Item 9

Pension Fund Investment Board
21 May 2012

Future Risks Facing the Warwickshire Pension Fund

Recommendation

That the Board note the report and consider any measures conducive to relieving the current risks and pressures pertaining to the Pension Fund.

1.0 Introduction

1.1 Risk is the potential that a chosen action or activity (including the choice of inaction) will lead to a loss (an undesirable outcome). The notion implies that a choice having an influence on the outcome exists (or existed). Potential losses themselves may also be called "risks".

1.2 Discussions at previous Investment Board meetings have highlighted some of the issues and associated risks, and a report has been requested.

1.3 Current risks facing the fund consist of longevity, member opt and fund maturity, inflation, poor investment return, investment volatility, low gilt yield, employer default and future unknown events.

2.0 Longevity Risk

2.1 Longevity is regarded as directly resulting from major medical advances, better health, increased income, rising prosperity and healthier life style choices by the population. Conversely, lifestyle choices that have led to a significant increase in rates of obesity and sedentary life styles have also impacted on the population’s wellbeing and survival prospects. However, these negative by products of the 21st century are regarded as springing from our growing prosperity and it is this that is the overriding drive to us living longer. Western civilized populations are prospering and living longer as a result.

2.2 Some quarters are taking a relaxed view on longevity, saying that a fund that is cash flow positive in the long term should not need to worry too much on longevity, given that future natural events could alleviate pressures. Conversely, other forecasters warn that the first person to reach 150 years has been already born and a third of new born babies today will reach 100 years. Current longevity improvements show no sign of reversal and pension funds need to be aware of these pressures.

2.3 The use of longevity swaps is one option. The drawing of longevity swaps has two benefits: firstly, it is a form of insurance against an age stampede by future retired LGPS pensioners achieving ages of 100 years and beyond. Secondly, and more importantly, with longevity swaps, a degree of certainty can be applied to the extent and limits of future fund liabilities.

2.4 The prosperous and therefore longer living county of Berkshire was the first LGPS fund to venture into longevity swaps with regard to its pensioner class of membership. Application to actives and the preserved benefit classes would be the next step. Traditionally, the active and preserved classes are very difficult to ensure because of the longer time horizon and less degree of certainty taken on by the insurer who are generally unwilling to take this further risk, and will generally hedge the pensioner class only.

2.5 With regard to the longevity risk, the Hutton reforms have helped out considerably. Hutton has proposed a later retirement culture with the retirement age to be linked to the State Pension Age (SPA). The linking of the SPA to the LGPS will constitute a major factor in limiting costs with the new scheme that will come into effect from 1 April 2014. As the SPA rises, so will the LGPS retirement age and this will take a significant amount of pressure from future liabilities and costs.

2.6 Moreover, costs will also reduce as a result of the Hutton recommended cost ceiling mechanism, known as the cap and collar. As LGPS longevity runs ahead of the SPA, and this really applies only to individual prosperous areas, then the cap and collar cost mechanism will switch the cost onus onto employee contributions, thus taking some of the risk and cost pressures away from the funds. It should be noted that this applies to future service only: accrued rights earned to 2014 are guaranteed within current LGPS rules.

2.7 The Hutton reforms have therefore taken some of the pressure from the need to insure against longevity increases and subsequent further costs. Although insurance might be applicable to small elements of the fund’s liability, certainty must come at a fair price if any insurance is taken. It should be remembered that cap and collar is two way. If longevity is reversed or other factors come into play, resulting in cost reductions, then the employee will benefit in terms of pressure on their contribution rates.

3.0 Fund Maturity Risk Including Opt-outs and Outsourcing

3.1 The LGPS continues to benefit from a very strong employer covenant with little risk of default (academies and smaller organisations aside). The scheme remains open and attractive, even after Hutton’s final recommendations come into force. The LGPS will remain with Defined Benefit status, albeit Career Average Revalued Earnings, and individual LGPS schemes are generally well funded.

3.2 In terms of where we want to get to, the picture is starting to become clear as to the proposed new regime and its future liabilities, but there are still many unknowns as central detailed negotiations come to fruition. The demands of Hutton alone will be sufficient to increase the pressure on the LGPS but, even with Hutton's fairness, it is not unreasonable to assume an increased potential for member opt outs from the LGPS and the resultant increasing maturity issues. Conversely, member opt out could be countered by the pending auto-enrolment regime with deliberate Government encouraged inertia applied, designed to keep people in their organisation pension schemes.

3.3 Hutton originally recommended that external private companies should be denied LGPS membership but it appears this proposal will not be adopted. However, with many local services outsourced to private sector companies who then become admitted bodies to the LGPS, deliberate company policy decisions to close membership to new employees will be a factor in the drop in future active member numbers.

3.4 The cost of the LGPS not winning the opt-out battle is scheme maturity, cash flow negative status and therefore significant changes to investment strategy. The fact that these pressures are being felt in the midst of significant local cutbacks, lay offs, early retirements, and involving significant numbers of highly paid senior staff, has not helped matters. LGPS communications are currently geared to move into positive publicity mode as soon as negotiations are concluded, and the Government will hopefully soon be in a position to announce the final new scheme details and Regulations shortly.

3.5 The 2013 actuarial valuation will be a vital stepping stone in planning for the future. Traditionally, the valuation takes account of the current scenario but there will now be more pressure on planning for future projected scenarios and contribution rates can be set according to the future projected position. The double whammy of poor future funding levels and negative cash flows could be countered at 2014 with compensating higher contribution rates. LGPS Funds will need to engage with their consultants and undertake scenario planning.

3.6 As part of the triennial valuation exercise, we need to assess our future cash income levels (contributions and dividend/interest receipts), the likely advance to future fund maturity, how long this will take and what the future investment strategy will be, with the assumption that it will be a significant de-risking strategy. Pitched against this is the need to invest in growth assets to reduce the fund's deficit.

3.7 The most likely outcome is that, over the long term, the LGPS will move towards the characteristics of the private sector. There will be similarities of average member age and less risky assets within fund portfolios.

4.0 Inflation Risk

4.1 Inflation is an issue and will continue to be so while the current low interest rate environment persists. The economic volatility that has been the catalyst for so many of today's challenges will also be with us for the foreseeable future. The Consumer Price Index (CPI) has been on a reducing trend after reaching record highs over the end of 2011 and early 2012. However, rising food prices have stopped the downward trend with the announcement of the March 2012 CPI index creeping up once again.

4.2 Inter-valuation monitoring gives early prior warning and further diversification into inflation hedged assets has taken place such as increased exposure to property. The buying of index-linked bonds also assists the mitigation of this risk. However, index-linked bonds have become very expensive though as a result of the low interest rate environment. The focus of the actuarial valuation process due to start next on 1 April 2013 will be on the real returns on growth assets, net of price and pay increases.

4.3 Some form of insurance for high inflation scenarios could be considered by the Fund in the future.

5.0 Investment Risk

5.1 The risk here is that Fund assets fail to deliver returns in line with the anticipated returns underpinning the valuation of liabilities over the long term. The LGPS is still able to anticipate a long term return on a relatively prudent basis and the triennial valuations will reset the roadmap when necessary. However, the risk of an inappropriate long term investment strategy and wrong decisions taken as to the overall risk budget will result in severe impact. Regular monitoring is required by advisors with an independent advisor able and willing to question accepted thinking.

5.2 Of course, a cataclysmic fall in equity markets, coupled with long term, low interest rates will impact significantly on the LGPS, leading to significant deterioration in funding levels. Significant proportions of funds allocated to bonds, property, hedge funds and absolute return strategies will alleviate such a fall in equities to some extent and we continue to hold the continued belief that equities are the best asset class, proven over the long term. Conversely, there is the risk that switching too much away from equities will result in losing out from the eventual bounce in equity markets, whenever that may be in the short/medium term future.

5.3 Where funding levels are poor (and Warwickshire's is one of the best within the LGPS), growth assets are needed to recover, but we must expect the accompanying volatility. Once the funding level has improved, we can take some of the risk away from the overall portfolio. It has become known as the flight path strategy where investment risk is reduced as the funding level improves, or when market conditions are such that the potential upside no longer justifies the risk.

5.4 Risks relating to individual manager choice and investment under-performance seem to be well addressed within the LGPS. There is an optimum source of endurance over the long term for results to be achieved by fund managers, and the expediting of contract termination where patience has been exhausted.

6.0 Volatility Risk

6.1 The LGPS has looked to the strength of the employer covenant, the positive cash flows and the long term performance of equities with a view to riding out the volatile times. Yet equities have not been the star performer since 2000. The hierarchy of returns, according to the magnitude of the risk that is taken, is challenged by the experience of the last twelve years.

6.2 There is still a strong pre-disposition towards traditional assets. Equities still feature very highly in LGPS portfolios, despite the risk averse times. There is an opportunity for the LGPS to take the lead, showing imagination and dynamism and challenging the current thinking. Funds should look regularly at the benchmarks set and assess their suitability for the objectives. And the asset classes: local or global; developed or emerging; passive or active. It must be remembered that passive strategies still hold a substantial element of risk.

6.3 There is the substantial risk of missing out on the upturn when it eventually emerges. The timing of asset allocation decisions to alternatives, while taken in good faith, can lock in losses. An overactive approach to asset allocation and manager change can damage returns, particularly when the additional costs associated with these actions are taken into account. A solution is to generate equity type returns from other sources and we are currently engaging with our consultant to appoint managers to manage absolute return multi-strategy portfolios, an alternative to straight equity investing.

6.4 By adhering to a clear strategy, managed with conviction, through focused governance, the Warwickshire Fund aims to perform well into the future.

7.0 Gilt Yield Risk

7.1 A fall in risk free returns on gilts leads to an automatic rise in the value placed on liabilities. The ten-year gilt rate paid 1.96% in 1897. The UK’s status as a safe haven has led to record recent gilt yield lows with the yield on ten-year gilts dropping to a record low of 1.92% on 19 January 2012, the lowest level since Bank of England records started in 1703.

7.2 Gilt allocation within the portfolio helps to mitigate this risk. But the bigger concern and therefore risk is that low gilt yields reflect a headlong rush from riskier assets, in the expectation that growth is slowing fast. 2012 and beyond could be stall years as far as UK growth recovery is concerned.

7.3 The Fund’s actuary could look at stabilising contributions for the most secure employers to counteract the effect of current market conditions that lead to extreme valuation outcomes. Early consultation/negotiation with the actuary will take place in readiness for the 2013 valuation. Bond yields could remain stubbornly low and discussions with the actuary need to take place at an early stage in order to assess if contribution rates need to reflect the current and continuing low interest rate environment.

8.0 Risk of Employers Ceasing to Exist

8.1 The risk of an employer ceasing to exist with insufficient funding or the adequacy of a bond is far more prevalent now than in previous years, especially with the advent of academies and the absence of any guarantee by the Government in the event of any of them folding.

8.2 Moreover, the increase in number of admitted bodies such as charities who are closing down and employers who have closed their scheme membership, thus resulting in termination penalties, will require special attention from LGPS managers.

8.3 LGPS managers now need to plan for possible exits and engage in dialogue with bodies in order to fully understand their circumstances. This needs to be monitored frequently and the security arrangements need the same monitoring emphasis.

8.4 If a body departing the scheme is regarded as likely over the short or medium term, a gradual switching to gilts funding can take place, thereby reducing the shock of moving in one fell swoop from a uniform funding assumption to termination status.

8.5 As detailed in the Fund's risk management plan, the employer risk to LGPS funds can be mitigated by:

- Seeking a funding guarantee from another scheme employer, or external body, wherever possible. If not possible, the Fund is at risk from default and financial loss. Some LGPS schemes have managed to secure rights to a member organisation's HQ property should it fold, resulting in outstanding liability.

- Politely alerting the employer to its obligations.

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- Vetting prospective employers before admission.

- Where permitted under the regulations, requiring a bond to protect the scheme from the extra cost of early retirements or redundancy if the employer failed.

8.6 The one size fits all investment strategy for all employer bodies may not be appropriate in the future. For example, different strategies might be appropriate for:

  - more mature employers or;
  - well funded employers who might prefer to de-risk or;
  - short term employers like contractors who do not want volatility or;
  - employers closer to cessation who don't want to risk a market fall before they cease.

8.7 Assets could be divided into low risk and general risk buckets with a division amongst the employers as considered necessary. Hymans are currently advising officers on this possibility.

9.0 Event Risk

9.1 These risks consist of unforeseen events associated with a country, company or asset class, for example, the re-nationalisation of the Argentine oil fields, the BP oil disaster, or events in general, such as the Iranian missile crisis, the uneasy situation in North Korea or tsunamis. They are difficult to anticipate and hedge against.

9.2 We have seen the use of various financial instruments being used for the management of risk. There are solutions by various providers designed to cover inflation risk, interest rate risk, longevity risk, fat tail and event risks. Most of these forms of insurance are regarded as being currently very expensive, but should not be ruled out in the future.

10.0 Effective Governance

10.1 A key approach is that effective governance is essential, making sure that time is spent on the right things, according to their impact. Understanding the long term nature of the risks and setting the investment strategy accordingly is the important thing to focus on.

10.2 And within that investment strategy, also addressing the need for tactical nimbleness, sometimes achieved by the timing of meetings to enable this additional speed. This can also be achieved by delegation of wider, more diversified portfolios to a manager who can adapt to changing markets, such as the pending absolute return, multi-asset strategy.

10.3 There is no unique recipe, but addressing the issue of focused governance is of paramount importance. Scheme management will be harder for officers and trustees, the Hutton reforms will place more demand on trustees, and decision making will get more involved and complicated.

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