

Pension Board

Date:	23 August 2016
Classification:	General Release
Title:	Risk Register Review
Report of:	Steven Mair <i>City Treasurer</i>
Wards Involved:	All
Policy Context:	Effective Control over Council Activities
Financial Summary:	There are no financial implications arising from this report

1. Executive Summary

- 1.1 This report gives an overview of the risk management arrangements for the Westminster Pension Fund.
- 1.2 This report focuses on two strategic funding risks to the Pension Fund. Firstly, the level of inflation and interest rates assumed in the valuation being inaccurate and secondly, Scheme members living longer than expected, both which could lead to higher than expected liabilities.

2. Key Matters for the Board

- 2.1 The Board note the contents of this paper.
- 2.2 The Board members consider an area of the Risk Register to focus on for the next meeting.

3. Background

- 3.1 As previously reported to the Pensions Board, it is best practice for Pension Funds to maintain a risk register to ensure that the risks they face are properly understood and where appropriate action is needed to mitigate them.

- 3.2 Risk management is an issue for all those involved in the management of an LGPS fund, including members of the Pension Fund Committee, officers managing the Fund and the fund administrator. The Pension Board's role is to assist the administering authority in such activities to ensure effective and efficient governance and administration of the Scheme, as outlined in its Terms of Reference. This includes making recommendations to the Committee concerning good governance.
- 3.3 Attached at Appendix 1 is the updated Pension Fund Risk Register, which was reported to the Pension Fund Committee (the 'Committee') in June 2016. This supersedes the version which was previously presented to the Pension Board. The risk register is a 'live' document and risks will change due to management action and the external environment.
- 3.4 The Pension Board members agreed at the preceding meeting which sections of the Risk Register they wish to focus on in future meetings.

4. Focus Area: Strategic: Funding – Inflation and Interest Rates Assumed in the Valuation are Inaccurate

- 4.1 *"The level of inflation and interest rates assumed in the valuation may be inaccurate leading to higher than expected liabilities"* is one of the risk areas which Board members have decided to focus on. This is referenced as Risk 4 in Appendix 1.
- 4.2 This risk has a medium risk classification. Strategic risks are generally inherent and cannot be mitigated against although the Pension Fund Committee needs to be aware of these risks particularly when making strategic decisions.
- 4.3 The following information has been provided by the Fund's Actuary, Barnett Waddingham.

Inflation

- 4.4 Inflation will have a direct impact on liabilities. For example, the rate of pensions increase is linked to the Consumer Prices Index. The following table sets out the pension increase orders applying to final salary benefits, which account for most of the Fund's liabilities, over the last three years:

Year	Pension increase order
2014	2.7%
2015	1.2%
2016	0%

- 4.5 Therefore, over the three year period, current and deferred final salary pensions were uprated by an effective rate of 1.3% p.a. This compares with the pension increase assumption of 2.7% p.a. at the 2013 valuation. Hence, looking at the pension increase experience alone, liabilities will have increased by less than assumed and this will help the funding position.
- 4.6 Similarly, the 2013 valuation assumed future inflationary salary growth of 1% p.a. over the three years to 31 March 2016 (in addition to a promotional scale), which is in line with the public sector pay awards over the period. Therefore Barnett Waddingham would not anticipate any significant deterioration in the funding position due to salary increases being higher than assumed, but they can confirm this when they carry out a full salary experience analysis as part of the valuation.
- 4.7 The starting point for the actuary when estimating future inflation levels is the market expectation as reflect in gilt and derivative pricing. The Actuary will also take into account other factors such as the Bank of England inflation target, history etc and may modify the market rate. The Actuary is forecasting very long term and this expects periods when out-turns will be lower or higher.

Interest rate / Discount rate

- 4.8 The most important assumption Barnett Waddingham make as part of each valuation is the discount rate, the assumed investment return on the Fund's assets. The 2013 valuation used a discount rate of 5.9% p.a. for Scheduled Bodies, with a lower discount rate being used for Admission Bodies reflecting the lower level of credit quality. The extent to which the actual investment return differs from the assumed investment return will affect the funding position and Barnett Waddingham does monitor this as part of their quarterly funding updates. From the most recent reports, it can be seen that the value of the Fund's assets are higher than where they were projected to be at the 2013 valuation, with an estimated return over the three year period of about 6.9% p.a..
- 4.9 The approach to setting the assumed investment return, or discount rate, is driven by the Fund's actual investment strategy. Barnett Waddingham take a view on the returns that may be expected from the Fund's actual asset allocation. This helps to maintain stability in the funding position and hence avoid significant volatility in the required contribution rate, which is of course a key risk. By contrast, other actuaries determine the discount rate in part by using the returns available on government bonds, regardless of which assets the Fund holds, and this "mismatch" between the valuation of assets and liabilities can create excessive volatility.
- 4.10 It is important to note that the discount rate is not static and that it changes every day depending on market conditions. Hence another key risk is that relating to changes in the assumptions. Again, Barnett Waddingham monitor this risk

through their quarterly monitoring reports, which help to illustrate how the liabilities are moving over time as result of these changes. At each triennial valuation, there may also be methodological changes to the way the financial assumptions are derived.

- 4.11 Therefore, Barnett Waddingham does monitor these financial risks between valuations and the assumptions they use for each valuation are then in part informed by a full review of experience over the period. In terms of mitigating the risks, the assumptions also contain an element of prudence so that, in their view, the actual experience of the Fund in future is more likely to be better than assumed than it is to be worse than assumed. The challenge for Actuary is the degree of prudence to build into the actuarial assumptions as excess prudence requires higher employer contributions.

5. Focus Area: Strategic: Funding – Scheme Members Live Longer Than Expected

- 5.1 “*Scheme members live longer than expected leading to higher than expected liabilities*” is the other area which Board members have decided to focus on. This is referenced as Risk 6 in Appendix 1.
- 5.2 This risk has a low risk classification.
- 5.3 It is not possible to predict with any certainty how long members of the Fund will live, and if members live longer than expected, the Fund’s funding position will deteriorate and additional contributions will be required.
- 5.4 At the last valuation in 2013, it was observed that over the previous decade, life expectancies had increased more quickly than most predictions. The assumption adopted at the last valuation for mortality projection gave a long term rate of improvement of 1.5% per annum, equivalent to 1 ½ years additional life expectancy every decade.
- 5.5 At this stage, it is difficult for the Actuary to offer comment on the mortality experience of the Fund. This can only be truly assessed once they have received full membership data as part of the valuation. Their specialist longevity team will be carrying out an in-depth analysis of the mortality experience over the last few years and will provide a full report over the coming months. Again, the outcome of this review will help to determine suitable mortality assumptions going forward.
- 5.6 Recent indications are that improvements in life expectancy has either stabilised or slowed, although care has to be taken in short term experience and medical innovations can lead to step changed in life expectancy.

6. Monitoring of Factors

- 6.1 Barnett Waddingham carries out a full assessment of all these factors every three years as part of the triennial valuation. Their valuation reports contain an analysis of how they have affected the funding position over the inter-valuation period. This analysis of experience over the period helps to inform the assumptions which they make going forward to ensure they remain appropriate.
- 6.2 A copy of the 2013 Actuarial Valuation Report can be found on the Pension Fund page of the Council's website, by following the link below:

<https://www.westminster.gov.uk/council-pension-fund>

7. Next Meeting

- 7.1 The Board members are asked to consider the Risk Register focus area for the next meeting.

If you have any queries about this report please contact the author:

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BACKGROUND PAPERS:

None

APPENDICES

Appendix 1 - Pension Fund Risk Register, reviewed June 2016