Agenda Item No. 4 (b)

FOR PUBLICATION

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

21 July 2021

Report of the Director of Finance & ICT

Derbyshire Pension Fund Risk Register

1. Purpose of the Report

To consider the Derbyshire Pension Fund (the Fund) Risk Register.

2. Information and Analysis

The Risk Register identifies:

- Risk item
- Description of risk and potential impact
- Impact, probability and overall risk score
- Risk mitigation controls and procedures
- Proposed further controls and procedures
- Risk owner
- Target risk score

The Risk Register is kept under constant review by the risk owners, with quarterly review by the Director of Finance & ICT. A detailed annual review of the Risk Register by Derbyshire Pension Board was also introduced in early 2021. A copy of both the Summary and Main Risk Registers are attached to this report as Appendix 2 and Appendix 3 respectively. Changes from the previous quarter are highlighted in blue font.

Risk Score

The risk score reflects a combination of the risk occurring (probability) and the likely severity (impact). Probability scores range from 1 (rare) to 5 (almost certain) and impact scores range from 1 (negligible) to 5 (very high). A low risk classification is based on an overall risk score of 4 or less; a medium risk score ranges between 5 and 11; and a high risk score is anything with a score of 12 and above.

The Risk Register includes a target score which shows the expected risk score once the proposed additional risk mitigation controls and procedures have been implemented. The difference between the actual and target score for each risk item is also shown to allow users to identify those risk items where the proposed new mitigation and controls will have the biggest effect.

Covid 19
The Fund's Business Continuity Plan has continued to work well and all of the Fund's critical activities have been maintained throughout the period of business disruption caused by the pandemic. Alternative processes set up to accommodate remote working, remain under review, taking into consideration the possibility of the current working arrangements being in place for some time.

High Risk Items
The Risk Register has the following four high risk items:

(1) Fund assets insufficient to meet liabilities (Risk No.19)

(2) LGPS Central related underperformance of investment returns (Risk No.30)

(3) Impact of McCloud judgement on funding (Risk No.37)

(4) Impact of McCloud judgement on administration (Risk No.44)

Fund assets insufficient to meet liabilities
There is a risk for any pension fund that assets may be insufficient to meet liabilities; funding levels fluctuate from one valuation to the next, principally reflecting external risks around both market returns and the discount rate used to value the Fund's liabilities. Every three years, the Fund undertakes an actuarial valuation to determine the expected cost of providing the benefits built up by members at the valuation date in today's terms (the liabilities) compared to the funds held by the Pension Fund (the assets), and to determine employer contribution rates.

As part of the valuation exercise, the Pension Fund's Funding Strategy Statement (FSS) is reviewed, to ensure that an appropriate funding strategy is in place. The FSS sets out the funding policies adopted, the actuarial assumptions used and the time horizons considered for each category of employer. The Fund's 2020 FSS was approved by Committee in March 2020 and proposed updates to the FSS are being presented to Committee today.

The Fund was 97% funded at 31 March 2019, with a deficit of £163m, up from 87%, with a deficit of £546m at 31 March 2016. The funding level provides a high-level snapshot of the funding position at a particular date and can be very

different the following day on a sharp move in investment markets. The next actuarial valuation is due to be carried out at 31 March 2022.

Whilst the Fund has a significant proportion of its assets in growth assets, the last two reviews of the Strategic Asset Allocation Benchmark have introduced a lower exposure to growth assets and a higher exposure to income assets with the aim of protecting the improvement in the Fund’s funding position.

LGPS Central Pool

The Fund is expected to transition the management of a large proportion of its investment assets to LGPS Central Limited (LGPSC), the operating company of the LGPS Central Pool (the Pool), over the next few years. The Fund has so far transitioned around 10% of its assets into LGPSC active products.

LGPSC is a relatively new company which launched its first investment products in April 2018. There is a risk that the investment returns delivered by the company will not meet the investment return targets against the specified benchmarks.

The Fund continues to take a meaningful role in the development of LGPSC, and has input into the design and development of the company’s product offering to ensure that it will allow the Fund to implement its investment strategy. The company’s manager selection process is scrutinised by the Pool’s Partner Funds and the Fund will initially continue to carry out its own due diligence on selected managers as confidence is built in the company’s manager selection skills.

The performance of LGPSC investment vehicles is monitored and reviewed jointly by the Partner Funds under the Investment Working Group (a sub-group of the Partner Funds’ Practitioners’ Advisory Forum) and by the Pool’s Joint Committee.

The Fund is also likely to maintain a large exposure to passive investment vehicles in the long term which will reduce the risk of total portfolio underperformance against the benchmark.

McCloud Judgement

The McCloud case relates to transitional protections given to scheme members in the judges’ and firefighters’ schemes which were found to be unlawful by the Court of Appeal on the grounds of age discrimination. MHCLG published its proposed remedy related to the McCloud judgement in July 2020.

The proposed remedy involves the extension of the current underpin protection given to certain older members of the Scheme when the LGPS benefit structure was reformed in 2014. It removes the condition that requires

a member to have been within ten years of their 2008 Scheme normal pension age on 1 Apr 2012 to be eligible for underpin protection. It is also proposed that underpin protection will apply where a member leaves with either a deferred or an immediate entitlement to a pension (previously it just applied to immediate entitlements). The underpin will give the member the better of the 2014 Scheme CARE or 2008 final salary benefits for the eligible period of service.

The changes will be retrospective, which means that benefits for all qualifying leavers since 1 April 2014 will need to be reviewed to determine whether the extended underpin will produce a higher benefit. This will have a significant impact on the administration of the Scheme. Analysis by Hymans Robertson (the Fund's actuary), suggests that around **1.2m** members of the LGPS, roughly equivalent to a quarter of all members, may be affected by the revised underpin. Locally it is estimated that around **26,000** members of the Fund are likely to fall into the scope of the proposed changes to the underpin.

Any increase in benefits for members will need to be funded by scheme employers. At a whole scheme level, Hymans estimate that total liabilities might increase by around **0.2%**, equivalent to around **£0.5bn** across the whole of the English and Welsh LGPS. This estimate is significantly less than the **£2.5bn** quoted in the MHCLG consultation. The difference is largely due to the materially higher pay growth assumption used by the Government Actuary's Department.

Hymans forecast that the impact of the remedy might be to increase average primary contributions by around **0.2%** of pay, with an increase in secondary contributions of around **0.1%** of pay. Whilst the impact at the whole scheme level is expected to be small, it may be material at an individual employer level. The impact on employers' funding arrangements is expected be dampened by the funding arrangements they have in place, however, it is likely there will be unavoidable upward pressure on contributions in future years.

With respect to the Government's cost control mechanism for public service pension schemes, HM Treasury (HMT) confirmed in February 2021 that it was 'un-pausing' the 2016/17 cost cap valuations, which will take into account the cost of implementing the McCloud remedy. HMT confirmed that any cost cap ceiling breaches will not result in benefit reductions, however, any cost floor breaches will be honoured, with any benefit increases taking effect from 1 April 2019.

The uncertainty caused by the McCloud judgement is reflected on the Risk Register under two separate risks for clarity, one under Funding & Investments and one under Administration, although the two risks are closely linked.

The funding risk relates to the risk of there being insufficient assets within the Fund to meet the increased liabilities. In line with advice issued by the LGPS Scheme Advisory Board (SAB), the Fund's 2019 actuarial calculations were based on the current benefit structure, with no allowance made for the possible outcome of the cost cap mechanism or McCloud. However, an extra level of prudence was introduced into the setting of employer contribution rates to allow for the potential impact of the McCloud case. This has been clearly communicated to the Fund's employers in the valuation letters.

In the short term, the impact of the uncertainty caused by the McCloud case is greatest for exit payments and credits as, at a cessation event, the cost of benefits is crystallised. The Funding Strategy Statement includes an allowance for a **1%** uplift in a ceasing employer's total cessation liability for cessation valuations that are carried out before any changes to the LGPS benefit structure are confirmed. The funding risk score will be reviewed when MHCLG's remedy is confirmed.

The administration risk relates to the enormous challenge that will be faced by administering authorities and employers in backdating scheme changes over such a significant period; this risk has been recognised by the SAB. Whilst the Fund already requires employers to submit information about changes in part-time hours and service breaks, the McCloud remedy may generate additional queries about changes since 1 April 2014; employers have, therefore, been asked to retain all relevant employee records. Communications are also being developed to check with employers on the data supplied to the Fund since 2014 with respect to changes in part-time hours and service breaks.

Aquila Heywood has provided the Fund with McCloud related tools for testing on the Altair pension administration system which would be used to identify, and subsequently bulk load, any required additional service history.

A McCloud Project Board has been set up to formalise the governance of this major project. The Fund will continue to keep up to date with news related to the McCloud remedy and the cost cap process from the Scheme Advisory Board, the Local Government Association, the Government Actuary's Department and the Fund's actuary.

New & Removed Items/Changes to Risk Scores

One new risk has been added to the Risk Register this quarter; no risks have been removed and no existing risk scores have been changed.

New Risks

Risks arising from a significant acceleration of the academisation of schools (Risk No. 18).

In April 2021, the Secretary of State for Education announced an acceleration of the academisation of schools noting: 'the government's vision for the school system to continue to move decisively towards a single model built on strong multi-academy trusts as its foundation', although no timetable was attached to this statement.

Academies are state-funded schools that are independent from local authorities and are directly funded and controlled from the Department for Education. All maintained schools, which are funded and controlled by a local authority, are allowed to convert to academy status.

Maintained schools are pooled with their local authority for the purpose of membership of the LGPS for their non-teaching staff. When a maintained school converts to an academy, it becomes a participating employer in the scheme in its own right.

Given the large number of remaining maintained schools in Derbyshire (over 300), there could potentially be a further big increase in the number of individual employers in the Fund despite the likelihood that many converting schools would join a multi-academy trust.

Any further division of LGPS members into an increasingly wider pool of employers, will increase pressure on several areas of Fund operations including: employer onboarding; the collection of data and contributions; employer training; & actuarial matters. Increased academisation would also likely lead to an increase in the outsourcing of functions and services involving LGPS members, which in turn would lead to a further increase in the number of employers in the Fund.

The evolving landscape of multi-academy trusts is also introducing increased administrative and funding challenges for LGPS funds as academies move between trusts and trusts consolidate their academies into single LGPS funds.

The Fund has an effective procedure for admitting new academies to the Fund, treating them as individual participating employers, backed by robust administrative and actuarial arrangements, which helps to mitigate some of the issues that arise when academies move between trusts.

This new risk has been included under the Governance section of the Risk Register as it has both funding and administrative implications. The Fund will continue to monitor local developments with respect to academisation and will monitor the administrative resource required by the Fund to support any increase in the number of participating employers. The funding implications of any academies consolidating in another LGPS fund will also be kept under review.

Updated Risk Narrative
No risks have been removed and no risk scores have been changed, however, the narrative for the following risks has been updated:

Risk No. 22, relating to the risk of failing to correctly assess the potential impact of climate change on the investment portfolio and on the funding strategy, has been updated following a discussion on the appropriate wording when the Risk Register was last considered by Committee.

Risk No. 24, relating to employer covenants, has been updated to reflect the new employer flexibilities which have given administering authorities greater flexibilities for collecting exit payments from employers ceasing their active participation in the Fund.

Risk No. 40, relating to the level of cyber liability insurance relating to the pension administration system, has been updated following further consideration of the level of cover.

Risk No. 42, relating to potential delays to issuing Annual Benefit Statements and Pension Savings Statements, has been updated to reflect possible delays caused by the roll-out of the member self-service system ‘My Pension Online’.

3. Implications

Appendix 1 sets out the relevant implications considered in the preparation of the report.

4. Background papers

Papers held by the Pension Fund.

5. Appendices

5.1 Appendix 1 – Implications.

5.2 Appendix 2 – Summary Risk Register

5.3 Appendix 3 – Main Risk Register

6. Recommendation

That the Committee notes the risk items identified in the Risk Register.

7. Reason for recommendation

One of the roles of Committee is to receive and consider the Fund's Risk Register.

Peter Handford

Director of Finance & ICT

Appendix 1

Implications

Financial

1.1 None

Legal

2.1 None

Human Resources

3.1 None

Information Technology

4.1 None

Equalities Impact

5.1 None

Corporate objectives and priorities for change

6.1 None

Other (for example, Health and Safety, Environmental Sustainability, Property and Asset Management, Risk Management and Safeguarding)

7.1 None