payment. This has the associated risk of the employer not being able to meet the exit payment and thus the exit payment falling to the other employers in the Fund.

There are relatively few employers of this type currently participating in the Fund and so the risks are considered relatively low at present.

## Employer Risks

Many different employers participate in the Fund. Accordingly, it is recognised that a number of employer-specific events could impact on the funding strategy including:

- Structural changes in an individual employer's membership
- An individual employer deciding to close the Scheme to new employees
- An employer ceasing to exist without having fully funded their pension liabilities.

The Administering Authority monitors the position of employers participating in the Fund, particularly those which may be susceptible to the events outlined and takes advice from the Fund Actuary when required.

In addition, the Administering Authority keeps in close touch with all individual employers participating in the Fund to ensure that, as Administering Authority, it has the most up to date information available on individual employer situations. It also keeps individual employers briefed on funding and related issues.

## Monitoring and Review

This FSS is reviewed formally, in consultation with the key parties as appropriate, at least every three years to tie in with the triennial actuarial valuation process.

The most recent valuation was carried out as at 31 March 2019, certifying the contribution rates payable by each employer in the Fund for the period from 1 April 2020 to 31 March 2023.

The timing of the next funding valuation is due to be confirmed as part of the government's *Local government pension scheme: changes to the local valuation cycle and management of employer risk* consultation which closed on 31 July 2019. At the time of drafting this FSS, it is anticipated that the next funding valuation will be due as at 31 March 2022 but the period for which contributions will be certified remains unconfirmed.

The Administering Authority also monitors the financial position of the Fund between actuarial valuations and may review the FSS more frequently if necessary.