CUMBRIA PENSIONS COMMITTEE
Meeting date: 23rd June 2020
From: Julie Crellin, Director of Finance (S151 Officer)

PENSION FUND UPDATE - PART 1

1.0 EXECUTIVE SUMMARY

1.1 ***This report provides Members with information supporting the recommendations to:***

- ***ensure compliance with amendments to LGPS regulations regarding exit credits for employers within the LGPS; and***
- ***to approve the draft unaudited accounts of the Cumbria LGPS for 2019/20.***

2.0 STRATEGIC PLANNING AND EQUALITY IMPLICATIONS

2.1 ***The Council's vision is to be "A Council that works with residents, businesses, communities and other organisations to deliver the best services possible within the available resources". As part of the approach to delivering this vision the Council aims to "Put customers at the heart of everything we do".***

2.2 ***Content that can be reported within the public domain is presented within this Part 1 report to Pensions Committee with commercially sensitive information and information not for public disclosure being presented in the Part 2 Pension Fund Update report on the agenda.***

2.3 ***There are no direct equality implications arising out of the recommendations in this report.***

3.0 RECOMMENDATIONS

It is recommended that the Pensions Committee:

3.1 ***Approve amendments to the Admission & Termination Policy, subject to consultation with Fund employers.***

3.2 Submit to the Audit and Assurance Committee (subject to any final amendments) the Cumbria LGPS Accounts 2019/20 for approval on behalf of the Council.

4.0 REGULATORY CHANGES WITHIN THE LGPS

4.1 Exit Credits

4.1.1 Where an employer within the LGPS contracts out part of its services (e.g. cleaning services) to a third party service provider, this will often involve a TUPE transfer for the affected staff. In most instances, that service provider will become a specific type of participating employer in the LGPS known as an ‘Admission Body’ and usually the letting employer will become a guarantor to the Admission Body.

4.1.2 With the LGPS being a defined benefits scheme, there is a risk that employer pensions contributions can increase during the term of the contract and pension liabilities may accrue that would be become due from the Admission Body on cessation of the contract (assuming that contract was not re-let to the service provider).

4.1.3 Consequently, employers can enter into a “risk sharing arrangement” where the letting employer agrees to limit the exposure of LGPS pension costs to the Admission Body both during the term of and at the termination of the contract. Such arrangements seek to ensure that the bidders for a contract would not need to price in additional LGPS risk to their contract price and thereby deliver better value for money the letting employers.

4.1.4 In May 2018, LGPS Regulations were amended to require Funds to pay an “exit credit” where an exiting employer’s net Funding Position within the Fund exceeded 100%. However, this took no account of any risk-sharing arrangements that some employers had with their letting authorities. This led to the scenario where an employer may have been protected through a risk sharing arrangement during their term in the LGPS, but also benefited from receipt of an exit credit at termination.

4.1.5 To rectify this. in February 2020, the Ministry of Housing, Communities and Local Government (MHCLG) confirmed that they would amend the LGPS Regulations so that:

- Administering authorities may determine the amount of any exit credit payment due, having regard to any relevant considerations, including representations from the exiting admission bodies and their letting employer; and
- The period within which an exit credit must be paid is increased from three months to six months (or a longer time, if agreed by the administering authority and the exiting employer).

4.1.6 MHCLG also noted that:

- Administering authorities will not be obliged to enquire into the precise risk sharing arrangement adopted. It will be for the parties to the arrangement to set out why the arrangements made by them make payment of an exit credit more or less appropriate;
- The Pensions Ombudsman has jurisdiction to hear complaints if any dispute is not resolved using the internal dispute resolution process; and
- Administering authorities should adopt a fair and reasonable exit credits policy which should be set out in their Funding Strategy Statement.

4.1.7 The amendment to the regulations required to give effect to these proposals came into force on 20th March 2020, but their effect is to be backdated to 18th May 2018.

4.1.8 The Fund has worked with the Actuary to update the Fund's Admission & Termination Policy (which forms part of the Fund's Funding Strategy Statement) to integrate a draft exit credit policy. This amended policy is presented in Appendix 1 to this report and, for ease of reference, areas of change have been highlighted in grey.

4.1.9 Essentially, where an Admission Body leaves the Fund:

- The Fund will write to the Admission Body and guarantor requesting written evidence of any risk sharing agreements within 14 days of notification.

  - Where evidence is provided, the Fund will follow the risk sharing protocols set out within the agreement between the two parties. Where there is no clarity within the risk sharing agreement as to the treatment of deficits or exit credits on termination, the Fund will determine the amount of any deficit due or exit credit payment due and to which party, having regard to any relevant considerations and taking account of the employers' exposure to risk.

  - Where no evidence is provided, the Fund will pursue the Admission Body for any deficit or pay any exit credits to the Admission Body. Where the Admission Body defaults on any liabilities due to the Fund, the guarantee will be called in from the guarantor.

- If the outgoing Admission Body disputes the treatment then the two parties will be expected to reach an agreement amongst themselves, and if they cannot then the Fund's IDRP process should be used. The Pensions Ombudsman has jurisdiction to hear complaints if the IDRP fails to resolve the dispute.

4.1.10 This treatment is in line with the Regulations, and is designed to ensure that the treatment on termination reflects the treatment of funding risk in the admission, and to avoid a situation where a Participating Employer can potentially benefit from a surplus without bearing responsibility for a deficit (or vice versa).

4.1.11 Minor amendments, associated with the 2019 actuarial valuation, have also been made to the policy.

4.1.12 It is recommended that Pensions Committee approve these amendments to the Admission and Termination Policy subject to a consultation with the Fund employers. This consultation will commence in August and the outcomes will be reported to a future Pensions Committee.

5.0 DRAFT UNAUDITED ACCOUNTS TO 31ST MARCH 2020

5.1 Timeframe

5.1.1 The Accounts and Audit Regulations 2015 (as amended) ordinarily require each Local Authority to publish its unaudited annual accounts (including the accounts of the Local Government Pension Scheme) by 31st May and publish its complete and audited accounts by 31st July. To help ease the burden on Local Authorities arising as a result of the unprecedented situation across the UK relating to COVID 19, the Government has issued revised Regulations for the production of the 2019/20 accounts. The revised Regulations apply to the 2019/20 accounting year only and require that unaudited accounts are published by 31st August 2020 and audited accounts by 30th November 2020.

5.1.2 At present, the Fund is aiming to publish its unaudited accounts on 26th June on its website. The draft accounts are presented in Appendix 2 to this report. These are subject to ongoing review and, consistent with accounting practice, if a material amendment (although not expected) was required to the accounts between the release of this report to Pensions Committee and 26th June, this will be reflected in the published unaudited accounts. Committee will be informed of the progress of the audit at its meeting in September.

5.1.3 The extension to accounts deadlines may result in narrative within the accounts being amended. In particular, the Events After Reporting Date (Note 21) - where the Fund is required to detail relevant significant events that have occurred within the Fund between 31st March 2020 and the publication of the audited accounts – may require updating before the final publication. The Note currently includes commentary regarding the impact of COVID-19 on the Fund and details of the merger of Northumberland and Tyne & Wear pension funds (two of the original partners of Border to Coast). Examples of events that may result in amendments to the Note include; further relevant information relating to the impact of COVID-19 on Fund assets, and material developments in relation to the McCloud judgement.

5.2 Summary of key Fund figures for the year-ended 31st March 2020

5.2.1 Membership: As at 31st March 2020 the total membership of the Fund was 58,396 (2018/19: 57,840) and consisted of 16,989 contributors/actives (2018/19: 16,453), 24,420 deferred members (2018/19: 25,202) and 16,987 pensioners (2018/19: 16,185).

5.2.2 Employers: At 31st March 2020 there were 126 (31st March 2019: 127) employer bodies in the Cumbria LGPS (for the full list see Note 25 within Appendix 2). The number of employers reduced by one during the year, this was as a result of one Academy employer joining the Fund and two Academies merging with others already in the Fund.

5.2.3 Performance: The Fund's investment performance is summarised at 5.2.5 and 5.2.6 below and, to provide context of how this sits in relation to market performance, this is preceded (at 5.2.4) by consideration of performance seen in global markets.

5.2.4 Global Investment Market Performance: The first nine months of the year-ended 31st March 2020 saw positive returns in most investment markets. In particular, global equity markets ended 2019 with gains and the best calendar year performance in a decade. The last quarter of the year, however, was dominated by the emergence of the COVID-19 pandemic. This had a significant effect on investment markets, for example Global and UK listed equities delivered negative returns of -16.0% and -25.1% respectively over the quarter, and negative returns of -6.7% and -18.5% respectively over the full year to 31st March 2020[1].

5.2.5 Fund-specific performance: The Fund's long-term approach to investment and its diverse portfolio of investment assets meant that, whilst it was affected by the significant market movements described in 5.2.4 above, the impact on performance was not as extreme as that experienced in the aforementioned equity markets. Overall, the Fund returned on its investments -2.8% (net of fees) for the year-ended 31st March 2020. As at 31st March 2020 the unaudited value of the Fund's net assets was £2,574m (a decrease of £129m (4.77%) from £2,703m as at 31st March 2019). In conclusion it is pleasing to note that the Fund's performance was better than the performance of the global and UK equity markets and, as at 31st March 2020, the Cumbria LGPS was approximately 91.1% funded.

5.2.6 The Fund is primarily focussed on longer-term performance and, whilst the Fund underperformed against its 3 year benchmark (delivering a return of 2.6% p.a. against a benchmark of 3.2%) it outperformed both its 5 and 10 year benchmarks (5 year: 5.6% p.a. against a benchmark of 5.2% and 10 year: 7.7% p.a. against a benchmark of 7.1%).

5.3 Key activities in 2019/20 included:

5.3.1 The completion of a Strategic Investment Review and the 2019 Actuarial Valuation;

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[1] As measured by the MSCI AC World Index and the UK FTSE All Share.

5.3.2 The completion of the transition of the Fund's Global Equity portfolio (equating to £588m, approx. 20% of the Fund at the point of transition) to Border to Coast's externally managed Global Listed Equity Alpha Fund;

5.3.3 The approval of new investments of £120m in Border to Coast Infrastructure Funds; £70m in a Border to Coast Private Equity Fund; and £50m in Partners Group Private Markets Credit fund; and

5.3.4 Steps were made to implement the revised strategic asset allocation as agreed in December 2019, including the first priority steps of reducing the Fund's listed equity holdings (by £340m, approx. 12% of the Fund) and, in conjunction with this, exiting the 'equity protection' overlay.

- The equity protection overlay (on c.£1bn of UK, US and European listed equities, representing approx. 36% of the total Fund value at that time) was implemented in April 2018 as a temporary solution to mitigate the risk of increased employer contributions at the 2019 actuarial valuation. This was duly achieved and the valuation signed-off by 31st March 2020.
- As noted above, the Fund exited the equity protection overlay in conjunction with undertaking the 12% strategic reduction in its holding of listed equities. Both activities took place in February when valuations of listed equities were considerably higher than those subsequently seen in March 2020. As such, whilst there was a cost to exiting the overlay, high level calculations indicate that this was more than offset by gains realised on the sale of the £340m listed equities. This is reflected in the performance of the Fund to 31st March 2020 which, as noted above, was -2.8% for the year against a backdrop in which the global and UK equity markets delivered returns of -6.7% and -18.5% respectively[2].

5.3.5 The implementation of the revised Strategy also involved the investment in a new 'Multi-Asset Credit' asset allocation to be 12% of the Fund. The new investments chosen were £100m with Apollo, £100m with CQS, and £130m with PIMCO.

5.4 Estimates within the Accounts

5.4.1 Members will be aware that the notes to the accounts set out the classification of asset and liability valuations into three levels, according to the quality and reliability of information used to determine their fair value (this is referred to as the 'Fair Value Hierarchy').

- Level one assets are those which are the most easily valued, such as listed equities and cash, as their values are derived from unadjusted quoted prices in active markets for identical assets or liabilities. 9% of the Fund's assets as at 31st March 2020 were classed as level 3.
- Assets are classed as level two when, whilst quoted market prices are not readily available, there is sufficient evidence to enable the valuation to be based significantly on observable market data. This includes pooled funds where the underlying assets are quoted assets such as equity and fixed interest bonds. 56% of the Fund's assets as at 31st March 2020 were classed as level 2.

[2] As measured by the MSCI AC World Index and the UK FTSE All Share.

- Level three assets are those where quoted market prices are not available and where at least one input into the valuation could have a significant effect on the calculation is not based on observable market data. Examples include property, private equity and infrastructure. 35% of the Fund's assets as at 31st March 2020 were classed as level 3.

5.4.2 As in previous years, where the actual value of an asset is not available as at 31st March 2020 (i.e. for the level 3 assets) the accounts include estimates of asset values. These estimations are undertaken by experienced professionals, for example, the Fund's directly held property portfolio is valued by an appropriately qualified (RICS) independent property valuer (CBRE Limited).

5.4.3 Property: In March, CBRE advised the Fund that, due to the impact of COVID-19 on the property market, it had concluded that it could attach less weight than in prior years to previous market evidence for comparison purposes used to inform opinions of value. As a result, CBRE has incorporated a 'material uncertainty' clause in their valuation. This is unusual but not unexpected in the circumstances, affecting financial and property markets internationally. This is consistent with the approach taken nationally and both CIPFA and the Royal Institute of Chartered Surveyors (RICS) have indicated that this does not necessarily imply that the valuation cannot be relied upon. Indeed, Ben Elder FRICS (Global Director of Valuation at RICS) issued the following statement[3]:

'Where a material uncertainty clause is being used, its purpose is to ensure that any client relying upon that specific valuation report understands that it has been prepared under extraordinary circumstances.

The term is not meant to suggest that the valuation cannot be relied upon; rather, it is used in order to be clear and transparent with all parties, in a professional manner that – in the current extraordinary circumstances – less certainty can be attached to the valuation than would otherwise be the case. Indeed, with regard to the process itself, professional valuers will almost certainly have undertaken far more due diligence than normal, in order to arrive at their estimate of value.'

5.4.4 Private Equity: Valuations for Private Equity investments are usually received a quarter in arrears, but in recognition of the potential significance of market impact from the global pandemic, the Fund has taken steps to ensure these investment are valued at an estimate to the fair value at 31st March, as best as is available at the time of preparation.

5.4.5 Some underlying investments are by the nature of their revenues more resilient than others, e.g. healthcare versus consumer spending. Where estimates have not been available for underlying investments, the relevant managers (Aberdeen Standard and Pantheon) have provided investors with an estimated decrease in valuation due to COVID-19 reflecting an impact similar to that in the public market sector indices. All such estimated decreases are subject to a degree of uncertainty; it is a highly fluid situation

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3 https://www.rics.org/uk/upholding-professional-standards/sector-standards/valuation/valuation-coronavirus/

and, whilst May saw a recovery of much of the decline in the public markets, returns are still volatile and the economic outlook remains uncertain.

5.4.6 Infrastructure: The Fund's Infrastructure investments have, in general, been impacted to a lesser degree by the global pandemic, as these include operational assets in renewable and contracted energy, power distribution and utilities. The largest private market investment held by the Fund, £121.897m in JPM Infrastructure Fund, has confirmed its valuation for March 2020 including audited valuations for each underlying portfolio company.

5.4.7 Officers have discussed the use of estimates in the unaudited accounts with the Fund's external auditors, Grant Thornton (GT). GT noted that they would be focussing part of their audits in relation to LGPS Pension Funds on evaluating whether, in their view, sufficient audit evidence can be obtained to corroborate significant estimates such as direct property asset valuations. This may lead to them adding an "Emphasis of Matter" paragraph into the Audit Opinion and Audit Findings Report. Such a paragraph is not a qualification to the audit opinion. Instead, it is a section intended to draw the user's attention to the material valuation uncertainty.

5.5 Next steps

5.5.1 The terms of reference of the Pensions Committee include the requirement that it submit the Pension Fund annual accounts to the Council. This is accomplished by submitting the annual accounts to the Audit and Assurance Committee as part of the Council's Accounts for approval on behalf of Council. It is therefore recommended that the draft unaudited accounts of the Cumbria LGPS for 2019/20 (subject to any final amendments) be submitted to the Audit and Assurance Committee for approval on behalf of the Council.

5.5.2 The audit plan will be presented by Grant Thornton to the Audit and Assurance Committee at its meeting of 29th July. The Pensions team continue to work with the external auditor as they prepare for the audit and implement the audit.

5.5.3 Pensions Committee will be provided with an update on the progress of the audit at its meeting scheduled for 15th September 2020. It is currently planned for the Audit and Assurance Committee to review the final accounts of the Council, including the accounts of the Cumbria LGPS, at its meeting on 3rd November.

6.0 OPTIONS

6.1 Pensions Committee may either:

- Approve the recommendations presented within this Pension Fund report; or
- Request further information from the Director of Finance (S151 Officer).

7.0 RESOURCE AND VALUE FOR MONEY IMPLICATIONS

7.1 Amendments to the LGPS Regulations associated with exit credits are not expected to have a significant resource implication to the Fund.

7.2 Resource and value for money implications of the Fund are considered within the draft Cumbria LGPS Accounts 2019/20 presented in Appendix 2.

8.0 LEGAL IMPLICATIONS

8.1 Under the Constitution Part 2H paragraph 2.2 (f) provides that it is a function of the Committee to annually review (as a minimum) and approve any amendments to the statutory policy statements as required by Local Government Pension Scheme Regulations.

8.2 Under the Constitution Part 2H paragraph 2.2 (a) provides that it is a function of the Committee to submit the Pension Fund Accounts to the Council in line with current financial standing orders

9.0 CONCLUSION

9.1 The Fund will update its Admissions and Termination policy to account for updated LGPS Regulations to exit credits for employers terminating from the Fund. These amendments are recommended subject to consultation with employers.

9.2 It is expected that the Fund will publish its unaudited accounts for 2019/20 on 26th June. The unaudited fund value at 31st March 2020 was £2,574m - a reduction of £129m since 31st March 2019.

Julie Crellin
Director of Finance (S151 Officer)

23rd June 2020

<u>APPENDICES</u>

Appendix 1 Amended Admission & Termination Policy
Appendix 2 Draft Unaudited Cumbria LGPS Accounts 2019/20

Electoral Division(s): All

Executive Decision		No	
Key Decision		No	
If a Key Decision, is the proposal published in the current Forward Plan?			N/A

Is the decision exempt from call-in on grounds of urgency?		No	
If exempt from call-in, has the agreement of the Chair of the relevant Overview and Scrutiny Committee been sought or obtained?			N/A
Has this matter been considered by Overview and Scrutiny? If so, give details below.		No	
Has an environmental or sustainability impact assessment been undertaken?			N/A
Has an equality impact assessment been undertaken?			N/A

N.B. ***If an executive decision is made, then a decision cannot be implemented until the expiry of the eighth working day after the date of the meeting – unless the decision is urgent and exempt from call-in and necessary approvals have been obtained.***

PREVIOUS RELEVANT COUNCIL OR EXECUTIVE DECISIONS

No previous relevant decisions.

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