

Identifying and managing risks

Addressee

This paper is addressed to the Pensions Committee of Suffolk County Council as administering authority for the Suffolk County Council Pension Fund (“the Fund”). It should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have especially accepted such liability in writing.

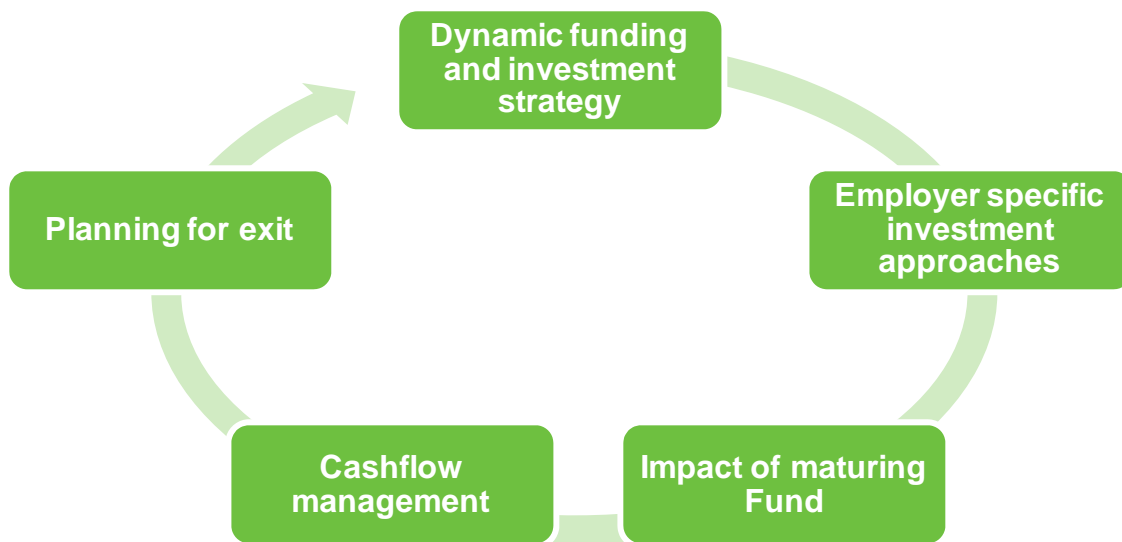
Background

The current economic and political landscape has increased the focus on pensions and, in particular, the LGPS. We are aware of a number of emerging trends and issues that are impacting many LGPS Funds as a result of the current reforms and the pressures caused by changes in investments markets. We have identified a number of key risks and themes that we believe funds should be aware of, and, where appropriate, start monitoring and managing these risks.

In this paper we outline each of these key themes, what the issue is and if we think this is something that the Committee needs to start making plans to deal with.

Key Themes

The 5 key themes we have identified are set out in the diagram below.



We believe it is important that the Fund is aware of the wider trends and risks facing many LGPS funds. However, the LGPS comprises a diverse range of funds with different membership, age and employer profiles. This means that the Committee should take an informed look at each of the themes and determine whether it is something that has relevance to them, could have a real financial impact on the Fund and is therefore something that needs to be looked at further.

HYMANS ROBERTSON LLP

Dynamic funding and investment strategies

Historically the investment strategy of most LGPS funds has been relatively static and has had a fairly significant allocation to more volatile returns seeking assets. This has broadly been true of Suffolk's investment strategy, although there have been more recent changes to the investment structure, as we discuss below. Increasingly funds are beginning to ask questions such as:

- Are we taking more risk than we need to?
- Could we take less risk without reducing the chances of achieving our long term funding objectives?
- What funding level do we need to achieve to take risk off the table and what is the growth strategy required to get there?

A dynamic approach to funding and investment strategy means that once funding levels reach a particular level (albeit most funds are well short of that level), it would be possible to reduce the amount of risk in the investment portfolio (i.e. to hold less in risky, growth assets) without reducing the likelihood of achieving long term success (which would generally be defined as achieving full funding in a specified time frame).

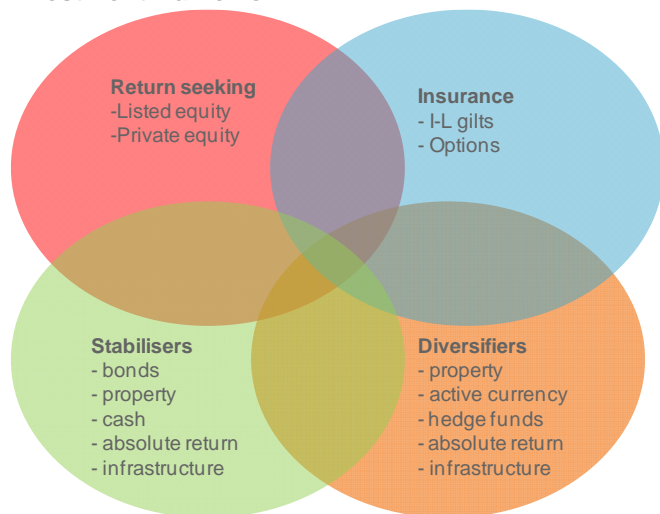
Relevance for Suffolk

The latest Navigator funding update in March 2012 showed an estimated gilts funding level of around 52%. While Suffolk is able to take a longer term perspective of investment and funding issues, it seems almost certain that the scope to reduce the amount of investment risk at the current time is minimal (without increasing contributions to unaffordable levels). [Note: Suffolk's gilts funding position is similar to most other LGPS funds.]

This position has been reflected in some of the recent investment strategy and structure work we have completed for the Committee. We have been keen to illustrate the scale of the problem currently facing Suffolk, particularly when we separate out future accrual. We can consider a "two funds" concept. This assumes a hypothetical split of the Fund into two parts, one in respect of the past service benefits (which holds all the assets and any deficit), and the other in respect of the future service benefits (which starts with no assets or liabilities). The key message taken from this concept is that changes to the future membership of the Fund do not have a direct impact on the deficit that already exists; however, the changes in future membership can impact the ability of the emerging future service assets and liabilities to mask the risks related to the past service liabilities.

When thinking about risk in this way, it means that the focus for improving the funding position has to be on generating a suitably high level of return in the most efficient way possible in order to reduce the deficit over time. The model Suffolk has used to identify these opportunities, illustrated below, and the recent changes to structure that have been agreed, exemplify this approach.

HYMANS ROBERTSON LLP

Investment framework

- Return seeking – principally equities.
- Stabilisers – lower risk assets with a greater predictability of return.
- Diversifiers – assets that seek to optimise return-seeking over different scenarios
- Insurance – assets that perform well when other assets are doing poorly. Insurance assets typically are a drag on returns (like an insurance premium).

In the short to medium term, we believe that the focus of the Committee should be to continue to identify and capture return generating opportunities in a risk efficient manner. There is little immediate prospect of moving from growth assets to lower risk assets.

However, following the next actuarial valuation in 2013, we would recommend that Suffolk review the Fund's longer term plan. The Committee should consider what a "dynamic" funding and investment strategy would look like for the Fund and have a clear plan in place (since things can change suddenly and it may take longer to sort out the governance).

Employer specific investment strategies

It is easy to assume that the LGPS comprises a set of homogenous funds, with similar underlying employers, facing exactly the same problems. However, we have always been aware that the composition and liability mix of each fund can differ significantly. These differences are increasingly coming to the fore as some authorities, employers, or both parties, become aware of some of the risks that they are exposed to. Some of the key objectives of the LGPS as a whole (affordability and stability of contributions) can result in an investment and funding strategy which may not meet the objectives of all the underlying employers within each fund. This has led to some funds considering separate investment strategies for different employers.

There are a range of circumstances which might cause you to consider employer specific investment strategies. These include:

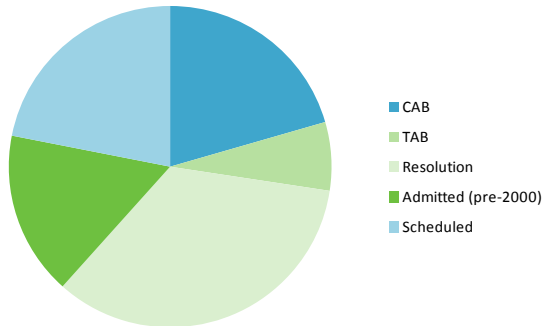
- Employers such as short term contractors that may be taking too much risk;
- Employers (e.g. magistrates) wanting to protect well or fully funded positions, including employers who have paid a gilts cessation basis;
- Employers heading for exit who want to reduce volatility; and
- The administering authority wanting to be protected from legal claims from employers who believe they have been unfairly exposed to investment risk.

While the implementation of separate investment strategies poses a significant challenge we are aware of some funds that are already doing this or are currently looking at the possibilities in more detail.

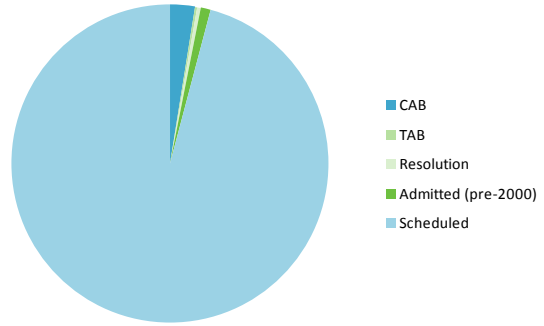
Relevance for Suffolk

In the two charts below we have shown the split of the Fund liabilities by type of employer. To understand the potential importance of the employer mix we have shown this by number of employer and also weighted by liability.

Employer split by number



Employer split by liability



The first chart shows that, of the 70 or so employers that form the Fund, a reasonable proportion of these by number are either Community or Transferee Admitted Bodies. These are the types of employer that might typically be facing some of the employer specific issues above. However, by liability, these employers are only around 3% of the value of the total Fund. The Fund is dominated by the Scheduled bodies.

The question is whether there is any benefit in considering employer specific investment strategies for this, relatively small, proportion of liabilities. In our view we do not think this is a key area of importance for the Fund at this point in time.

However, there are some potential exceptions to this. There were recent proposals to outsource a significant proportion of the services within Suffolk County Council. Depending on the basis for this type of change, there could potentially be a significant change to the employer mix and the covenant and risk tolerance of the employer as a result of this change. If such a change were implemented, then we believe it would be worthwhile reconsidering the employer mix and the potential need for employer specific strategies.

A recent change along these lines is the move by a number of schools to academy status (recent transfers comprise around 3% of fund liabilities). While the employer in this instance is still effectively government-backed it is unclear if there will be a difference in the tolerance for risk and short term volatility and the extent to which this is allowed for in funding discussions. This might be a developing area of for future risk management work.

Changing membership profile

Many funds have already started looking at some of the “bigger picture” risks impacting the membership. We believe that the maturity of the membership has been accelerating in recent years. There have been a range of reasons for this shift including pensioners living longer, direct policy actions such as outsourcing, early retirement and redundancy exercises, or opt-outs resulting from higher contribution rates. The speed and impact will vary from one Fund to the next.

We believe that, for many funds, it is important they investigate the consequences of possible or expected changes in membership. The impact of something like the level of opt-outs is probably the hardest to gauge for most funds, particularly when we balance this against auto-enrolment. However, most Funds will have a much clearer idea on the authority’s plans for staffing levels and plans to outsource work.

There are a range of risks relating to a change in the membership profile that we need to be aware of:

- Any immediate financial implications (are transfers out required and if so on what basis);

HYMANS ROBERTSON LLP

- How this will impact the short term cash flow position of the Fund;
- What it means for the long term required level of returns given the impact on maturity and investment time horizons; and
- The implications for contribution and investment strategies.

In the past, many authorities have outsourced services and only considered the immediate implications from a payroll (and political) perspective. The cost from a pensions perspective is something that needs to be carefully considered.

Relevance for Suffolk

At the last actuarial valuation, about 40% of the Fund's liabilities were pensioners. This had increased very slightly from around 38% at the previous valuation reflecting a slight shift in maturity over the period. It is unclear whether this is likely to continue, but the extent to which Suffolk and the underlying employers are being impacted by pressures to reduce the workforce and make savings across the public sector would suggest that this is the case.

By far the biggest potential issue for the Fund is the extent to which outsourcing is adopted and on what basis. Some of the plans for the Fund which were discussed in recent years could have a significant impact on the risk profile of the Fund. Any decisions on outsourcing need to account for the impact this would have on the pension Fund. If there are a significant number of outsourcings (particularly if these take place on a closed basis), then the impact on the stabilisation mechanism currently in place to manage contribution rates may be affected. In the extreme, the membership changes could mean that the chances of the Fund reaching full funding within the timescales set at the last valuation using comPASS modelling may be no longer acceptable to the Committee. We therefore recommend that comPASS is revisited at the 2013 actuarial valuation cycle (which will take into account the significant market changes since 2010 which will also put pressure on the stabilisation mechanism currently in place).

More generally, in our view the maturity and changes to the membership profile are factors which the Committee should monitor over time, either as part of the regular valuation cycle or as any significant changes to the liability structure are considered.

Practical cashflow management

As discussed above, we are seeing greater evidence of the maturity profile of LGPS funds increasing. The result is that some funds are becoming cash flow negative, either in terms of benefit outflow relative to contribution income, or for some, even allowing for investment income. The assets are there to pay the benefits so it is inevitable that funds will need to draw on them at some point; however, that date may occur sooner than originally expected.

A change in the cash flow profile in the short term is not a significant risk. However, it poses some practical problems which many funds have never had to face before, the key issue being, ensuring there is cash to make benefit payments when they fall due. This means that many Funds are starting to face questions such as; how much cash will I need each month, and what level of cash balance should I try and maintain?

We have been working with some Funds to help them understand their cash balance needs and how this might vary from month to month. This requires us to look in more detail at the expected cash flows, the assumptions underlying them and the extent to which actual cash flow experience can differ from the expected. This means looking closely at the expected cash flows from the benefit side (pension payments, lump sums, transfers and contributions) as well as the assets and the investment structure.

HYMANS ROBERTSON LLP

Relevance for Suffolk

Last year we carried out some analysis of the net cash flow position of the Fund and how this might change depending of different assumptions about the future membership. The main scenarios that were considered were a continuation of the active membership at current levels and immediate reductions of 15% and 25% in the active membership.

This analysis showed that the Fund was in a relatively strong and positive net cash flow position. The net cash flow position (excluding investment income) is expected to remain positive for the next 20 years if the active membership is maintained and this would remain so for even a 15% fall in the active membership. A more significant fall of 25% in the active membership would bring the net position closer to neutral going forward and therefore make cash flow management more of an issue. These projections also do not account for unexpected "spikes" in cashflow requirements resulting from early retirements and lump sum payments which can cause shorter term issues.

It should be noted that none of the above scenarios take investment income into account in the net cash flow position. At the moment all income is reinvested across the mandates. If investment income is taken into account, then cash flow should be manageable even in more extreme conditions subject to organising the investments appropriately. Some of the recent changes to investment structure also have implications for the ability to generate and access cash on a short term basis.

In addition, the analysis was carried out before the announcement regarding extension to pay restraint for local government employers in Autumn of last year. The further pay restraint could impact on the contribution income (and therefore net cash flows) to the Fund due to falling salary levels over the short and longer term.

In our view the Committee should consider delegating the officers to:

- Review the cash flow position on a regular basis as the membership evolves;
- Review the level and regularity of cash generation within the various mandates and the ability to draw this down if needed;
- Review the liquidity of the mandates within the Fund and the ability to realise assets at short notice if required (given redundancy programmes can result in short term spikes in cash requirements).

Planning for exit

As shown earlier in this paper there are a number of employers and sections of the liabilities that potentially have limited tenure in the Fund. This means that some employers and the Fund itself may be exposed to a range of risks and uncertainties. These include:

- Shifting goalposts from ongoing funding to gilts based funding at exit (resulting in a much higher cash funding requirement);
- Uncertain timing of exit / last active leaving;
- Uncertain employer covenant; and
- Unaffordable funding plans (gilts based funding, shorter deficit recovery period).

There are a number of ways that we can help manage the risks to the Fund and the underlying employers. Some of the actions that the Fund could take include:

- Identifying and monitoring the employers at risk or clearly heading for exit;
- Starting a dialogue with employers including providing information on outcomes and options (e.g. quantifying gilts shortfall);

HYMANS ROBERTSON LLP

- Putting in place a plan for the route to exit;
- Creating funding solutions involving security which help the employer and the overall Fund;
- Developing exit policies and articulate through a formal 'employer policy' or the FSS;
- Once funding is on track, assisting with complementary investment approaches (as per earlier section);
- Introducing pre and post-retirement discount rate target Funding Levels (better for maturing employers); and
- Working with employers to set affordable funding plans using tools like our "tractor" and "comPASS" models.

We believe that these type of measure will reduce risk to the administering authority (e.g. risk that employer refuses to pay and argues that it wasn't clear what the outcome would be at exit) in addition to helping the employers understand and plan for the future.

Relevance for Suffolk

As shown in the charts earlier in this paper, while relatively small by liabilities, there are a number of employers that may at some point exit the Fund. At that point, they will be required to pay what would be a substantial amount of money which they may or may not be able to afford. This is a significant risk to the Fund and one that can grow over time as pools of orphaned and underfunded liabilities emerge.

We believe that, in the lead up to the next valuation year, the Committee should identify the employers that may be heading toward an exit position and either enters into discussions with them on funding plans or develops an acceptable plan on how to manage their risks in future.

Summary and conclusions

Helping the Committee to understand and manage risk is a very important part of our role as advisers. This paper provides a brief summary of our views on some of the emerging risks within the LGPS and the extent to which the Fund may be affected by these risks. We believe that many of these risks are already in hand or do not pose an immediate threat to the Fund. However, changes like a major outsourcing or further significant cuts in staffing and pension scheme membership could change this position.

Of the risks identified, we believe that the Committee should ensure that there are adequate plans in place leading up to the valuation for those employers approaching exit from the Fund to protect against being left with a deficit from those employers that they are unable to fund.

There are a number of other risks such as changes to the membership profile and the cash flow profile that have the potential to become more significant over time and therefore we recommend that they are reviewed at suitable intervals going forward.

Prepared by:-

David Walker, Investment Consultant

Linda Dudley, Actuary

July 2012

For and on behalf of Hymans Robertson LLP