Merton Council

Pension Fund Investment Advisory Panel Agenda

Membership

Councillors:

Owen Pritchard (Chair)
Adam Bush (Vice-Chair)
Mark Allison
Gwyn Isaac
Tina Pickard

Co-opted members:

Gwyn Isaac
Tina Pickard

Substitute Members:

Date: **Thursday 18 July 2019**

Time: **7.00 pm**

Venue: **Committee Rooms, 1st floor, Merton Civic Centre, London Road, Morden, SM4 5DX**

This is a public meeting and attendance by the public is encouraged and welcomed. For more information about the agenda please contact Merton.PensionFund@merton.gov.uk or telephone 020 8545 3458.

All Press contacts: communications@merton.gov.uk, 020 8545 3181

Pension Fund Investment Advisory Panel Agenda
18 July 2019

Note on declarations of interest

Members are advised to declare any Disclosable Pecuniary Interest in any matter to be considered at the meeting. If a pecuniary interest is declared they should withdraw from the meeting room during the whole of the consideration of that mater and must not participate in any vote on that matter. If members consider they should not participate because of a non-pecuniary interest which may give rise to a perception of bias, they should declare this, .withdraw and not participate in consideration of the item. For further advice please speak with the Assistant Director of Corporate Governance.

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Merton Pension Fund Advisory Panel (Part 1)

Minutes of the meeting held on **28 March 2019**

Attendance:

Cllr. Adam Bush (Chair),

Cllr. Mark Allison,

Gwyn Isaac (GMB Union Rep)

Roger Kershaw (LBM),

Nemashe Sivayogan (LBM)

Apologies received from

Cllr. Owen Pritchard.

Caroline Holland

Tina Pickard

Additional Attendees:

Aniket Bhaduri and Adam Briggs (JLT)

Suresh Patel- EY

1.0 MEETING (Part 1)

1.1 Introductions made by Chair.

1.2 Members Declaration of Interest – None.

2.0 PRESENTATION OF MINUTES OF LAST MEETING (2nd October 2018)

2.1 Agreed as true record.

3.0 QUARTERLY FUND PERFORMANCE (Oct-Dec 2018)

3.1 NS presented the report - Over the 3 months to 30 December 2018, total Fund assets returned -6.5% and underperformed its target by 7.8%.

3.2 The Fund's total market value decreased by £46.3m in the quarter, from £708.3 to £662.1m. Over the last 12 months, the Fund performance is -3.9%, and 3 year annualised performance is 9.3%. The annual performance target is 5.5%.

4.0 Merton Pension – 2018-19 Fund Audit Plan

4.1 SP presented the audit plan and answered the question raised regarding controls and IFRS 9. SP highlighted the reduction in the audit fees.

5.0 Merton Pension Fund - March 2019 Triennial valuation

5.1 RK presented the report and explained the valuation timetable and the process.

5.2 Committee approved the report.

6.0 Update on London CIV

6.1 RK presented the report and informed the committee ,the appointment of the new CEO at LCIV. The committee requested LCIV to attend the June committee meeting.

7.0 AOB

Committee:

London Borough of Merton Pension Committee Date: 18 July 2019

London Borough of Merton Pension Board Date: 26 June 2019

Wards: All

Subject: Merton Pension Fund Performance – March 2019

Lead officer: Caroline Holland - Director of Corporate Services

Lead member: Councillor. Mark Allison.

Contact officer: Roger Kershaw- AD Resources

This is a Public Document

RECOMMENDATION

Members are asked to note the content of this report, in particular, the market values and performance of the total fund and component portfolios for the quarter ending 31 March 2019, attribution of the results and the market environment during the period.

1.0 PURPOSE OF REPORT

1.1 To report the investment performance at total fund level, and of the individual fund managers, for the quarter to 31 March 2019. The report highlights the performance of the total Fund by asset class compared to the customised benchmark.

1.2 The report gives the Committee a consistent basis on which to review the performance of the Fund as at 31 March 2019 and provide information to support future actions including periodic rebalancing and review of investment strategy and investment management arrangement.

2.0 FUND PERFORMANCE

2.1 The attached Fund Analysis & Performance Report (**Appendix 1**) produced by the Fund's investment and performance consultants JLT Employee Benefits provides useful analysis and insights of the Pension Fund activities and results for the quarter to 31 March 2019

The table overleaf shows the performace for the period ending 31 March 2019

Manager / Fund	3 months %		12 months %		3 years % p.a.	
	Fund	Bmark	Fund	Bmark	Fund	Bmark
UBS- Passive Equity Fund†	9.8	n/a	7.9	n/a	11.8	n/a
UBS – Alternative Beta	9.2	9.2	n/a	n/a	n/a	n/a
LCIV RBC Sustainable Equity Fund	13.4	9.9	n/a	n/a	n/a	n/a
LCIV Global Alpha Growth Fund	12.4	10.2	n/a	n/a	n/a	n/a
BlackRock World Low Carbon Equity Tracker Fund	9.5	9.8	n/a	n/a	n/a	n/a
Global Equities						
Aberdeen Global Emerging Market Equities Fund	7.3	7.5	n/a	n/a	n/a	n/a
UBS – HALO EM Fund	11.2	7.4	n/a	n/a	n/a	n/a
Emerging Market Equities						
LCIV Global Total Return Fund	2.7	1.1	n/a	n/a	n/a	n/a
LCIV Diversified Growth Fund	6.2	1.1	n/a	n/a	n/a	n/a
DGF						
UBS Triton Property Unit Trust	0.6	0.3	7.1	4.8	6.9	6.1
BlackRock UK Property Fund	0.1	0.3	4.9	4.8	6.1	6.1
Property						
MIRA Infrastructure Global Solution II, L.P.*	-6.5	0.2	n/a	n/a	n/a	n/a
Quinbrook Low Carbon Power LP*	-1.6	0.6	n/a	n/a	n/a	n/a
Infrastructure						
Churchill Middle Market Senior Loan Fund II*	-1.4	0.5	n/a	n/a	n/a	n/a
Private Credit						
Growth Assets						
Aberdeen Bonds Portfolio	4.7	4.7	6.3	5.9	7.5	7.4
Bonds						
LCIV MAC Fund	2.6	1.2	n/a	n/a	n/a	n/a
Multi-Asset Credit						
Stabilising Assets						
TOTAL MERTON PENSION FUND	**8.0**		**7.7**		**10.6**	
Strategic Target (5.5% p.a.)	**1.3**		**5.5**		**5.5**	

* Partial quarter performance shown. These funds were entered into in mid-January 2019 and hence the fund returns are not reflecting the entire of Q1 2018. Returns for private market managers are approximate, and may be low initially due to the J-curve effect.

† Benchmark suspended in Q2 2018 as a result of transition activity. This impacts 3 month, 12 month and 3 year benchmark returns.

2.2 Over the 3 months to 31 March 2019, total Fund assets returned 8.0% compared to the target of 1.3%. This equates to outperformance by 6.7%. The Fund's total market value increased by £58.6m over the quarter, from £662.1m to £720.7m. Over the last 12 months, the Fund performance is 7.7%, and 3 year annualised performance is 10.6%. The annual performance target is 5.5%.

2.3 The table below shows the total fund valuation and the movements in investments during the December quarter.

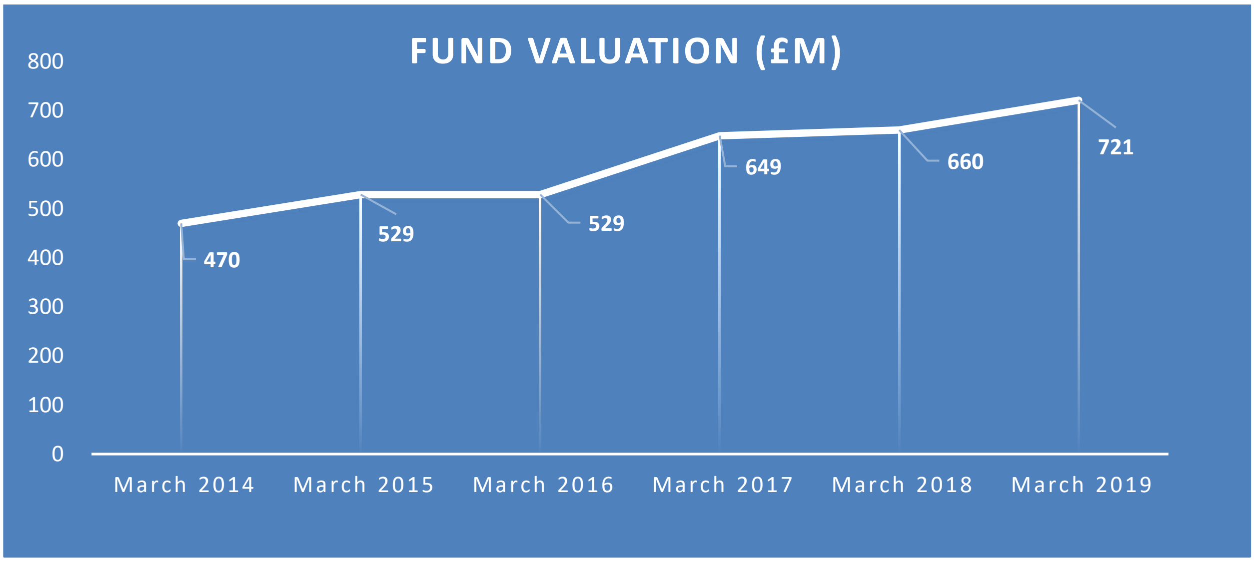
Manager / Fund	31-December-18 Valuation £000s	31-December-18 Weight %	Cashflow £000s	Growth £000s	31-March-19 Valuation £000s	31-March-19 Weight %
UBS - Passive Equity	89,363	13.5	-7,917	8,213	89,659	12.4
UBS – Alternative Beta	64,643	9.8	-	5,963	70,606	9.8
LCIV RBC Sustainable Equity Fund	65,854	9.9	-	8,840	74,694	10.4
LCIV Global Alpha Growth Fund	63,235	9.6	-	7,832	71,067	9.9
BlackRock World Low Carbon Equity Tracker Fund	64,282	9.7	-	6,099	70,381	9.8
Global Equities	**347,378**	**52.5**			**376,408**	**52.2**
Aberdeen Emerging Market Equities Fund	27,302	4.1	-	1,748	29,050	4.0
UBS – HALO EM Fund	41,304	6.2	-	1,904	45,916	6.4
Emerging Market Equities	**68,606**	**10.4**			**74,966**	**10.4**
LCIV Global Total Return Fund	32,786	5.0	-	885	33,671	4.7
LCIV Diversified Growth Fund	31,020	4.7	-	1,904	32,924	4.6
Diversified Growth Fund	**63,806**	**9.6**			**66,595**	**9.2**
UBS Triton Property Unit Trust	17,008	2.6	-	-41	16,967	2.4
BlackRock UK Property Fund	7,973	1.2	-	-55	7,918	1.1
Property	**24,981**	**3.8**			**24,885**	**3.5**
MIRA Infrastructure Global Solution II, L.P.	-	-	1,235	-80	1,156	0.2
Quinbrook Low Carbon Power LP	-	-	4,457	-72	4,385	0.6
Infrastructure	**-**	**-**			**5,541**	**0.8**
Churchill Middle Market Senior Loan Fund II	-	-	2,567	-36	2,532	0.4
Private Credit	-	-			2,532	0.4
Growth Assets	**504,772**	**76.2**			**550,925**	**76.4**
Aberdeen Bonds	83,661	12.6	-	3,905	87,567	12.2
Bonds	**83,661**	**12.6**			**87,567**	**12.2**
LCIV MAC Fund	67,572	10.2	-	1,788	69,360	9.6
Multi Asset Credit	**67,572**	**10.2**			**69,360**	**9.6**
Stabilising Assets	**151,233**	**22.8**			**156,927**	**21.8**
Cash	6,078	0.9	6,741	-	12,819	1.8
TOTAL MERTON PENSION FUND	**662,083**	**100.0**			**720,673**	**100.0**

2.4 During the quarter the fund continued implementing its new investment strategy and the chart below details the Fund's strategic asset allocation and the actual allocation to date.

2.5 In the quarter the Fund moved assets on to the private market investments.£5.6m was investemtn in infrastructure and £2.5m on Pricate debt. The full capital committements will be drawn in stages as capital callsover 3-5 years.

Asset Class		Market Value £000s	Actual Weight %	Strategic Allocation %	Relative %	Strategic Range %
Global Equities		376,408	52.2	40.0	12.2	15-85
Emerging Market Equities		74,966	10.4	10.0	0.4	0-20
Diversified Growth Fund		66,595	9.2	10.0	-0.8	0-20
Property		24,885	3.5	5.0	-1.5	0-10
Private Credit		2,531	0.4	7.5	-7.1	0-10
Infrastructure		5,541	0.8	7.5	-6.7	0-15
Long Index Linked Gilts		51,067	7.1	10.0	-2.9	0-30
Corporate Bonds		36,500	5.1	-	5.1	0-10
Multi Asset Credit		69,360	9.6	10.0	-0.4	0-20
Cash		12,819	1.8	-	1.8	-
TOTAL MERTON PENSION FUND		**720,673**	**100.0**	**100.0**	**-**	

2.6 The following graph illustrates the Fund’s market value trend over the past 5 years and as at 31 December 2018. It shows that in this period the Fund value has appreciated by £192m or 41% .



3.0 Market Background/Outlook

3.1 The rate of acceleration in global economic growth has moderated as financial conditions tighten and trade tensions impact business sentiment and overall demand. Regional differences remain pronounced with the relative strength of the US and the continued weakness in Chinese demand data most noteworthy. Meanwhile, developed world consumption growth and investment remains healthy and is supported by robust labour markets and continued wage growth.

3.2 Equity markets worldwide saw sharp falls in both October and December as 2018 proved to be the worst year since the global financial crisis for many markets. Major developed bourses such as the US and Japan were amongst the biggest fallers for the quarter. Meanwhile, in contrast to the pattern earlier in the year, emerging markets performed relatively well, although Chinese stocks continued to lag.

3.3 Appendix 1 provides more detail on the market statistics and the assets classes the fund is invested in for 3 months, 1 year and 3 years.

4. OTHER ISSUES AFFECTING THE FUND

4.1 none

5. FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

5.1 All relevant implications are included in the report.

6. LEGAL AND STATUTORY IMPLICATIONS

6.1 All relevant implications are included in the report.

7. HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

7.1 N/A

8. RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

8.1 Risk management is an integral part of designing the investment portfolio of the fund.

9. BACKGROUND PAPERS

9.1 JLT Employee Benefits performance report and LCIV performance report.

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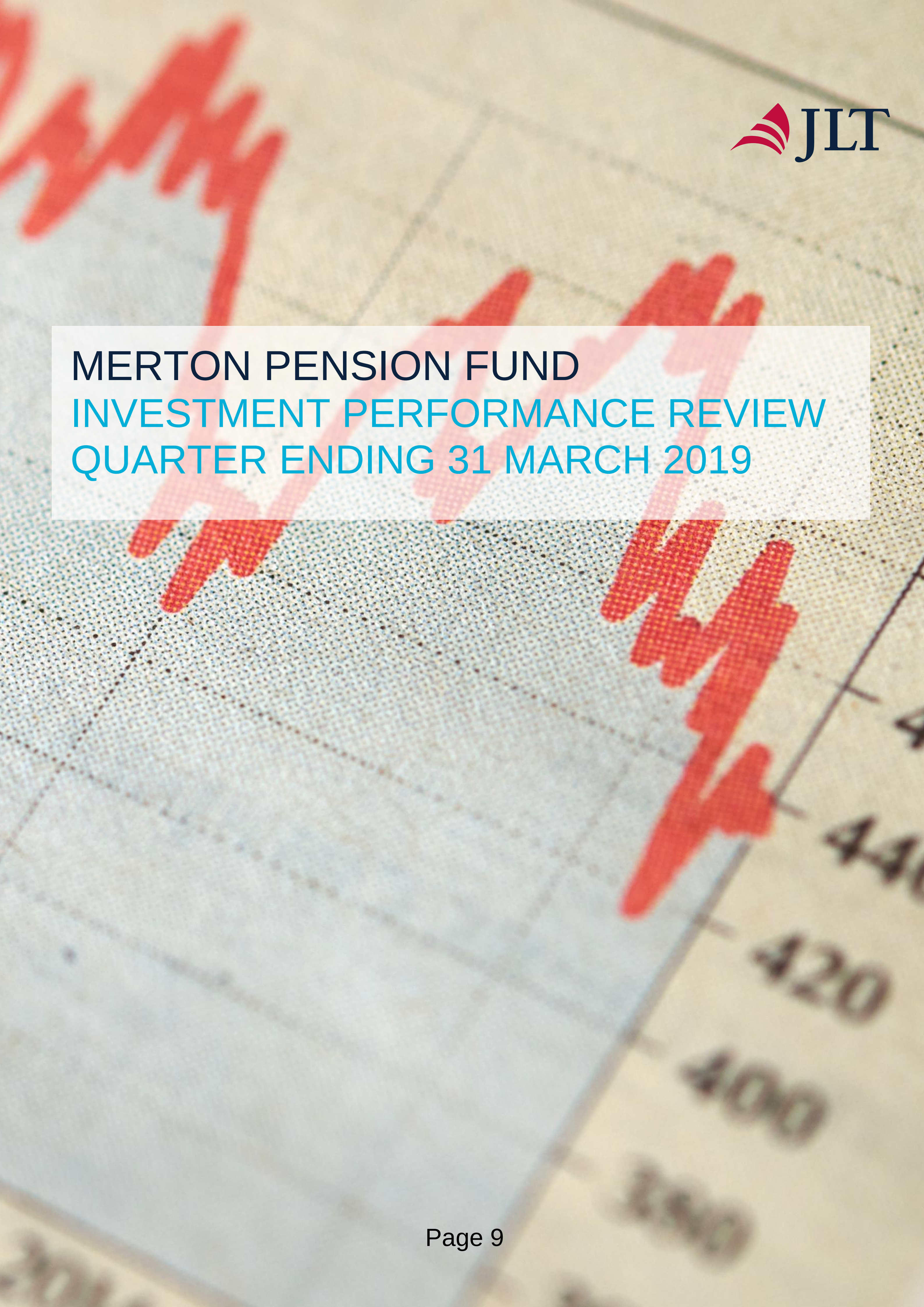


MERTON PENSION FUND

INVESTMENT PERFORMANCE REVIEW
QUARTER ENDING 31 MARCH 2019

1 STRATEGIC ASSET ALLOCATION
31 MARCH 2019

Allocation by underlying asset class

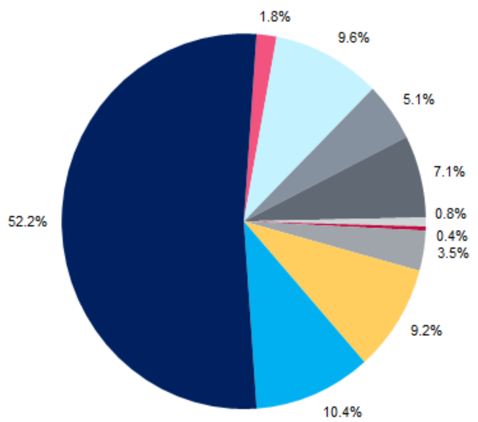
Asset Class		Market Value £000s	Actual Weight %	Strategic Allocation %	Relative %	Strategic Range %
Global Equities		376,408	52.2	40.0	12.2	15-85
Emerging Market Equities		74,966	10.4	10.0	0.4	0-20
Diversified Growth Fund		66,595	9.2	10.0	-0.8	0-20
Property		24,885	3.5	5.0	-1.5	0-10
Private Credit		2,531	0.4	7.5	-7.1	0-10
Infrastructure		5,541	0.8	7.5	-6.7	0-15
Long Index Linked Gilts		51,067	7.1	10.0	-2.9	0-30
Corporate Bonds		36,500	5.1	-	5.1	0-10
Multi Asset Credit		69,360	9.6	10.0	-0.4	0-20
Cash		12,819	1.8	-	1.8	-
TOTAL MERTON PENSION FUND		**720,673**	**100.0**	**100.0**	**-**	

Points to note

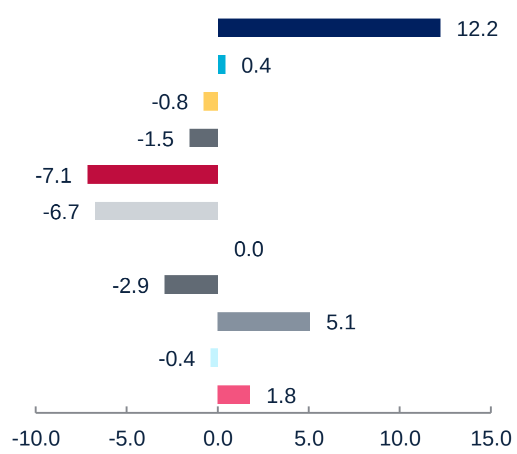
- The Strategic Asset Allocation reflects the strategy to be implemented as part of the 2017 Investment Strategy Review; as such, a number of asset classes will be under or overweight for an interim period until the portfolio is fully constructed.

- Total allocation to Global Equities decreased to 52.2% over the quarter, thereby being 12.2% overweight relative to its strategic allocation. However, this allocation will fall over time as the Fund transitions to Private Credit and Infrastructure.

Actual Asset Allocation as at 31 March 2019



Deviation from Strategic Allocation



Note: Totals may not sum due to rounding.

2 VALUATION SUMMARY
31 DEC 2018 TO 31 MAR 2019

Manager / Fund	31-December-18				31-March-19	
	Valuation £000s	Weight %	Cashflow £000s	Growth £000s	Valuation £000s	Weight %
UBS - Passive Equity	89,363	13.5	-7,917	8,213	89,659	12.4
UBS – Alternative Beta	64,643	9.8	-	5,963	70,606	9.8
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Cash	6,078	0.9	6,741	-	12,819	1.8
TOTAL MERTON PENSION FUND	**662,083**	**100.0**			**720,673**	**100.0**

NOTE: INCOME REINVESTED BY LCIV FUNDS IN THE QUARTER AMOUNTED TO £0.5M.

3 PERFORMANCE SUMMARY
PERIOD ENDING 31 MARCH 2019

Manager / Fund	3 months %		12 months %		3 years % p.a.	
	Fund	Bmark	Fund	Bmark	Fund	Bmark
UBS- Passive Equity Fund †	9.8	n/a	7.9	n/a	11.8	n/a
UBS – Alternative Beta	9.2	9.2	n/a	n/a	n/a	n/a
LCIV RBC Sustainable Equity Fund	13.4	9.9	n/a	n/a	n/a	n/a
LCIV Global Alpha Growth Fund	12.4	10.2	n/a	n/a	n/a	n/a
BlackRock World Low Carbon Equity Tracker Fund	9.5	9.8	n/a	n/a	n/a	n/a
Global Equities						
Aberdeen Global Emerging Market Equities Fund	7.3	7.5	n/a	n/a	n/a	n/a
UBS – HALO EM Fund	11.2	7.4	n/a	n/a	n/a	n/a
Emerging Market Equities						
LCIV Global Total Return Fund	2.7	1.1	n/a	n/a	n/a	n/a
LCIV Diversified Growth Fund	6.2	1.1	n/a	n/a	n/a	n/a
DGF						
UBS Triton Property Unit Trust	0.6	0.3	7.1	4.8	6.9	6.1
BlackRock UK Property Fund	0.1	0.3	4.9	4.8	6.1	6.1
Property						
MIRA Infrastructure Global Solution II, L.P.*	-6.5	0.2	n/a	n/a	n/a	n/a
Quinbrook Low Carbon Power LP*	-1.6	0.6	n/a	n/a	n/a	n/a
Infrastructure						
Churchill Middle Market Senior Loan Fund II*	-1.4	0.5	n/a	n/a	n/a	n/a
Private Credit						
Growth Assets						
Aberdeen Bonds Portfolio	4.7	4.7	6.3	5.9	7.5	7.4
Bonds						
LCIV MAC Fund	2.6	1.2	n/a	n/a	n/a	n/a
Multi-Asset Credit						
Stabilising Assets						
TOTAL MERTON PENSION FUND	**8.0**		**7.7**		**10.6**	
Strategic Target (5.5% p.a.)	**1.3**		**5.5**		**5.5**	

* Partial quarter performance shown. These funds were entered into in mid-January 2019 and hence the fund returns are not reflecting the entire of Q1 2018. Returns for private market managers are approximate, and may be low initially due to the J-curve effect.

† Benchmark suspended in Q2 2018 as a result of transition activity. This impacts 3 month, 12 month and 3 year benchmark returns.

4 MARKET BACKGROUND
PERIOD ENDING 31 MAR 2019

MARKET STATISTICS

Market Returns Growth Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	9.4	6.4	9.5
Overseas Developed	9.6	11.3	15.2
North America	11.3	17.5	17.1
Europe (ex UK)	8.1	2.9	11.2
Japan	4.5	-0.9	12.3
Asia Pacific (ex Japan)	7.7	4.8	13.6
Emerging Markets	7.9	1.9	14.5
Frontier Markets	3.5	-15.4	7.0
Property	0.4	5.0	6.5
Hedge Funds**	5.0	-1.2	3.6
Commodities**	14.1	-5.0	4.5
High Yield**	6.3	3.5	7.1
Emerging Market Debt	7.0	4.2	5.8
Senior Secured Loans**	4.5	1.0	3.9
Cash	0.2	0.6	0.4

Market Returns Bond Assets	3 Mths %	1 Year %	3 Years % p.a.
UK Gilts (>15 yrs)	6.0	4.7	6.3
Index-Linked Gilts (>5 yrs)	6.3	5.7	9.1
Corporate Bonds (>15 yrs AA)	7.1	6.2	7.6
Non-Gilts (>15 yrs)	7.8	4.9	7.3

Exchange Rates: Change in Sterling	3 Mths %	1 Year %	3 Years % p.a.
Against US Dollar	2.31	-7.11	-3.22
Against Euro	4.16	1.74	-2.74
Against Yen	3.22	-3.32	-3.71

Inflation Indices	3 Mths %	1 Year %	3 Years % p.a.
Price Inflation – RPI	-0.2	2.4	3.0
Price Inflation – CPI	-0.1	1.9	2.2
Earnings Inflation*	0.1	3.2	2.6

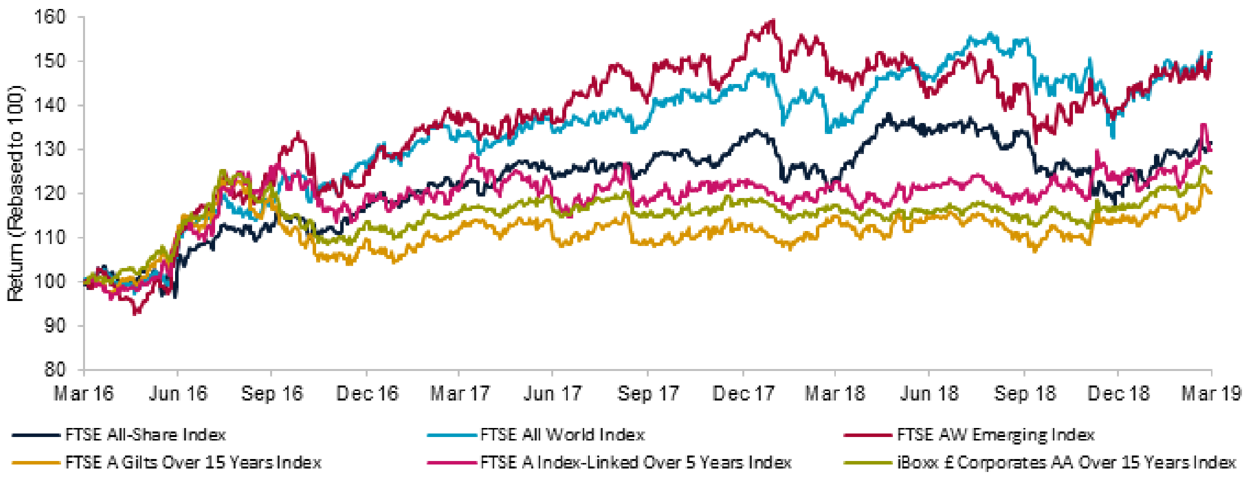
Yields as at 31 December 2018	% p.a.
UK Equities	4.22
UK Gilts (>15 yrs)	1.48
Real Yield (>5 yrs ILG)	-1.86
Corporate Bonds (>15 yrs AA)	2.36
Non-Gilts (>15 yrs)	2.92

Absolute Change in Yields	3 Mths %	1 Year %	3 Years % p.a.
UK Equities	-0.24	0.37	0.45
UK Gilts (>15 yrs)	-0.28	-0.15	-0.69
Real Yield (>5 yrs ILG)	-0.27	-0.20	-0.88
Corporate Bonds (>15 yrs AA)	-0.41	-0.22	-1.00
Non-Gilts (>15 yrs)	-0.44	-0.10	-0.79

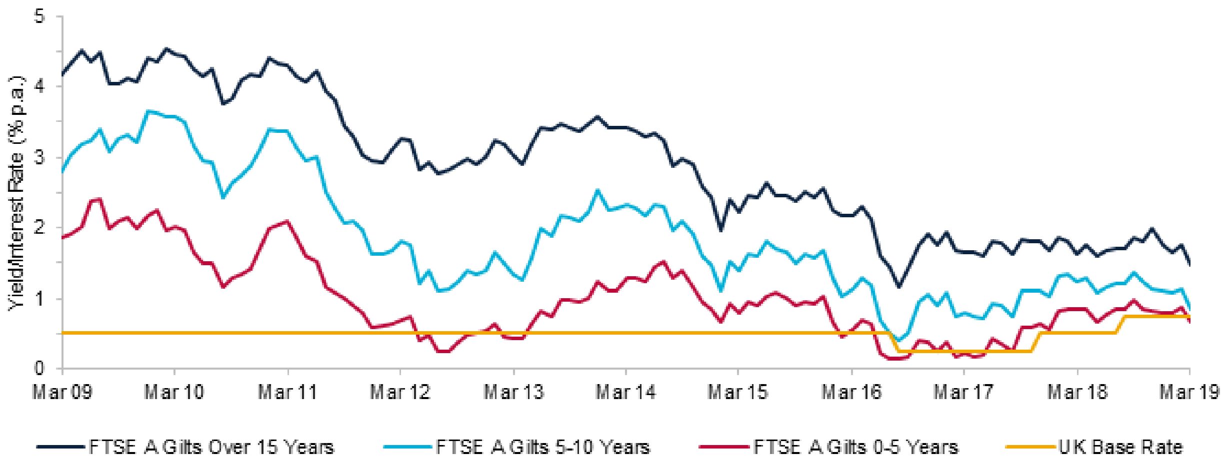
Source: Thomson Reuters.
Note: * Subject to 1 month lag ** GBP Hedged

MARKET SUMMARY CHARTS

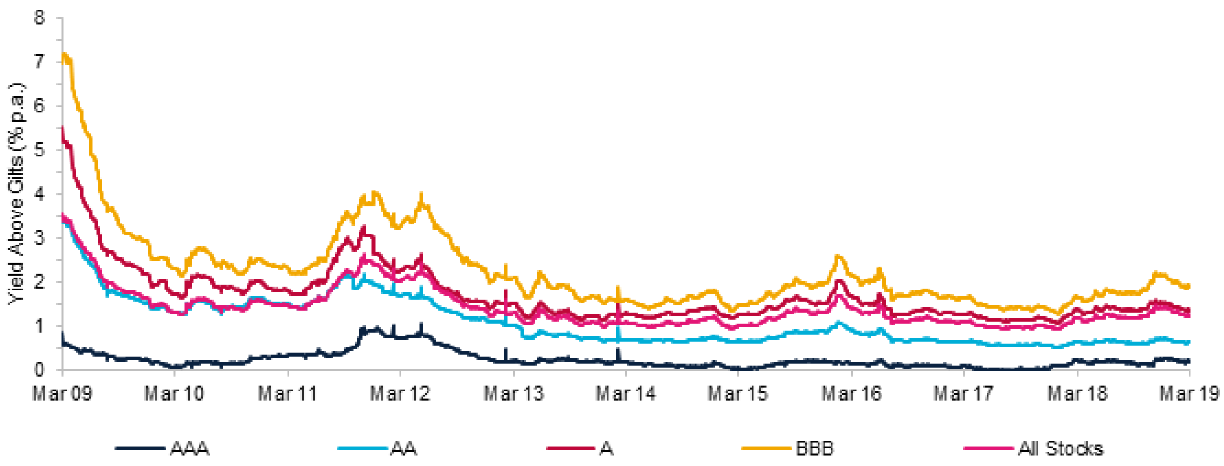
Market performance – 3 years to 31 March 2019



UK government bond yields – 10 years to 31 March 2019



Corporate bond spreads above government bonds – 10 years to 31 March 2019



Source: Thomson Reuters

5 MARKET EVENTS

	What happened?	
Asset Class	**Positive Factors**	**Negative Factors**
United Kingdom	• UK equities rose over the quarter in line with the global equity markets, despite the uncertainty over the global economic outlook. Central banks moved towards a more dovish stance, helping fuel the risk-on rally. • UK domestic stocks also performed well on the back of expectations of a delay in Brexit.	• The IHS Markit/CIPS UK Services PMI fell to 48.9 in March from 51.3 in February, the first contraction in the services sector since July 2016.
North America	• The S&P 500 made its best start in 30 years on account of higher than expected earnings for Q4 2018, posting positive returns for all the 3 months. • The US Fed left interest rates unchanged and adopted a dovish stance, thereby providing some respite in the cost of borrowing for US corporations.	• Earning & revenue forecasts for Q1 2019 are down on concerns of slowing economic growth and fading tax cuts impact. As per data from Factset, the estimated earning decline for S&P 500 would be -3.9%, marking the first YoY decline in earnings since Q2 2016. • The US 10 year Treasury yield went below the 3 month yield for first time since 2017, raising concerns of a recession.
Europe (ex UK)	• Economic growth in the Eurozone continued to remain positive with the Q4 2018 GDP growing at 1.2% YoY. While the growth rate has moderated slightly, it remains healthy. • The European Central Bank (ECB) has committed to maintaining its interest rates at the current levels through 2019. It has also announced several schemes to inject liquidity into the economy.	• Inflation in the Eurozone reached a two-year low in March. The annual headline inflation number came in at 1.4%, down from the high of 2.1% seen in last year. Core inflation still remains subdued at 0.8%, significantly below the ECB's target of 2.0%.
Japan	• Nikkei rose over the quarter as the Yen depreciated amidst a risk-on sentiment. Corporate earnings improved due to developments in Japan's domestic economy.	• Ongoing uncertainty around the US-China trade dispute adversely impacted the economy. Weakening of global auto sales and Chinese demand for capex goods led to a downgrade of EPS estimates.
Asia Pacific (ex Japan)	• Signs of progress in US-China trade negotiation and delay in the imposition of further tariff on Chinese goods by the US was welcomed by the markets.	• Economic growth over the quarter was largely subdued due to weak macroeconomics data from the US and China.
Emerging Markets	• The MSCI Emerging Markets Index started 2019 on a positive note. The index was up by 7.4%, mainly led by China. Markets reacted positively to the US Fed's dovish stance and Trump's decision to suspend further tariffs on China.	• Chinese economic data over January and February raised concerns over slowdown in Chinese economy.

	What happened?	
Asset Class	**Positive Factors**	**Negative Factors**
Conventional Gilts	• UK nominal gilts performed well as yields fell across all maturities over the quarter, especially in March. • Globally, government bonds rallied following the dovish stance of the US Federal Reserve, indicating no rate hikes for this year. • Demand for gilts remains robust and auctions by the DMO continue to be oversubscribed.	
Index-Linked Gilts	• UK index-linked gilts performed well as yields fell across all maturities over the quarter. • Demand for index-linked gilts remains robust and auctions by the DMO continue to be oversubscribed.	
Corporate Bonds	• UK corporate bonds generated positive returns over the quarter as corporate bond yields fell owing to narrower credit spreads and a fall in gilt yields. Whilst gilt yields fell primarily in the month of March, credit spreads narrowed mainly in the first two months of the quarter on the back of a risk-on rally. • Across the various sectors, credit spreads narrowed with the capital goods and insurance sectors being the best performer over the quarter.	
Commodities	• Energy prices led the increase in the S&P GSCI Spot Index over Q1 as crude oil prices rebounded due to production cuts from OPEC and other oil producers. Base metals also moved higher amid positive signs emanating from US-China trade talks.	• Record levels of US crude oil production limited the price increase. Downward revision of global growth by the OECD also put downward pressure on commodity prices.
UK Property		• In Q1 2019, the Brexit-related uncertainties continued to affect UK construction activities. The IHS Markit/CIPS UK construction purchasing managers' index fell to a three quarter low at 49.7, below the 50 threshold level. Commercial construction was the worst performing sector, with business activity falling to the greatest extent since March 2018.

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Committees:

London Borough of Merton Pension Committee Date: 18 July 2019

Standard and General Purpose Committee Date: 25 July 2019

London Borough of Merton Pension Board Date: 26 Sept 2019

Wards: All

Subject: Merton Pension Fund 2018/19 Audit Report

Lead officer: Caroline Holland - Director of Corporate Services

Lead member: Councillor. Mark Allison.

Contact officer: Roger Kershaw- AD Resources

This is a Public Document

RECOMMENDATION
Members are asked to note the content of this report and approve the attached.

(1) Note the External Auditor's Report as set out in Appendix 1.

(2) Note the Letter of Representation as set out in Appendix 1.

1 The Purpose of the Report

1.1 This report presents the Merton Pension Fund's Audit report for the year-ended 31 March 2019.

1.2 The audit report will be presented by EY at the Pension Fund Advisory Committee (PFAC) on the 18 July 2019 and the Pension fund accounts and the annual report will be signed off after presenting to the General Purpose Committee on the 25 July 2019.

2. CONTEXT

1.1 This report presents the audit report to the 2018-19 Annual Pension Fund Report and the Statement of Accounts. The Statement of Accounts has been prepared in accordance with The 2018/19 Code of Practice on Local Authority Accounting in the United Kingdom (the Code) and CIPFA guidance on Accounting for Local Government Pension Scheme.

1.2 The external auditors Ernst and Young have completed their audit into the Pension Fund and provided an unqualified opinion. The pension fund Annual report and the statement of accounts will be signed off after presenting to the Standard and General Purpose Committee on the 25 July 2019.

1.3 The Pension Fund Annual Report carries a very valuable information about the fund and its activities in 2018-19. The regulation require the audited accounts and the annual report must be published by the 1 December.

1.4 Merton Pension Fund annual report will be published on the Council website/pension fund page after the main council statement of account and the Pension Fund statement of accounts being signed off on or before the 31 July 2019.

1.5 The publication of the Pension Fund Annual Report and Statement of Accounts helps to keep Fund members informed, shows good governance, and helps to demonstrate effective management of Fund assets.

1.6 The Accounts comprise two main statements with supporting notes. The main statements are:

- Dealings with Members, Employers and Others, which is essentially the fund's revenue account
- The Net Assets Statement, which can be considered as the funds balance sheet

1.7 In the year the fund assets increased by £58m showing a net asset value of £721m as at 31 March 2018. (£663m) In 2018/19 fund total expenditure was £32m, with the major expenditure being benefit payments to the members (£31m).

1.8 In 2018/19, the Fund recorded a total income of £50m. From which, £42m was from dealings with members and £8m from investment income. The council is the administrating authority and the major employer (92%) of the Fund and in the year made a total employer and employee contribution of £21m

1.9 The fund carried out a major asset transition as part of moving onto its new investment strategy. As a result of this the fund now have a well-diversified portfolio with assets value of £721m.

1.10 Overall, fund membership has increased marginally 2.9% and showed a total membership of 13,668 at the year-end. This was made up of 4,150 active members, 5,592 deferred and 3,926 pensioners.

2. FINANCE

2.1 The total audit fees charged by EY was 16.2k and this showed a reduction of £4.8k from the previous year. The reduction in fee was mainly due to the new audit contract arrangement by the National Audit office.(NAO)

2.2 This is defined as the fee required by auditors to meet statutory responsibilities under the Local Audit and Accountability Act 2014 in accordance with the NAO Code.

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3. OTHER ISSUES AFFECTING THE FUND

None

4. FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

None.

5. LEGAL AND STATUTORY IMPLICATIONS

None.

6. HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

N/A

7. RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

None

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Merton Pension Fund
Audit results report

Year ended 31 March 2018

July 2019

Building a better working world

9 July 2019

Dear Committee Members

We are pleased to attach our audit results report for the forthcoming meeting of the Standards and General Purposes Committee. This report is intended solely for the use of the Standards and General Purposes Committee, other members of the Authority, and senior management. It should not be used for any other purpose or given to any other party without obtaining our written consent.

We have substantially completed our audit of Merton Pension Fund for the year ended 31 March 2019. Subject to receiving the final documents listed in our report, we confirm that we expect to issue an unqualified audit opinion on the financial statements in the form at Section 3, before the 31 July 2019, the date by which regulations require the Council to publish its accounts.

We would like to thank your staff for their help during the engagement.

We welcome the opportunity to discuss the contents of this report, or any other issues arising from our work with you, at the Standards and General Purposes Committee meeting on 25 July 2019.

Yours faithfully

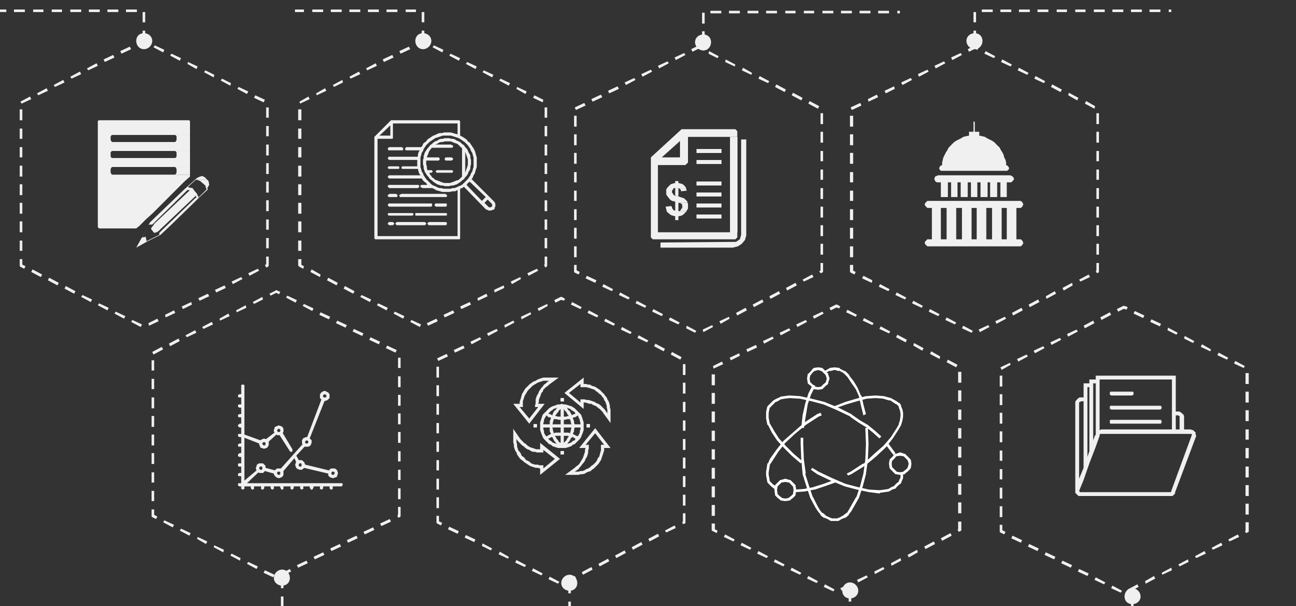
Suresh Patel

Associate Partner

For and on behalf of Ernst & Young LLP

Encl

Contents



Page 25

Public Sector Audit Appointments Ltd (PSAA) have issued a 'Statement of responsibilities of auditors and audited bodies'. It is available from the Chief Executive of each audited body and via the PSAA website (www.psaa.co.uk). It is available from the Chief Executive of each audited body and via the PSAA website.
This Statement of responsibilities serves as the formal terms of engagement between appointed auditors and audited bodies. It summarises where the different responsibilities of auditors and audited bodies begin and end, and what is to be expected of the audited body in certain areas.
The 'Terms of Appointment (updated April 2018)' issued by PSAA sets out additional requirements that auditors must comply with, over and above those set out in the National Audit Office Code of Audit Practice (the Code) and statute, and covers matters of practice and procedure which are of a recurring nature.
This Audit Results Report is prepared in the context of the Statement of responsibilities / Terms and Conditions of Engagement. It is addressed to the Members of the audited body, and is prepared for their sole use. We, as appointed auditor, take no responsibility to any third party.
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01 Executive Summary

Executive Summary

Scope update

In our Audit Plan presented at the 14 March 2019 Standards and General Purposes Committee meeting, we provided you with an overview of our audit scope and approach for the audit of the financial statements. We carried out our audit in accordance with this plan, with the following exception:

- Changes in materiality: We updated our planning materiality assessment using the draft financial statements. Based on our materiality measure of gross expenditure on provision of services, we have updated our overall materiality assessment to £7.2m (Audit Planning Report – £6.6m). This results in updated performance materiality, at 75% of overall materiality, of £5.4m, and an updated threshold for reporting misstatements of £360,000.

Status of the audit

We have substantially completed our audit of the Pension Fund's financial statements for the year ended 31 March 2019 and have performed the procedures outlined in our Audit Plan. Subject to satisfactory completion of the following items we expect to issue an unqualified opinion on Merton Pension Fund's financial statements in the form which appears at Section 3.

- Completion of subsequent events review.
- Receipt of the signed management representation letter.
- Final review of the amended financial statements and annual report.

A national issue has resulted in a relatively late change to the pension fund accounts and IAS26 fund liability disclosure. It relates to legal rulings regarding age discrimination arising from public sector pension scheme transitional arrangements, commonly described as the McCloud ruling. The draft pension fund accounts did not recognise this matter, but officers were aware of the issue and intended to disclose it as a contingent liability. However, since the year-end there has been additional evidence, including the legal ruling by the Supreme Court on 27th June 2019 which rejected the Government's appeal, which suggested that the amounts should in fact be able to be fully calculated and so included in the IAS26 liability disclosed within the financial statements. We consider the impact of this on the financial statements further in Section 4.

Audit differences

Some disclosure changes have been made to both the financial statements and annual report, including changes made by the Fund to Note 14.3 of the draft financial statements, which reconciles movements in investments during the year. Full details of audit differences are set out in Section 4.

Executive Summary

Areas of audit focus

Our Audit Plan identified key areas of focus for our audit of Merton Pension Fund's financial statements. This report sets out our observations and conclusions, including our views on areas which might be conservative, and where there is potential risk and exposure. We summarise our consideration of these matters, and any others identified, in the "Key Audit Issues" section of this report.

We ask you to review these and any other matters in this report to ensure:

- There are no other considerations or matters that could have an impact on these issues
- You agree with the resolution of the issue
- There are no other significant issues to be considered.

There are no matters, apart from those reported by management or disclosed in this report, which we believe should be brought to the attention of the Standards and General Purposes Committee.

Control observations

We have not identified any significant deficiencies in the design or operation of an internal control that might result in a material misstatement in your financial statements and which is unknown to you.

Other reporting issues

We have no other matters to report.

Independence

Please refer to Section 7 for our update on Independence. There are no relationships from 1 April 2018 to the date of this report, which we consider may reasonably be thought to bear on our independence and objectivity.

02 Areas of Audit Focus

Significant risk

Risk of manipulation of Investment income and valuation

What is the risk?

As identified in ISA (UK and Ireland) 240, management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records directly or indirectly and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. We identify and respond to this fraud risk on every audit engagement.

We assessed that the risk of manipulation of investment income and valuation through management override of controls was most likely to affect investment income and assets in the year, specifically through journal postings.

Significant Risk

What did we do and what judgements did we focus on?

- Tested journals at year-end to ensure there are no unexpected or unusual postings;
- Undertook a review of reconciliations to the fund manager and custodian reports and investigated any reconciling differences;
- Re-performed the detailed investment note using the reports we have acquired directly from the custodians or fund managers, including the agreement of investment additions and disposals in the year;
- Sought to obtain further independent support for the valuation of pooled year-end investments where this can be obtained;
- Checked the reconciliation of holdings included in the Net Assets Statement back to the source reports; and
- Reviewed accounting estimates for evidence of management bias,

We utilised our data analytics capabilities to assist with our work, including journal entry testing. We assessed journal entries for evidence of management bias and evaluated for business rationale.

What are our conclusions?

We have not identified any material weaknesses in controls or evidence of material management override. We have not identified any instances of inappropriate judgements being applied. We did not identify any other transactions during our audit which appeared unusual or outside the Pension Fund's normal course of business.

Other area of audit focus

IFRS 9 Financial instruments

What is the risk?

A new accounting standard , IFRS 9, is applicable for pension fund accounts from the 2018/19 financial year. This impacts:

- How financial assets are classified and measured;
- How the impairment of financial assets are calculated; and
- The disclosure requirements for financial assets.

What did we do and what management judgements did we focus on?

We:

- Assessed the Fund's implementation arrangements considering application of the new standard, transitional adjustments and planned accounting for 2018/19;
- Considered the classification and valuation of financial instrument assets;
- Reviewed the new expected credit loss model impairment calculations for assets; and
- Checked additional disclosure requirements.

What are our conclusions?

The transition to IFRS 9 did not have a significant impact on the classification, measurement or impairment of Fund financial assets. Our work identified some minor changes to the disclosure of financial assets which have been made in the updated financial statements.

Other area of audit focus

London Collective Investment Vehicle (LCIV)

What is the risk?

During the year the Fund terminated most of the investments it held at the start of the year and reinvested funds both inside and outside of LCIV. This resulted in significant changes to the fund managers and custodian used by the Fund and has resulted in an increase in the number of fund managers and custodians employed compared to previous periods.

What did we do and what management judgements did we focus on?

We:

- Considered and documented an understanding of the revised arrangements, including the Fund’s arrangements with LCIV. A highly material value of Funds is now invested in the London CIV, exclusively in pooled funds.
- Obtained further independent support for the valuation of pooled Investments at year-end where this was possible.

What are our conclusions?

We are satisfied that the Funds were transferred into LCIV in accordance with the Fund’s investment strategy and that new fund manager and custodian arrangements are in place. LCIV offer a number of investments to individual members of the CIV. LCIV acts as the fund manager in respect of all of the investments it offers. It, however, delegates management of the individual funds through sub-contracting arrangements to other fund managers acting on its behalf. Merton Pension Fund continues to determine the specific LCIV funds in which it invests. As the Fund continues to exercise this control we have determined LCIV is acting as an agent in terms of the services provided to the Fund.

We were able to agree the year end carrying value of LCIV investments to independent confirmation from the sub-contracted fund managers, the custodian (via the online LCIV portal) and independent market evidence where possible. The change in investment holdings and investment in LCIV has generated additional work for Fund officers and has taken more time and resource to gain audit assurance. We therefore propose to charge an additional fee, subject to Public Sector Audit Appointments agreement, in respect of this.

Some changes have also been made by the Fund to Note 14.3 of the draft financial statements, which reconciles movements in investments during the year.

03 Audit Report

Draft audit report

Our opinion on the financial statements

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF MERTON PENSION FUND

Opinion

We have audited the pension fund financial statements for the year ended 31 March 2019 under the Local Audit and Accountability Act 2014. The pension fund financial statements comprise the Fund Account, the Net Assets Statement and the related notes 1 to 24. The financial reporting framework that has been applied in their preparation is applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/19.

In our opinion the pension fund financial statements:

- give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2019 and the amount and disposition of the fund's assets and liabilities as at 31 March 2019; and
- have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/19.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the pension fund in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard and the Comptroller and Auditor General's (C&AG) AGN01, and we have fulfilled our other ethical responsibilities in accordance with these requirements.
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the Director of Corporate Services' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the Director of Corporate Services has not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the pension fund's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

Draft audit report

Our opinion on the financial statements

Other information

The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. The Director of Corporate Services is responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

Matters on which we report by exception

We report to you if:

- we issue a report in the public interest under section 24 of the Local Audit and Accountability Act 2014;
- we make written recommendations to the audited body under Section 24 of the Local Audit and Accountability Act 2014;
- we make an application to the court for a declaration that an item of account is contrary to law under Section 28 of the Local Audit and Accountability Act 2014;
- we issue an advisory notice under Section 29 of the Local Audit and Accountability Act 2014; or
- we make an application for judicial review under Section 31 of the Local Audit and Accountability Act 2014.

We have nothing to report in these respects

Draft audit report

Our opinion on the financial statements

Responsibility of the Director of Corporate Services

As explained more fully in the Statement of the Responsibilities set out on page 170, the Director of Corporate Services is responsible for the preparation of the Authority's Statement of Accounts, which includes the pension fund financial statements, in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/19, and for being satisfied that they give a true and fair view.

In preparing the financial statements, the Director of Corporate Services is responsible for assessing the Pension Fund's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Pension Fund either intends to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.
A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at https://www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Use of our report

This report is made solely to the members of Merton Pension Fund, as a body, in accordance with Part 5 of the Local Audit and Accountability Act 2014 and for no other purpose, as set out in paragraph 43 of the Statement of Responsibilities of Auditors and Audited Bodies published by Public Sector Audit Appointments Limited. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Fund and the Fund's members as a body, for our audit work, for this report, or for the opinions we have formed.

04 Audit Differences

Audit Differences

In the normal course of any audit, we identify misstatements between amounts we believe should be recorded in the financial statements and the disclosures and amounts actually recorded. These differences are classified as “known” or “judgemental”. Known differences represent items that can be accurately quantified and relate to a definite set of facts or circumstances. Judgemental differences generally involve estimation and relate to facts or circumstances that are uncertain or open to interpretation.

Summary of adjusted differences

We highlight any misstatements greater than £5.4 million which have been corrected by management during the course of our audit. There are no corrected differences we wish to bring to your attention.

We report to you any uncorrected misstatements greater than our nominal value of £360,000. There are no uncorrected misstatements to bring to your attention.

McCloud ruling

As noted in the Executive Summary a national issue has resulted in a relatively late change to the pension fund accounts and IAS26 fund liability disclosure. It relates to legal rulings regarding age discrimination arising from public sector pension scheme transitional arrangements, commonly described as the McCloud ruling. The draft pension fund accounts did not recognise this matter, but officers were aware of the issue and intended to disclose it as a contingent liability. However, since the year-end there has been additional evidence, including the legal ruling by the Supreme Court on 27th June 2019 which rejected the Government’s appeal, which suggested that the amounts should in fact be able to be fully calculated and so included in the IAS26 liability disclosed within the financial statements. The actuary has now estimated the impact of the McCloud ruling on the present value of promised retirement benefits. The estimated increase in value of £7.1 million has now been disclosed at Note 19 to the accounts, with further associated disclosure added to recognise this as a source of estimation uncertainty and post balance sheet event.

05 Other reporting issues

Other reporting issues

Consistency of other information published with the financial statements.
We must give an opinion on the consistency of the financial and non-financial information in the Statement of Accounts 2018/19 with the audited financial statements. Financial information in the Statement of Accounts 2018/19 and published with the financial statements was consistent with the audited financial statements.

Other powers and duties
We have a duty under the Local Audit and Accountability Act 2014 to consider whether to report on any matter that comes to our attention in the course of the audit, either for the Authority to consider it or to bring it to the attention of the public (i.e. "a report in the public interest"). We did not identify any issues which required us to issue a report in the public interest. We also have a duty to make written recommendations to the Authority, copied to the Secretary of State, and take action in accordance with our responsibilities under the Local Audit and Accountability Act 2014. We did not identify any issues.

Other reporting issues

Other matters

As required by ISA (UK&I) 260 and other ISAs specifying communication requirements, we must tell you significant findings from the audit and other matters if they are significant to your oversight of Merton Pension Fund's financial reporting process. They include the following:

- Significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures;
- Any significant difficulties encountered during the audit;
- Any significant matters arising from the audit that were discussed with management;
- Written representations we have requested;
- Expected modifications to the audit report;
- Any other matters significant to overseeing the financial reporting process;
- Related parties;
- External confirmations;
- Going concern; and
- Consideration of laws and regulations.

Page 41

We have nothing to report in respect of these matters.

06 Assessment of Control Environment

Assessment of Control Environment

Financial controls

It is the responsibility of the Pension Fund to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Our responsibility as your auditor is to consider whether the Pension Fund has put adequate arrangements in place to satisfy itself that the systems of internal financial control are both adequate and effective in practice.

As part of our audit of the financial statements, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. As we have adopted a fully substantive approach, we have therefore not tested the operation of controls.

Although our audit was not designed to express an opinion on the effectiveness of internal control we are required to communicate to you significant deficiencies in internal control.

We have not identified any significant deficiencies in the design or operation of an internal control that might result in a material misstatement in your financial statements of which you are not aware.

07 Independence

Independence

Confirmation

We confirm that there are no changes in our assessment of independence since our confirmation in our audit planning report dated March 2018. We complied with the FRC Ethical Standards and the requirements of the PSAA's Terms of Appointment. In our professional judgement the firm is independent and the objectivity of the audit engagement partner and audit staff has not been compromised within the meaning of regulatory and professional requirements.
We consider that our independence in this context is a matter which you should review, as well as us. It is important that you consider the facts known to you and come to a view. If you would like to discuss any matters concerning our independence, we will be pleased to do this.

We confirm we have undertaken no non-audit work outside the PSAA Code requirements.

The FRC Ethical Standard requires that we provide details of all relationships between Ernst & Young (EY) and your Pension Fund, and its directors and senior management and its affiliates, including all services provided by us and our network to your Pension Fund, its directors and senior management and its affiliates, and other services provided to other known connected parties that we consider may reasonably be thought to bear on the our integrity or objectivity, including those that could compromise independence and the related safeguards that are in place and why they address the threats.

There are no relationships from 1 April 2018 to the date of this report, which we consider may reasonably be thought to bear on our independence and objectivity.

Page 45

Fee analysis

As part of our reporting on our independence, we set out below a summary of the fees paid for the year ended 31 March 2018.

	Final Fee 2018/19	Planned Fee 2018/19	Scale Fee 2018/19	Final Fee 2017/18
	£	£	£	£
Total Audit Fee – Code work	18,170*	16,170	16,170	21,000

* Includes a proposed fee of £2,000 for additional work arising from the significant changes made to the Fund's investment holdings during the year, movement of funds into LCIV and the resulting in changes in fund manager and custodian arrangements. The proposed additional fee remains subject to approval by Public Sector Audit Appointments Limited (PSAA)

All fees exclude VAT

07 Appendices

Audit approach update

We are required to communicate whether there have been any changes to the audit of the net assets statement from the prior year audit. In 2018/19 we have again taken a fully substantive approach to the audit and there have been no significant changes to our approach.

Our audit procedures are designed to be responsive to our assessed risk of material misstatement at the relevant assertion level. Assertions relevant to the balance sheet include:

- Existence: An asset, liability and equity interest exists at a given date
- Rights and Obligations: An asset, liability and equity interest pertains to the entity at a given date
- Completeness: There are no unrecorded assets, liabilities, and equity interests, transactions or events, or undisclosed items
- Valuation: An asset, liability and equity interest is recorded at an appropriate amount and any resulting valuation or allocation adjustments are appropriately recorded
- Presentation and Disclosure: Assets, liabilities and equity interests are appropriately aggregated or disaggregated, and classified, described and disclosed in accordance with the applicable financial reporting framework. Disclosures are relevant and understandable in the context of the applicable financial reporting framework

Appendix B

Summary of communications

Date	Nature	Summary
Throughout the year	Meetings, calls and e-mails	The Associate Partner and Senior Manager have been in regular contact with the Director of Corporate Services and Head of Treasury and Pensions in respect of the Fund’s risks, accounts closedown and the audit approach.
Standards and General Purposes Committee 6/9/2018 29/11/2018 14/3/2019 Pension Fund Investment Advisory Panel 18/7/2018 2/10/2018 28/11/2018 28/3/2019	Meetings and reports	The current or previous Associate Partner and/or Senior Manager have attended all meetings of the Standards and General Purposes Committee held during the year and through to the date of issue of this report. The Associate Partner has also attended meetings of the Pension Fund Investment Advisory Panel.

In addition to the above specific meetings and letters the audit team met with the management team multiple times throughout the audit to discuss audit findings.

Appendix C

Required communications with the Standards and General Purposes Committee

There are certain communications that we must provide to the audit committees of UK clients. We have detailed these here together with a reference of when and where they were covered:

		Our Reporting to you
Required communications	**What is reported?**	**When and where**
Terms of engagement	Confirmation by the Standards and General Purposes Committee of acceptance of terms of engagement as written in the engagement letter signed by both parties.	The statement of responsibilities serves as the formal terms of engagement between the PSAA's appointed auditors and audited bodies.
Our responsibilities	Reminder of our responsibilities as set out in the engagement letter.	14 March 2019 Standards and General Purposes Committee – Audit Plan
Planning and audit approach	Communication of the planned scope and timing of the audit, any limitations and the significant risks identified.	14 March 2019 Standards and General Purposes Committee – Audit Plan
Significant findings from the audit	• Our view about the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures • Significant difficulties, if any, encountered during the audit • Significant matters, if any, arising from the audit that were discussed with management • Written representations that we are seeking • Expected modifications to the audit report • Other matters if any, significant to the oversight of the financial reporting process	25 July 2019 Standards and General Purposes Committee– Audit Results Report

Appendix C

Required communications	What is reported?	Our Reporting to you – When and where
Public Interest Entities / Major Local Audits	For the audits of financial statements of public interest entities our written communications to the audit committee include: • A declaration of independence • The identity of each key audit partner • The use of non-member firms or external specialists and confirmation of their independence • The nature and frequency of communications • A description of the scope and timing of the audit • Which categories of the balance sheet have been tested substantively or controls based and explanations for significant changes to the prior year, including first year audits • Materiality • Any going concern issues identified • Any significant deficiencies in internal control identified and whether they have been resolved by management • Subject to compliance with regulations, any actual or suspected non-compliance with laws and regulations identified relevant to the audit committee • Subject to compliance with regulations, any suspicions that irregularities, including fraud with regard to the financial statements, may occur or have occurred, and the implications thereof • The valuation methods used and any changes to these including first year audits • The scope of consolidation and exclusion criteria if any and whether in accordance with the reporting framework • The identification of any non-EY component teams used in the group audit • The completeness of documentation and explanations received • Any significant difficulties encountered in the course of the audit • Any significant matters discussed with management • Any other matters considered significant	14 March 2019 Standards and General Purposes Committee – Audit Plan and 25 July 2019 Standards and General Purposes Committee– Audit Results Report

Page 50

Appendix C

		Our Reporting to you
Required communications	What is reported?	When and where
Going concern	Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including: • Whether the events or conditions constitute a material uncertainty • Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements • The adequacy of related disclosures in the financial statements	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Misstatements	• Uncorrected misstatements and their effect on our audit opinion • The effect of uncorrected misstatements related to prior periods • A request that any uncorrected misstatement be corrected • Material misstatements corrected by management	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Subsequent events	• Enquiry of the Audit Committee where appropriate regarding whether any subsequent events have occurred that might affect the financial statements.	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Fraud	• Enquiries of the Audit Committee to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the Pension Fund • Any fraud that we have identified or information we have obtained that indicates that a fraud may exist • Unless all of those charged with governance are involved in managing the Pension Fund, any identified or suspected fraud involving: a. Management; b. Employees who have significant roles in internal control; or c. Others where the fraud results in a material misstatement in the financial statements. • The nature, timing and extent of audit procedures necessary to complete the audit when fraud involving management is suspected • Any other matters related to fraud, relevant to Audit Committee responsibility.	25 July 2019 Standards and General Purposes Committee– Audit Results Report

Appendix C

		Our Reporting to you
Required communications	**What is reported?**	**When and where**
Related parties	Significant matters arising during the audit in connection with the Pension Fund's related parties including, when applicable: • Non-disclosure by management - Inappropriate authorisation and approval of transactions • Disagreement over disclosures - Non-compliance with laws and regulations • Difficulty in identifying the party that ultimately controls the Pension Fund	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Independence	Communication of all significant facts and matters that bear on EY's, and all individuals involved in the audit, objectivity and independence. Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as: • The principal threats • Safeguards adopted and their effectiveness • An overall assessment of threats and safeguards • Information about the general policies and process within the firm to maintain objectivity and independence Communications whenever significant judgments are made about threats to objectivity and independence and the appropriateness of safeguards put in place. For public interest entities and listed companies, communication of minimum requirements as detailed in the FRC Revised Ethical Standard 2016: • Relationships between EY, the company and senior management, its affiliates and its connected parties • Services provided by EY that may reasonably bear on the auditors' objectivity and independence • Related safeguards • Fees charged by EY analysed into appropriate categories such as statutory audit fees, tax advisory fees, other non-audit service fees • A statement of compliance with the Ethical Standard, including any non-EY firms or external experts used in the audit	14 March 2019 Standards and General Purposes Committee – Audit Plan and 25 July 2019 Standards and General Purposes Committee– Audit Results Report
External confirmations	• Management's refusal for us to request confirmations • Inability to obtain relevant and reliable audit evidence from other procedures.	We have received all requested confirmations

Page 52

Appendix C

		Our Reporting to you
Required communications	**What is reported?**	**When and where**
Consideration of laws and regulations	• Subject to compliance with applicable regulations, matters involving identified or suspected non-compliance with laws and regulations, other than those which are clearly inconsequential and the implications thereof. Instances of suspected non-compliance may also include those that are brought to our attention that are expected to occur imminently or for which there is reason to believe that they may occur • Enquiry of the Audit Committee into possible instances of non-compliance with laws and regulations that may have a material effect on the financial statements and that the audit committee may be aware of	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Significant deficiencies in internal controls identified during the audit	• Significant deficiencies in internal controls identified during the audit.	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Written representations we are requesting from management and/or those charged with governance	• Written representations we are requesting from management and/or those charged with governance	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Material inconsistencies or misstatements of fact identified in other information which management has refused to revise	• Material inconsistencies or misstatements of fact identified in other information which management has refused to revise	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Auditors report	• Any circumstances identified that affect the form and content of our auditor's report	25 July 2019 Standards and General Purposes Committee– Audit Results Report
Fee Reporting	• Breakdown of fee information when the audit planning report is agreed • Breakdown of fee information at the completion of the audit • Any non-audit work	14 March 2019 Standards and General Purposes Committee – Audit Plan and 25 July 2019 Standards and General Purposes Committee– Audit Results Report

Management representation letter

Merton Pension Fund

Management Rep Letter

xx July 2019
Suresh Patel
Associate Partner
1 More London Riverside
London
SE1 2AF

This letter of representations is provided in connection with your audit of the financial statements of Merton Pension Fund ("the Fund") for the year ended 31 March 2019. We recognise that obtaining representations from us concerning the information contained in this letter is a significant procedure in enabling you to form an opinion as to whether the financial statements give a true and fair view of the financial transactions of the Fund during the period from 1 April 2018 to 31 March 2019 and of the amount and disposition of the Fund's assets and liabilities as at 31 March 2019, other than liabilities to pay pensions and benefits after the end of the period, have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/19.

We understand that the purpose of your audit of the Fund's financial statements is to express an opinion thereon and that your audit was conducted in accordance with International Standards on Auditing (UK), which involves an examination of the accounting system, internal control and related data to the extent you considered necessary in the circumstances, and is not designed to identify - nor necessarily be expected to disclose – all fraud, shortages, errors and other irregularities, should any exist.

Accordingly, we make the following representations, which are true to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves:

A. Financial Statements and Financial Records

1. We have fulfilled our responsibilities, under the relevant statutory authorities, for the preparation of the financial statements in accordance with the Accounts and Audit Regulations 2015 and CIPFA LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/19.
2. We confirm that the Fund is a Registered Pension Scheme. We are not aware of any reason why the tax status of the scheme should change.
3. We acknowledge, as members of management of the Fund, our responsibility for the fair presentation of the financial statements. We believe the financial statements referred to above give a true and fair view of the financial position and the financial performance of the Fund in accordance with the CIPFA LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/19, and are free of material misstatements, including omissions. We have approved the financial statements.

Management representation letter

Merton Pension Fund

Management Rep Letter

4. The significant accounting policies adopted in the preparation of the financial statements are appropriately described in the financial statements.
5. As members of management of the Fund, we believe that the Fund has a system of internal controls adequate to enable the preparation of accurate financial statements in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/2019 that are free from material misstatement, whether due to fraud or error.
6. There are no unadjusted audit differences identified during the current audit and pertaining to the latest period presented.

B. Non-compliance with laws and regulations including fraud

1. We acknowledge that we are responsible for determining that the Fund's activities are conducted in accordance with laws and regulations and that we are responsible for identifying and addressing any non-compliance with applicable laws and regulations, including fraud.
2. We acknowledge that we are responsible for the design, implementation and maintenance of internal controls to prevent and detect fraud.
3. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
4. We have not made any reports to The Pensions Regulator, nor are we aware of any such reports having been made by any of our advisors.
5. There have been no other communications with The Pensions Regulator or other regulatory bodies during the Fund year or subsequently concerning matters of noncompliance with any legal duty.
6. We have no knowledge of any identified or suspected non-compliance with laws or regulations, including fraud that may have affected the Fund (regardless of the source or form and including without limitation, any allegations by "whistleblowers"), including non-compliance matters:

- Involving financial improprieties
- Related to laws or regulations that have a direct effect on the determination of material amounts and disclosures in the Fund's financial statements
- Related to laws and regulations that have an indirect effect on amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operations of the Fund, its ability to continue, or to avoid material penalties
- Involving management, or employees who have significant roles in internal control, or others
- In relation to any allegations of fraud, suspected fraud or other non-compliance with laws and regulations communicated by employees, former employees, analysts, regulators or others.

C. Information Provided and Completeness of Information and Transactions

1. We have provided you with:

- Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters.
- Additional information that you have requested from us for the purpose of the audit.
- Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

2. You have been informed of all changes to the Fund rules.
3. All material transactions have been recorded in the accounting records and are reflected in the financial statements.

Management representation letter

Merton Pension Fund

Management Rep Letter

2. You have been informed of all changes to the Fund rules.
3. All material transactions have been recorded in the accounting records and are reflected in the financial statements.
4. We have made available to you all minutes of the meetings of the Fund and committees of members of the management of the Fund (or summaries of actions of recent meetings for which minutes have not yet been prepared) held through 2018/19 to the most recent meeting of the Pension Fund Investment Advisory Panel on 18 July 2019, and Standards and General Purposes Committee on 25 July 2019.
5. We confirm the completeness of information provided regarding the identification of related parties. We have disclosed to you the identity of the Fund's related parties and all related party relationships and transactions of which we are aware, including sales, purchases, loans, transfers of assets, liabilities and services, leasing arrangements, guarantees, non-monetary transactions and transactions for no consideration for the period ended, as well as related balances due to or from such parties at 31 March 2019. These transactions have been appropriately accounted for and disclosed in the financial statements.
6. We have disclosed to you, and the Fund has complied with, all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance, including all covenants, conditions or other requirements of all outstanding debt.
7. No transactions have been made which are not in the interests of the Fund members or the Fund during the fund year or subsequently.
8. We believe that the significant assumptions we used in making accounting estimates, including those measured at fair value, are reasonable.

D. Liabilities and Contingencies

1. All liabilities and contingencies, including those associated with guarantees, whether written or oral, have been disclosed to you and are appropriately reflected in the financial statements.
2. We have informed you of all outstanding and possible litigation and claims, whether or not they have been discussed with legal counsel.
3. We have recorded and/or disclosed, as appropriate, all liabilities relating to litigation and claims, both actual and contingent, and have disclosed in Note 24 to the financial statements all guarantees that we have given to third parties.

E. Subsequent Events

1. Other than as described in Note 6 to the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or notes thereto.

F. Other information

1. We acknowledge our responsibility for the preparation of the other information. The other information comprises the London Borough of Merton Pension Fund Annual Report 2018-19.
2. We confirm that the content contained within the other information is consistent with the financial statements.

Management representation letter

Merton Pension Fund

Management Rep Letter

G. Derivative Financial Instruments

1. We confirm that the Fund has made no direct investment in derivative financial instruments.

Management has duly considered and deemed as appropriate the assumptions and methodologies used in the valuation of ‘over the counter’ derivative financial instruments which the Fund is holding, and these have been communicated to you.

I. Pooling investments, including the use of collective investment vehicles and shared services

1. We confirm that all investments in pooling arrangements, including the use of collective investment vehicles and shared services, meet the criteria set out in the November 2015 investment reform and criteria guidance and that the requirements of the LGPS Management and Investment of Funds Regulations 2016 in respect of these investments has been followed.

J. Actuarial valuation

1. The latest report of the actuary, Alison Hamilton from Barnett Waddingham as at 31 March 2016, has been provided to you. To the best of our knowledge and belief we confirm that the information supplied by us to the actuary was true and that no significant information was omitted which may have a bearing on his report.

K. Estimates

1. We believe that the measurement processes, including related assumptions and models, used to determine accounting estimates in the financial statements have been consistently applied and are appropriate in the context of CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2018/2019.

Yours faithfully,

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Caroline Holland
Director of Corporate Service

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Councillor Peter McCabe
Chair, Standards and General Purposes Committee

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BARNETT WADDINGHAM
beyond the expected

London Borough of Merton Pension Fund

Actuarial valuation as at 31 March 2019

Indicative assumptions

Barnett Waddingham LLP

10 July 2019

BARNETT WADDINGHAM
beyond the expected

Contents

Introduction

We have been asked by London Borough of Merton, the administering authority to the London Borough of Merton Pension Fund (the Fund), to carry out an actuarial valuation of the Fund as at 31 March 2019. The Fund is part of the Local Government Pension Scheme (LGPS), a statutory scheme administered in accordance with the Local Government Pension Scheme Regulations 2013, as amended (the Regulations). The actuarial valuation is required under Regulation 62.

The purpose of this paper is to provide detail on our anticipated approach to the 2019 valuation and to provide an indication of the assumptions that will be adopted. A further version of this paper may be produced following initial discussions with the Fund

The final assumptions used will be agreed with the administering authority and will be consistent with the Fund's Funding Strategy Statement.

This report is addressed to London Borough of Merton as administering authority to the Fund. It is not intended to assist any user other than London Borough of Merton in making decisions and we do not accept any liability to third parties in respect of this report. The administering authority must provide us with sufficient and up to date information relating to matters relevant to our advice. We will only be able to accept responsibility for the advice based on the information provided.

This advice is subject to and complies with Technical Actuarial Standard 100: Principles for Technical Actuarial Work (TAS 100) and Technical Actuarial Standard 300: Pensions (TAS 300) as issued by the Financial Reporting Council (FRC).

Barnett Waddingham

Fund Actuaryy

Executive summary

Methodology

We do not propose any fundamental changes to the existing overall approach to setting contributions. In particular, we will continue to use a smoothed approach and the discount rate will be based on a weighted average of estimates of long-term investment returns with an allowance for prudence.

Discount rate

The discount rate is a prudent assessment of the future expected investment return. We derive the expected return from each asset class and the discount rate is then a weighted average of each return, based on the long term asset allocation of the Fund, less an adjustment for expenses and prudence.

At this valuation we have proposed a change in the underlying equity model so that it incorporates global indicators rather than UK indicators. We believe this change is appropriate as we were concerned that the UK indicators were overestimating longer-term dividend streams. This results in a lower assumed return from equities than under the previous model.

The asset allocation strategy has also changed since the 2016 valuation and our discount rate assumption will reflect this. The table below summarises the long-term asset strategy used for the indicative assumptions in this report (based on the Fund's March 2017 Investment Strategy Statement), and the comparative strategy used for the Fund's discount rate at the 2016 valuation.

Long-term strategic allocation	Indicative for 2019 valuation	2016 valuation
Gilts	10%	23%
Other bonds	0%	2%
Cash	0%	0%
Equities	65%	70%
Property and infrastructure	12.5%	5%
Multi asset credit	12.5%	0%
Total	**100%**	**100%**

Longevity assumptions

The administering authority have asked the specialist longevity team at Barnett Waddingham to carry out an analysis of recent mortality experience of members of the Fund to feed into the assumption for the post-retirement mortality tables to be used. As part of this analysis we also expect there to be some suggested changes to the allowance made for future improvements in life expectancies in order to reflect current trends. Initial expectations are that these changes should reduce the value of the liabilities compared to the assumptions used at the previous valuation and thus provide some offset to the increase in liabilities resulting from the change in discount rate.

Changes to assumptions

The assumptions that we provide in this paper are our central assumptions for the 2019 valuation, based on market conditions and information received up to 30 June 2019. The market statistics that we will use in the agreed assumptions will be smoothed around the valuation date so that the market conditions used are the average of the daily observations over the period 1 January 2019 to 30 June 2019. As part of the 2019 valuation, there is likely to be a range of assumptions that are acceptable both to the Fund and to us as the Fund actuary. Once we have finalised the 2019 valuation membership data, we can carry out further testing of the suitability of the proposed assumptions and discuss the implications with the Fund. We can then agree the final assumptions following that process.

Regulatory uncertainties

There are currently a few important regulatory uncertainties surrounding the 2019 valuation as follows:

- McCloud/Cost cap and the effect on the future and historic LGPS benefits structure;
- Timing of future actuarial valuations moving away from a triennial cycle; and
- GMP equalisation.

More detail is contained in the report about each of these issues as well as the outcome of the 2016 Section 13 review. At this stage we have made no allowance in the proposed assumptions but as we go through the valuation process we will work closely with the administering authority to consider how to approach each of these issues when setting the contribution rates for employers.

Proposed assumptions

Our indicative principal assumptions are set out below:

Assumption	Proposed assumptions for 2019 valuation	Assumptions used for the 2016 valuation
Market date	31 March 2019 (as the assumptions are smoothed, we used market data between 1 January 2019 and 30 June 2019)	31 March 2016 (as the assumptions are smoothed, we used market data between 1 January 2016 and 30 June 2016)
CPI inflation	2.6% p.a.	2.4% p.a.
Salary increases	3.6% p.a.	3.9% p.a. with a short term overlay for salaries to increase in line with CPI to 31 March 2020
Discount rate	5.3% p.a.	5.5% p.a.
Post-retirement mortality		
Base tables	TBC BW longevity team currently undertaking analysis	S2PA tables with a multiplier of 80% for males and 85% for females 95% of the S2PMA tables for male dependants and 100% of the S2DFA tables for female dependants
Model Long-term rate of improvement	CMI 2018 1.25% p.a.	CMI 2015 1.5% p.a.
Life expectancy of 65 year old:	Retiring today: Male: TBC Female: TBC	Retiring today: Male: 24.3 years Female: 25.9 years

Background

The purpose of the 2019 actuarial valuation is to set appropriate contribution rates for each employer in the Fund for the period from 1 April 2020 to 31 March 2023, as required under Regulation 62. This three year period is currently being considered by the Ministry of Housing, Communities and Local Government (MHCLG) as there is a possibility of moving to a quadrennial valuation cycle in line with other public service schemes. This is likely to have a knock-on effect on the number of years of contributions certified as part of the 2019 valuation and there is more detail on this below.

The contribution rates comprise two elements, the primary rate and the secondary rate:

- The primary rate for each employer is the employer's future service contribution rate (i.e. the rate required to meet the cost of future accrual of benefits) expressed as a percentage of pay.
- The secondary rate is an adjustment to the primary rate to arrive at the total rate each employer is required to pay (for example, to allow for deficit recovery).

Regulation 62 specifies four requirements that the actuary "must have regard" to and are detailed below:

1. The existing and prospective liabilities arising from circumstances common to all those bodies
2. The desirability of maintaining as nearly a constant a primary rate as possible
3. The current version of the administering authority's funding strategy statement
4. The requirement to secure the "solvency" of the pension fund and the "long-term cost efficiency" of the Scheme, so far as relating to the pension fund.

The wording of the second objective is not ideal in that it appears to be aimed towards the primary rate rather than taking into account the surplus or deficit of the employer. We believe that if we achieve reasonably stable total individual employer rates (which seems like a preferable objective) then we will also meet the regulatory aim.

The third clause simply means that we should be aware of and take account of your Funding Strategy Statement (FSS). It is the responsibility of the Fund to draft and maintain this statement although we are usually consulted on the drafting.

Definitions for "solvency" and "long-term cost efficiency" are included in CIPFA's FSS guidance. These can be briefly summarised as:

- ensuring that employers are paying in contributions that cover the cost of benefit accrual and target a fully funded position over an appropriate time period using appropriate actuarial assumptions, and
- that employers have the financial capacity to increase contributions (or there is an alternative plan in place) should contributions need to be increased in future.

Section 13

Under Section 13 of the Public Service Pensions Act 2013, MHCLG is required to commission a report on the actuarial valuations of the LGPS funds, and this report is to be prepared by the Government Actuary's Department (GAD). The purpose of the "Section 13" report to is report on whether the following aims are achieved: compliance, consistency, solvency and long-term cost efficiency, and to identify any funds that cause concerns.

The report covering the 2016 valuations was published in September 2018 and made a number of general recommendations as well as recommendations specific to individual funds. The London Borough of Merton Pension Fund was highlighted in GAD's report as one of the Funds which had not reduced its deficit recovery period from that set at the 2013 valuation (despite the Fund already having one of the lowest recovery periods across the LGPS Funds).

One of the general recommendations stated that *"the Scheme Advisory Board should consider what steps should be taken to achieve greater clarity and consistency in actuarial assumptions, except where differences are justified by material local variations, with a view to making a recommendation to the MHCLG Minister in advance of the next valuation"*. If this recommendation is taken forward, this would clearly have a material impact on the ability of fund actuaries and administering authorities to set assumptions that they believe to be appropriate for their own fund.

There are good reasons why assumptions vary across funds. In particular, different investment strategies lead to different expected future returns, a fund's geographical region and membership profile has a significant impact on longevity assumptions and the fund's attitude to risk is factored into the discount rate through a transparent and bespoke level of prudence. Changes in assumptions will also only be made if considered appropriate in light of experience and other factors emerging since the previous valuation. We do not have a house view on assumptions. However, the external push towards consistency is another factor that we may need to consider in setting appropriate assumptions for the Fund and we will discuss consistency at various points in this document.

One "consistent" set of assumptions may be the set of assumptions that we are required to provide 2019 valuation results on to the LGPS Scheme Advisory Board (SAB) in order to aid comparison between funds. The assumptions used are a mixture of standardised and local demographic assumptions. We do not believe that these assumptions as a whole are appropriate for the funding of the Fund but they are a useful reference point.

Current regulatory uncertainties

There are currently a few important regulatory uncertainties surrounding the 2019 valuation which we have set out below. At this stage we have made no allowance for any of these issues in the proposed assumptions advice as we are awaiting further guidance. However, we are keen to engage with the administering authority at an early stage to consider the approach to each of these issues as we go through the 2019 valuation process.

McCloud/Cost cap

Cost cap background

The 2016 national Scheme valuation was used to determine the results of HM Treasury's (HMT) employer cost cap mechanism for the first time. The HMT cost cap mechanism was brought in after Lord Hutton's review of public service pensions with the aim of providing protection to taxpayers and employees against unexpected changes (expected to be increases) in pension costs. The cost control mechanism only considers "member costs". These are the costs relating to changes in assumptions made to carry out valuations relating to the profile of the Scheme members; e.g. costs relating to how long members are expected to live for and draw their pension.

Therefore, assumptions such as future expected levels of investment returns and levels of inflation are not included in the calculation, so have no impact on the cost management outcome.

The 2016 HMT cost cap valuation revealed a fall in these costs and therefore a requirement to enhance Scheme benefits from 1 April 2019. However, as a funded Scheme, the LGPS also had a cost cap mechanism controlled by the SAB in place and HMT allowed SAB to put together a package of proposed benefit changes in order for the LGPS to no longer breach the HMT cost cap. These benefit changes were due to be consulted on with all stakeholders earlier this year and implemented from 1 April 2019.

McCloud judgement

On 20 December 2018 there was a judgement made by the Court of Appeal which resulted in the Government announcing their decision to pause the cost cap process across all public service schemes. The delay is a consequence of the McCloud judgement, which could result in all public service schemes having to unravel the transitional protections built into the new schemes, post Hutton's review.

The McCloud judgement was in relation to a legal challenge by members of the New Judicial Pension Scheme (NJPS) against the age-based transitional provisions put into place when the new judicial pension arrangements were introduced in 2015. The members argued that these transitional provisions were directly discriminatory on grounds of age and indirectly discriminatory on grounds of sex and race, based on the correlation between these two factors reflected in the judicial membership. The Tribunal ruled against the Government, deeming the transitional provisions as not a proportionate means of achieving a legitimate aim.

The Government applied to the Supreme Court to appeal the McCloud ruling, however, it was announced on 27 June 2019 that the Government's application was denied.

It is therefore unclear what this means for the LGPS. On 14 February 2019 the SAB released a series of Q&As and a question for administering authorities to consider how they should approach the 2019 valuation. There was an overwhelming majority of funds who wanted SAB to provide guidance in order to promote a consistent approach between the funds.

On 14 May 2019, the SAB published an advice note covering the implications of McCloud and the cost cap in relation to the 2019 fund valuations. The note recommended that should there be no finalised outcome by 31 August 2019 then no changes should be made to the Scheme benefit design for valuation purposes. However each administering authority should consider how they approach the additional risks that these potential extra costs may pose. This would involve making employers aware of the potential for extra costs to arise, for example via the Fund's FSS. Once the outcome is known, it may be possible to revisit contributions through an interim valuation, subject to the outcome of a current consultation regarding changes to the local valuation cycle.

McCloud impact analysis

The Scheme Advisory Board, with the consent of the Ministry of Housing, Communities and Local Government (MHCLG), commissioned GAD to report on the possible impact of the McCloud/Sargeant judgement on LGPS liabilities, and in particular, those liabilities to be included in local authorities' accounts under IAS26 as at 31 March 2019. This followed an April 2019 CIPFA briefing note which said that local authorities should consider the materiality of the impact. This analysis was to be carried out on a "worst-case" basis, (i.e. what potential remedy would incur the highest increase in costs/liabilities). The results of this analysis are set out in GAD's report dated 10 June 2019.

Timing of future actuarial valuations

LGPS valuations currently take place on a triennial basis which results in employer contributions being reviewed every three years. In September 2018 it was announced by the Chief Secretary to HMT, Elizabeth Truss, that the national Scheme valuation would take place on a quadrennial basis (i.e. every four years) along with the other public sector pension schemes. The results of the national Scheme valuation are used to test the cost control cap mechanism and HMT believed that all public sector schemes should have the cost cap test happen at the same time with the next quadrennial valuation in 2020 and then 2024.

Although this has no immediate effect on the local fund triennial valuation process, and the 2019 valuation is going ahead as planned, we understand that MHCLG are considering the implications of also moving the local fund valuations to a quadrennial basis. There is an ongoing consultation regarding this and, until the outcome of this is known, it is unclear how many years of contributions we will need to certify as part of the 2019 valuation, as the next valuation could be delayed until 2024. As part of the consultation, there is a proposal enabling interim valuations which would allow funds to reassess funding positions and contribution rates prior to 2024.

Allowance for GMP equalisation

On 26 October 2018 the judgement was published for the Lloyd's Banking Group Pensions Trustees Ltd vs Lloyds Bank Plc & Others on how their Guaranteed Minimum Pensions (GMPs) should be equalised. However, HMT have confirmed that the GMP judgement "does not impact on the current method used to achieve equalisation and indexation in public service pension schemes", which is set out here:

https://www.gov.uk/government/consultations/indexation-and-equalisation-of-gmp-in-public-service-pension-schemes/consultation-on-indexation-and-equalisation-of-gmp-in-public-service-pension-schemes

On 22 January 2018, the Government published the outcome to its *Indexation and equalisation of GMP in public service pension schemes* consultation, concluding that the requirement for public service pension schemes to fully protect the GMP element of individuals' public service pension would be extended to those individuals reaching SPA before 6 April 2021. HMT published a Ministerial Direction on 4 December 2018 to implement this outcome, with effect from 6 April 2016.

The assumption made at the 2016 valuation was that funds pay limited increases for members that have reached SPA by 6 April 2016, with the Government providing the remainder of the inflationary increase and that funds will be required to pay the full indexation on GMPs for those attaining State Pension Age after 6 April 2016. This effectively assumes that the Government extends their current policy indefinitely and we believe this is a sensible approach to making an interim allowance for GMP equalisation.

Therefore we are not anticipating any change in our approach to valuing GMP in the 2019 valuation unless there is further guidance released for public service schemes.

Summary of position as at 31 March 2016

The previous valuations of the London Borough of Merton Pension Fund was carried out as at 31 March 2016 by us and the results are set out in our report dated 31 March 2017. The funding position is summarised below:

2016 valuation results	London Borough of Merton Fund
Funding level	94%
Surplus (deficit)	(£32.7m)

The primary rate (future service contribution rate) calculated to cover the cost of benefits that would be built up over the year after the valuation was 15.2% p.a. of pensionable pay.

In practice, employers are assessed individually in setting the minimum contributions due from them over the inter-valuation period.

Proposed central assumptions – financial assumptions

To produce the future cashflow or liabilities and their present value we need to formulate assumptions about the factors affecting the Fund's future finances. We can consider these assumptions as:

- The statistical assumptions which generally provide estimates of the likelihood of benefits and contributions being paid. This includes the rates of mortality, early retirement and staff turnover; and
- The financial assumptions which determine the estimates of the amount of benefits and contributions payable as well as their current or present value. This includes inflation, salary increases and investment returns (also referred to as the discount rate).

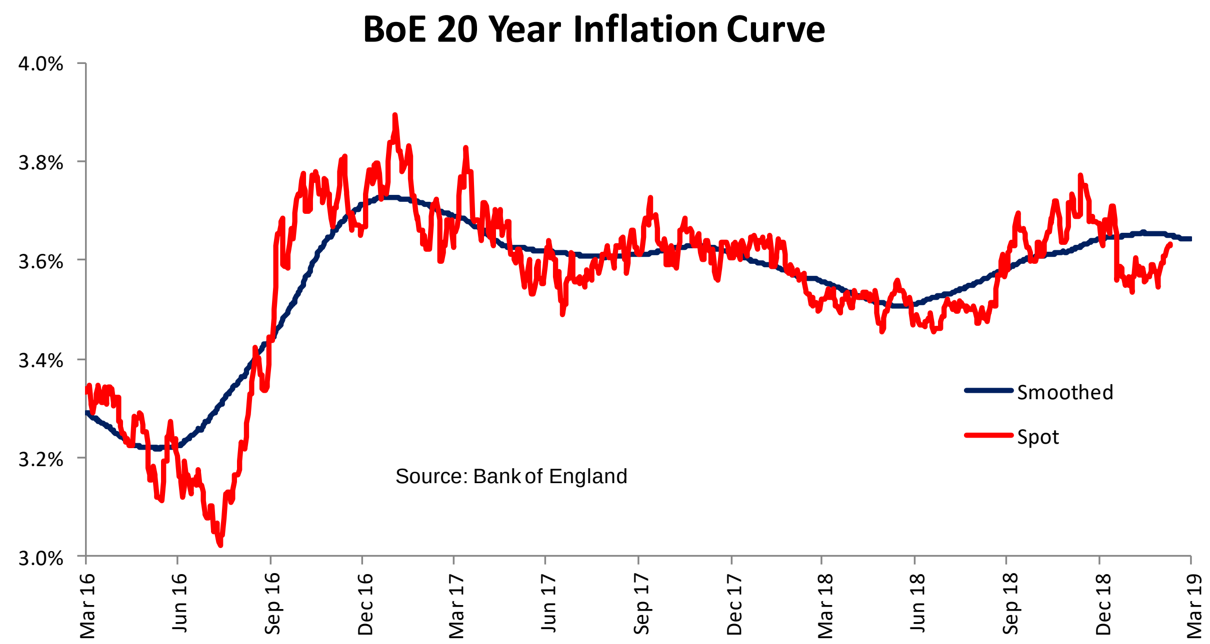
The assumptions that we use as part of our approach are a combination of market-related statistics, historical averages and judgement (e.g. future salary increases). In addition, the base market statistics that we use are smoothed around the valuation date so that the market conditions used are the average of the daily observations over the period 1 January 2019 to 30 June 2019. Assets are also smoothed in a consistent way. The smoothing mechanism is used to help with the objective of setting reasonably stable contribution rates.

Where there is greater uncertainty in a particular assumption, the recommended assumption may include a margin for prudence. As the assumptions are being used to set contributions, this simply means that using a prudent assumption will give more potential scenarios where the calculated contributions are sufficient than those where they are not. We suggest that an overall prudence adjustment is made to the discount rate only and so we derive neutral assumptions for all other assumptions.

When looking at a market yield curve we generally take the 20 year point on that curve for all funds as this helps produce consistent assumptions for our funds as we have estimated that 20 years is consistent with the duration of an average LGPS fund's liabilities.

Price inflation (RPI)

Our starting assumption for inflation is the (smoothed) 20 year point on the Bank of England implied Retail Price Index (RPI) inflation curve which is 3.6% p.a. as at 31 March 2019 (allowing for market information up to and including 30 June 2019).



This statistic is based on the difference between fixed-interest and index-linked gilts and there are reasonable theoretical reasons for this to overstate inflation, for example due to the preference of investors to purchase inflation-linked products to provide protection against unexpected inflation. This difference may be referred to as an inflation risk premium.

There is a significant degree of subjectivity at present in coming to a view on the existence of an inflation risk premium and we are not strongly persuaded that it should be included. Hence we propose that there should be no inflation risk premium.

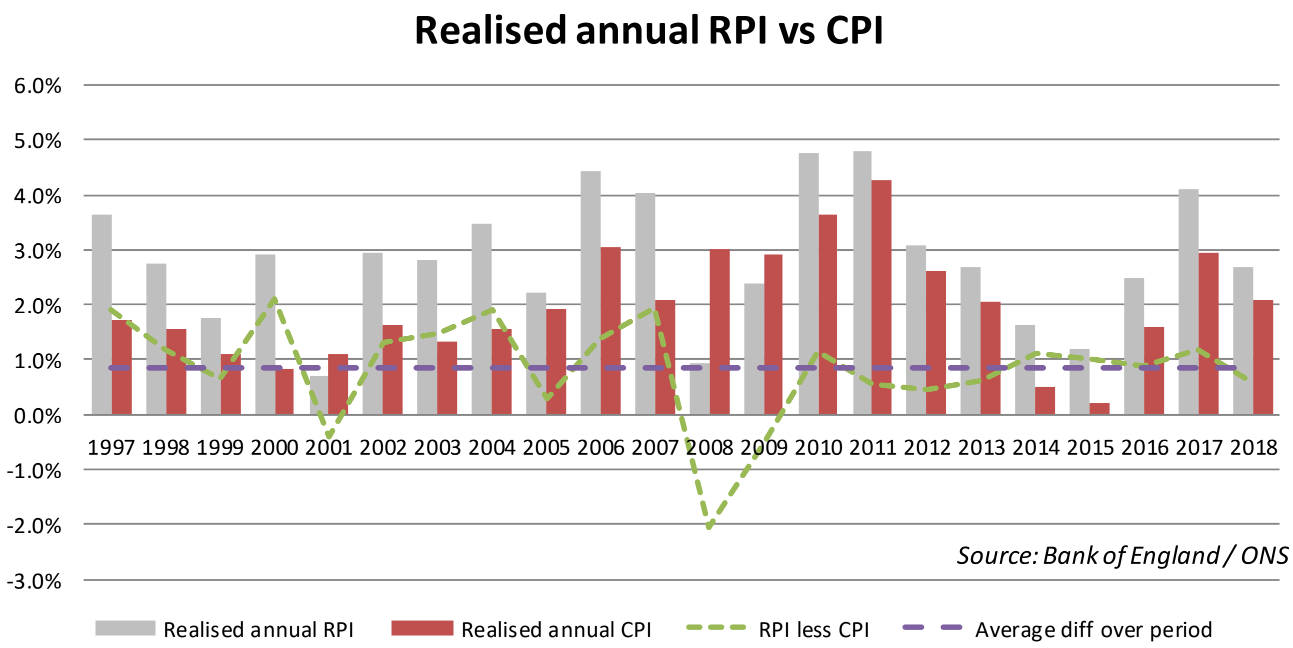
Therefore, our illustrative (neutral) assumption for RPI inflation is 3.6% p.a.

The approach to setting the RPI inflation assumption is consistent with that taken for the 2016 valuation.

Price inflation (CPI)

There is currently no reliable market-derived measure for Consumer Price Index (CPI) inflation as there is no sufficiently deep and liquid market in CPI-linked instruments.

Historically, RPI inflation has exceeded CPI inflation but the difference has been fairly volatile from year to year. The graph below shows 1-year RPI increase figures and 1-year CPI increase figures since 1997 (with the year-on-year difference and average difference over the 21 year period also shown).



At the 2016 valuation, we assumed that future CPI inflation would be 0.9% p.a. less than future RPI inflation. This difference is primarily due to the "formula effect" which occurs as a result of the CPI being calculated using a predominantly different averaging method than RPI. The formula effect is theoretically proportionate to the level of inflation itself and so when implied inflation is higher, there is an argument for assuming a higher formula effect.

Given implied RPI inflation is currently around 0.3% higher than at 31 March 2016, we propose that the assumption for the difference between future RPI inflation and CPI inflation is increased from 0.9% p.a. to 1.0% p.a. We also recently moved to this as a standard assumption for IAS19 and FRS102 pensions accounting where this assumption is required to be best estimate.

Therefore, we would propose an illustrative (neutral) CPI assumption of 2.6% p.a. as at 31 March 2019.

The Bank of England has a CPI target of 2.0% p.a. Effectively, we are saying that the market suggests that the Bank will, on average, not make this target and CPI inflation will average higher than the target over the next 20 years.

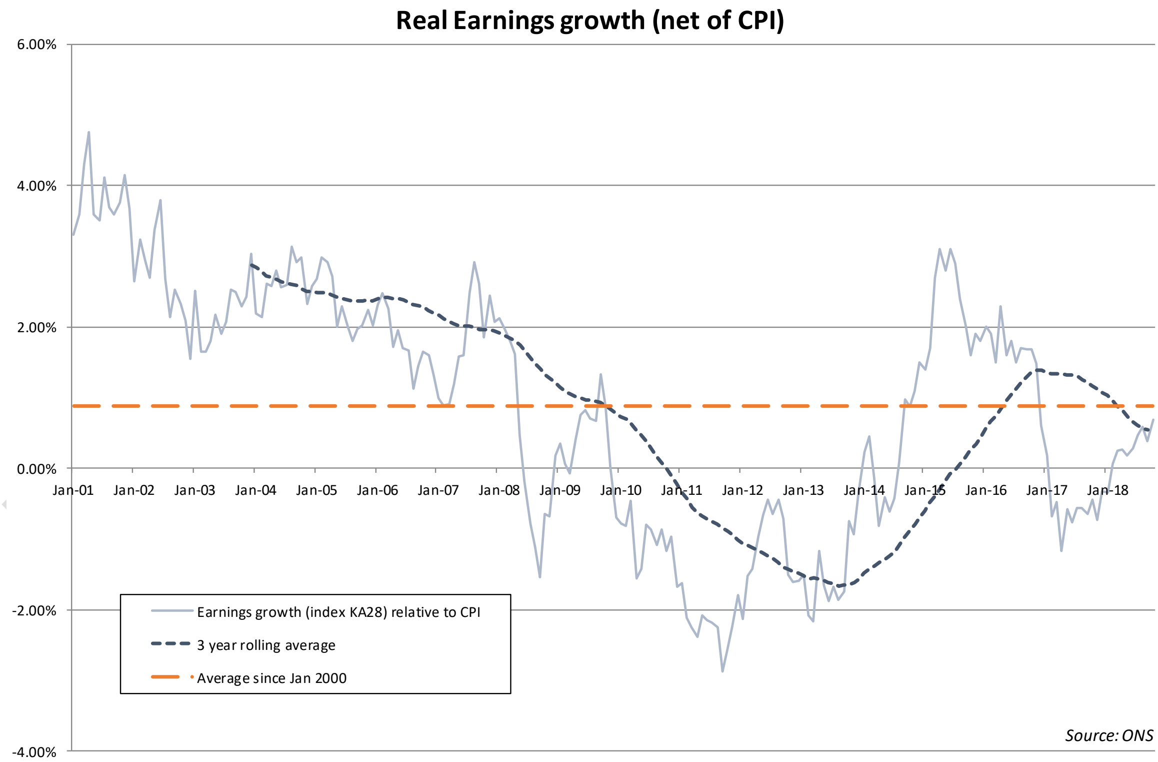
In the 29 October 2018 Budget, the Chancellor announced that "over time" pension increases would be in line with Consumer Prices Index Housing (CPIH). CPIH is CPI but with housing costs (the average change in residential rents) included in the basket of goods that are measured. As housing costs often increase quicker than other goods CPIH is generally higher than CPI (but not always). All else being equal this would increase liabilities slightly.

However, as Eurostat, the body which sets the statistical methodology on which CPI is based, had previously stated its intention to amend CPI to include housing costs, we had already factored this into our CPI assumption at the 2016 valuation. Eurostat have since revoked this intention but as we had already built in an allowance, the move to CPIH means that the existing difference remains appropriate and therefore we do not feel that any further adjustments are necessary at this stage.

Salary increases

While the LGPS was a final salary scheme for benefits earned prior to 1 April 2014, it is now a career average revalued earnings (CARE) scheme so that benefits earned after 1 April 2014 are increased in line with inflation rather than salary increases. Therefore, the overall effect of the salary increase assumption is less than it was previously and the primary rate is unaffected by the salary increase assumption.

The chart below shows past UK earnings growth reflected in the ONS's Average Weekly Earnings (AWE) statistics (which reflect both inflationary and promotional increases).



Earnings growth has typically been relatively volatile, especially over short time periods. It has historically been more stable in real terms although we can see from the graph above that there is still significant volatility over the last 18 years. Over the last 18 years the overall average rate has been around CPI plus 0.9%.

We would propose this as a reasonable starting point for estimating long-term future earnings growth (we have rounded up to CPI plus 1.0% p.a.). We propose that this assumption reflects both inflationary and promotional increases and therefore we would remove the salary scale assumption which previously applied in addition to the salary increase assumption. The removal of the promotional scale simplifies our overall allowance for salary increases.

At the last valuation, we included a short-term overlay to the salary increase assumption to reflect short-term restriction in public sector pay. We are proposing not to include a short-term overlay at this valuation, particularly as in the short-term we expect an upward pressure on earnings from the proposed increases to the national living wage to 2020.

Therefore, we would propose an illustrative (neutral) salary increase assumption equal to CPI plus 1.0% p.a.

Proposed central assumptions - discount rate

To determine the value of accrued liabilities and future contribution requirements at any given point in time it is necessary to discount future payments to and from the Fund. There are a number of different approaches which can be adopted in deriving the discount rate to be used, and the approach that is most appropriate will depend on the purpose of the valuation, the overall funding objectives and the risk appetite of the administering authority.

As outlined earlier in this document, we believe that the most appropriate starting point for a valuation that sets employer contribution rates is to consider the expected returns on the long-term investment strategy. We do this by grouping the various assets into broad classes, deriving an assumed return for each asset class and then working out the average based on the asset allocation between the groups.

When deriving the neutral returns for the asset classes, we will mainly be considering the return that can be achieved from passive investing. The rationale behind this is that any outperformance will then come through as "profit" rather than being anticipated in advance and there is also a practical reason which is simply that there is more information with which to make a robust assumption about future returns from passive investment across the entire asset class. The active/passive distinction is not straightforward for all asset classes but the above is the general principle.

Our approach is to consider a neutral estimate of the assumed investment return for each asset class and then make an overall explicit adjustment for prudence to the discount rate assumption, which is in line with our approach for most other LGPS funds.

Our approach is what could be called a "best-estimate minus" approach.

Consistency and Section 13 considerations

The discount rate is certainly an assumption where there is justification for variance between funds due to different investment strategies or different attitudes to risk leading to different levels of prudence in the assumption.

The discount rate used to provide results to the SAB on a standardised set of assumptions has not been confirmed, but we suspect it will be equal to the "SCAPE" rate used for unfunded schemes which was recently revised from CPI plus 2.8% p.a. to CPI plus 2.4% p.a. In theory this should have no impact on the discount rates used in the funded LGPS. However, the lower SCAPE rate is likely to have some bearing on the assumptions used by GAD for carrying out the Section 13 analysis for the 2019 valuation (i.e. they are likely to use lower discount rates in their analysis) and so is arguably another factor to consider when choosing a discount rate for the funding valuation.

This is considered in more detail later in this section.

Asset types

For the purposes of the 2019 valuation, we have considered the Fund's Investment Strategy Statement dated March 2017. We propose grouping the assets into the following types:

- Gilts
- Other bonds
- Cash
- Equities
- Property and infrastructure
- Multi asset credit

Where the assets do not have a widely-published objective market-based indicator of future returns, then we consider the characteristics and benchmark of each fund's investment in these asset classes to derive an assumption that we believe is appropriate and this is usually based on building up from the returns derived for simpler asset classes.

Our proposed neutral returns for these asset classes are set out below. We are aiming to propose consistent derivation methods between funds to help with the consistency objective but we are happy to consider changes to these, particularly if they can be locally justified.

Gilts

Redemption yields from gilts give an indication of the future rates of return and most funds typically invest in long-dated gilts so we can use these published rates. We propose to use the smoothed 20 year point of the Bank of England nominal gilt yield curve, consistent with the duration of an average LGPS fund's liabilities. **This gives an illustrative (neutral) assumption of 1.7% p.a. at 31 March 2019.**

For our index-linked gilt return assumption, we would propose to use the fixed-interest gilt assumption less any inflation risk premium. As we are proposing an inflation risk premium of zero, the assumption is the same as the fixed-interest gilt return assumption, i.e. 1.7% p.a.

This is consistent with the approach at the 2016 valuation.

Other bonds and fixed income

This asset class would generally be considered to consist of corporate bonds and other investable non-government debt. The yield on these can, in theory, be accessed directly from the market. Our starting point is to allow for 90% of the spread between the Merrill Lynch Non-Gilts AAA-A Over 15 year yield and the FTSE Gilts Over 15 year yield. **This would give a neutral assumption of 2.6% p.a. at 31 March 2019.**

This is consistent with the approach at the 2016 valuation.

Cash

The Fund always needs to hold cash in order to pay benefits although it might also hold it for tactical reasons. At the 2016 valuation, we used the smoothed Merrill Lynch 20 year LIBOR swap curve point. It can be argued that a 20 year time horizon is too long for short-term holdings in cash. In addition, LIBOR is to be discontinued by the FRC from 2021 and SONIA will replace it as the reference rate for swap transactions.

We would propose to use the current Bank of England base rate of 0.75% p.a. for simplicity.

However, as we understand, from the current ISS, that the Fund does not currently intend to hold a significant proportion of its assets as cash at any time; no weighting is being given to the assumed return on cash when calculating the discount rate.

Equities

Model

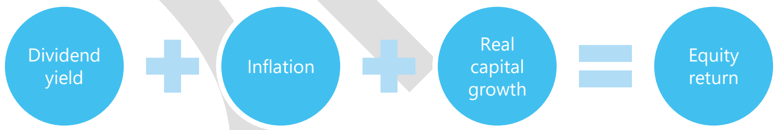
Unlike the previous asset classes, there is no direct market indicator of future equity returns and so some degree of judgement is required.

Given the extra risk and volatility from investing in equities compared to most other asset classes, it is reasonable to assume that long-term expected returns for equities will be higher than the other asset classes.

When setting this assumption, we take a cashflow-based approach and consider the return on a portfolio of equities as being equal to the dividends paid on these shares plus the growth in the value of the shares.

We also assume that the growth in the value of the equities will, over the long-term, be in excess of and linked to inflation i.e. if we assume that prices are going to increase at a faster/slower rate, we assume that there will be a corresponding change to equity values.

This means that our assumption is:



Finally, we compare the equity return assumption suggested by this model to other asset returns and to independent forecasts.

Region

We understand that a significant proportion of the Fund's equity holdings are global equities. Ideally, the model would therefore incorporate global factors (appropriately weighted between the different markets and allowing for any currency hedging). Previously we effectively used the UK model as a proxy for global equities and this gave similar long-term returns at 31 March 2016. However, the proportion of corporate earnings paid as dividends in the FTSE All-Share is currently at its highest level since 1993 and so we are concerned that this might be overstating longer-term dividend streams. Therefore, as discussed below, we propose to use global indicators. In our opinion, this should give a more appropriate view for the Fund's future equity performance.

We are conscious of the current and potential volatility in UK markets due to Brexit and as a result, we will be carrying out further regular reviews to check whether we believe that the model is still appropriate for future use or whether any adjustments are needed. This will be for the purpose of monitoring funding levels and future valuations rather than directly affecting the 2019 valuation.

Dividend yield

One of the effects of including the dividend yield in the equity return assumption is when equity values fall (so that the asset value falls) the dividend yield increases so the overall equity return and discount rate assumptions increase. Effectively, we assume that at least some of the fall in the asset value will be recovered in future i.e. the value of the assets that we need now to pay the accrued benefits (the liabilities) in future also falls. This also works the other way too (i.e. if there is an asset bubble, future assumed returns fall under our model) so this approach gives some automatic stabilisation when there are market shocks. This does mean that in a climate where equity values have fallen, which was the case towards the end of 2018, our equity return model gives higher assumptions than might be obtained from other models.

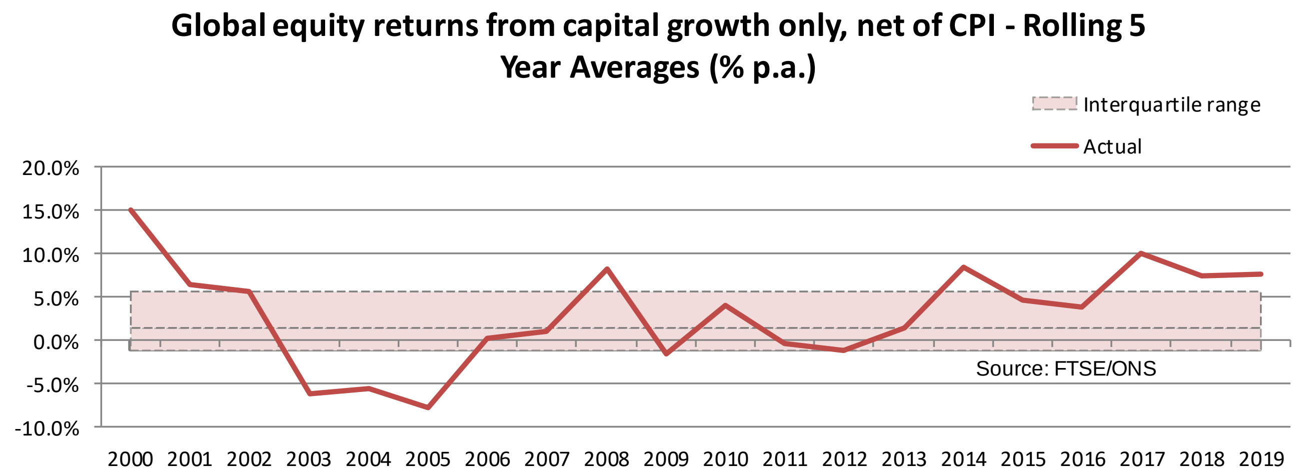
When the dividend yield increases in this way, it triggers a review whereby we consider whether under current market conditions we believe our model is still sufficiently robust, i.e. does it still give long-term assumptions that we are comfortable with and that are reasonable for the purposes of setting employers' contribution rates. As discussed above, we are concerned the dividend yield on the FTSE-All Share may be overstating longer-term dividend streams.

Therefore, as discussed above, we propose to use the FTSE All-World dividend yield which in our opinion should give a more balanced view of longer-term dividend streams, particularly given the Fund has a significant proportion of assets invested in global equities. We believe this provides a long-term assumption for equity returns that is reasonable for setting employers' contribution rates.

Real capital growth

The other building block for determining the equity assumption is the real capital growth assumption. At the last valuation, this was +1.2% for the neutral assessment of the real capital growth in relation to CPI i.e. the equity assumption was equal to the dividend yield plus the CPI assumption plus 1.2%.

As we have used a global dividend yield and a UK inflation assumption, it follows that our real capital growth assumption is global capital growth in relation to UK inflation. The next chart shows the capital growth from global equities based on the FTSE All-World index, relative to CPI, since the turn of the century, together with the inter-quartile range (i.e. the range of observations that account for 50% of all observations around the median).



As we can see, equity capital returns are very volatile. The median value, observing the data since 2000, was around 1.5% p.a. above CPI, although there have been prolonged periods when the returns have been significantly different.

We believe therefore that a suitable neutral assumption for the capital growth assumption (in relation to CPI) is 1.5% p.a.

Equity assumption

Updating the dividend yield to be based on the FTSE All-World index and global real capital growth assumption of 1.5% p.a. would give a neutral equity assumption of 6.7% p.a. at 31 March 2019. This is summarised below:

Property and infrastructure

Intuitively, property would be expected to give long-term returns somewhere between those on gilts and equities. Further, the ability to review rents might mean there is some inflation linkage. At the 2016 valuation, our assumption was that property returns would be 3.5% p.a. above CPI with an upper limit of the equity return assumption. We propose to adopt the same assumption at the 2019 valuation.

We understand the Fund is also invested in infrastructure, for which we have adopted the same assumptions as our property assumption.

This gives a neutral property assumption of 6.1% p.a. at 31 March 2019.

Multi asset credit

The Fund is invested in a multi asset credit fund with a benchmark of LIBOR plus 4%-5% p.a. **We have therefore considered a neutral return equal to 4.75% p.a.** for this, equal to the current Bank of England base rate (as a proxy for short term interest rates) plus the outperformance of 4% p.a.

Expenses

At the 2016 valuation, we included a deduction of 0.1% to the discount rate assumption in order to allow for administration, oversight and governance expenses.

To allow for (passive) investment management expenses, we included a further deduction of 0.1% in the discount rate. In practice, this figure might be higher due to the use of active management but the aim is to more than cover these additional expenses by achieving excess returns.

The following table summarises the administrative expenses of the Fund over recent years (including oversight and governance costs), as disclosed in the Fund accounts:

Year	Fund assets at start of year (£000s)	Admin expenses over year (£000s)	**% of Fund assets**
2016/17	530,822	559	**0.11%**
2017/18	650,516	761	**0.12%**
2018/19	663,151	699	**0.11%**

Based on this, we propose to maintain a deduction to the discount rate of 0.1% in allowance for administrative expenses

Therefore our total expenses allowance, including an allowance for passive investment expenses, is proposed to be a deduction of 0.2% to the discount rate.

Allowance for prudence

Based on the methodology described above, the derivation of the above investment return assumptions would result in a neutral estimate – in other words assumptions that produce returns that are not overly pessimistic nor optimistic.

Where there is greater uncertainty in a particular assumption, such as the discount rate, the recommended assumption should include a margin for prudence. We feel that it is appropriate to include a prudence margin into the discount rate assumption to reflect this uncertainty.

Ultimately, the adjustment to allow for prudence is a subjective one, having considered:

- Views on the ability of employers to pay more later if required (the employer covenant)
- Attitude to risk and risk appetite of the administering authority
- Levels of volatility in the assumed asset returns
- Consistency of the prudence margin with the previous valuation.

The discount rate in real terms should also be considered in light of the SAB standardised comparative basis and estimate of the Section 13 basis that will be set by GAD.

The prudence allowance adopted at the 2016 valuation was 0.4%.

We would not recommend reducing the level of prudence from the previous valuation as we believe a deduction below 0.4% may not sufficiently improve the likelihood that returns on fund assets would exceed the assumed discount rate over the long term.

However, as discussed above, we have made a significant methodological change to our underlying equity model so that it incorporates global indicators rather than UK indicators. This results in a lower neutral assumption for returns on equities, and therefore a less optimistic discount rate compared to the methodology at the previous valuation.

Therefore, for the purposes of these illustrative assumptions, we have proposed to maintain a prudence allowance of 0.4%.

The final choice of prudence allowance will reflect discussions with the administering authority and investment advisers.

Combining returns

The principle behind setting the discount rate is that it reflects the actual investment strategy of the Fund so that we take the above base assumptions and combine them to get an overall discount rate. In doing this we can consider the current asset allocation or an allocation that reflects the long-term strategy. It is usually our preference to reflect the long-term strategy, where known.

Based on information provided by the Fund in a March 2017 Investment Strategy Statement, the long-term strategic benchmark allocation of the Fund is as follows:

Asset Class	Benchmark allocation
Gilts	10%
Other bonds	0%
Cash	0%
Equities	65%
Property and infrastructure	12.5%
Multi Asset Credit	12.5%
Total	**100%**

Therefore our discount rate assumption is calculated as follows:

Asset class	2019 allocation	Neutral assumption (p.a.)
Gilts	10%	1.7%
Other bonds	0%	2.6%
Cash	0%	0.8%
Equities	65	6.7%
Property and infrastructure	12.5%	6.1%
Multi asset credit	12.5%	4.8%
Less expenses		(0.2%)
Neutral return		**5.7%**
Less prudence allowance		(0.4%)
Prudent discount rate assumption		**5.3%**

At 31 March 2016, the discount rate was 5.5% p.a.

We can compare this discount rate to the "SCAPE" rate used for unfunded schemes which is likely to have some bearing on the discount rate used by GAD for carrying out the Section 13 analysis for the 2019 valuation. At the 2016 valuation, the Fund's discount rate was equal to CPI plus 3.1% p.a., which compared to a SCAPE rate of CPI plus 3.0% p.a. (the SCAPE rate was subsequently reduced to CPI plus 2.8%). The discount rate was therefore within acceptable bounds in GAD's analysis.

The SCAPE rate is now CPI plus 2.4% p.a. and we can reasonably expect that this will lead to a reduction in the acceptable discount rate bounds within GAD's analysis. Our proposed discount rate of 5.3% p.a. is equivalent to CPI plus 2.7% therefore maintains a similar gap between the SCAPE rate and the discount rate.

Proposed central assumptions – statistical

The key demographic assumption required for determining the pension liabilities is the post-retirement mortality assumption. However, we also need to consider the retirement age assumptions as well as pre-retirement assumptions such as withdrawals and transfers out. As previously mentioned, we propose to incorporate all margins for prudence in our financial assumptions and therefore the assumptions detailed in this section will be used in both our neutral and funding basis proposals.

Post-retirement mortality

The Fund should review their post-retirement mortality assumptions at each valuation, taking into account all available evidence, to ensure they remain appropriate for the Fund.

There are two aspects to consider in determining appropriate post-retirement mortality assumptions:

- Choosing an appropriate mortality assumption applicable today taking into account characteristics of the Fund members, and;
- Making an appropriate allowance for mortality to improve in future.

Base rates

The current funding basis adopts the S2PA mortality tables with a multiplier of 80% for males and 85% for females. For dependant members, the tables adopted were 95% of the S2PMA tables for males and 100% of the S2DFA tables for females.

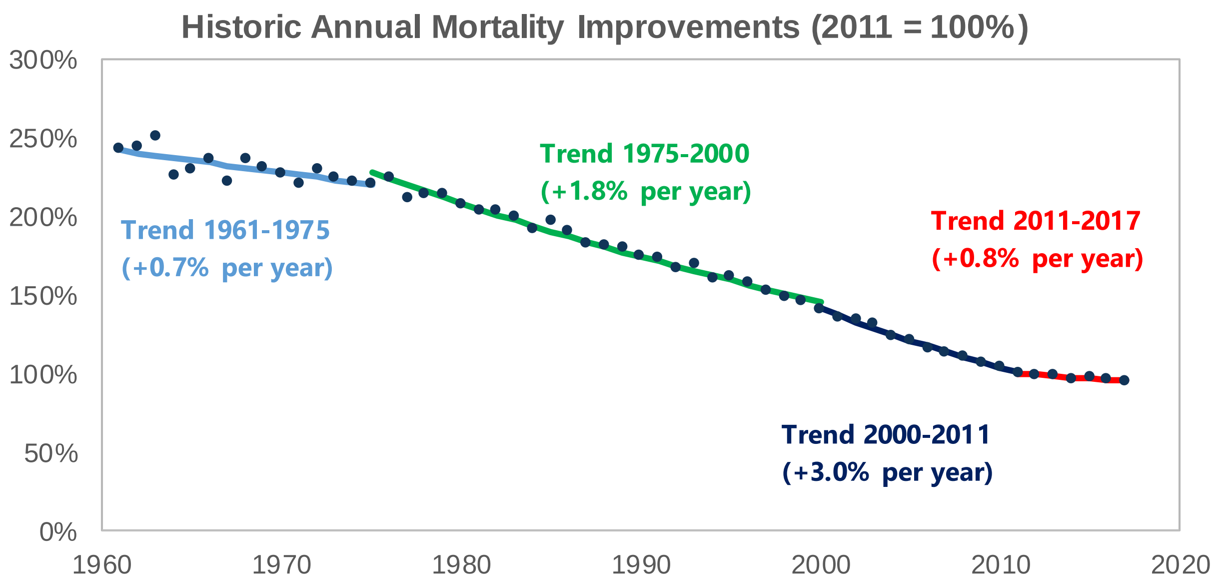
These tables were chosen based on a full analysis of longevity experience in the years leading up to the 2016 valuation, which was conducted by our specialist longevity team. At the 2019 valuation, a similar analysis will be carried out and so the precise base tables to be adopted will be confirmed at a later date.

Model

At the 2016 valuation, to project mortality into the future we used the CMI_2015 projections model, with a long-term improvement of 1.5% p.a. The model is updated annually by the CMI to take into account the latest available data.

The CMI_2018 model was released on 7 March 2019. The latest version continues the post-2011 trend of low improvements and subsequent falls in projected life expectancies – in particular, there were nil improvements in mortality over 2018.

The following chart shows the trend in annual mortality improvements, in particular, the levelling out of mortality improvements over the last 10 years.



Source: Barnett Waddingham calculations using Office for National Statistics data

In the 2016 model, the CMI introduced a "smoothing" parameter to the model, which allows the user to adjust how much weight is placed on recent mortality data. This was set at a core value of 7.5 in the 2016 model and this core value has been reduced to 7.0 in the 2018 model (thus placing more weight on recent data). We have no reason to suspect that 7.0 is an inappropriate choice as the trend for low improvements has been observed for a number of years now and so we would propose to use 7.0.

In the 2018 model, a further parameter was introduced to the model – "the initial addition to mortality improvements" with a core value of 0%. This parameter makes it easier for users to adjust the Model to better fit the population they are modelling, in particular if there is evidence that mortality improvements of pension scheme members have been higher than those of the general population (the CMI model is based on general population data). As this is a new parameter in the model, we propose to retain the core value of 0% for now but will assess the suitability of it further and advise if we believe an adjustment is justified.

We therefore, currently, plan to adopt the 2018 version of the CMI model without any adjustments to the core values.

Long-term rate of mortality improvements

As well as choosing to use the CMI model, we need to specify the long-term rate of mortality improvements. The Fund used a long-term rate of improvement of 1.5% p.a. at the 2016 valuation, as did most LGPS funds. Although we are also aware that a significant number of LGPS funds used a long-term rate of improvement of 1.25% p.a.

It is a highly subjective assumption and hard to place a definitive value on as it depends on factors such as improvements in medical technology and societal behaviours so it crosses a range of disciplines. From survey information from the Pensions Regulator, we understand around 70% of private sector pension schemes adopt an assumption of 1.5% p.a. Most private sector pension schemes include an allowance for prudence in their long-term rate of mortality improvement assumption and therefore there is an argument that a best estimate assumption would be lower than this. As we aim to include prudence in the discount rate only, **we would propose to decrease the long-term rate of improvement used in the model to 1.25% p.a.**

Retirement ages

Members can be subject to multiple retirement age regimes in the LGPS. At the last valuation, we assumed that members would retire at the average age that their various tranches of benefit are payable from. For example, if a member has a large amount of pension payable from age 60, it is likely to be financially advantageous for them to take their benefits closer to age 60 than to age 65, or later. However, if most of their benefit is payable from their State Pension Age and they only have a small amount of pension available without reduction at earlier ages, they are likely to retire later.

We have performed an analysis of retirement patterns using data covering the two years to 31 March 2018 for the LGPS funds that we advise (where data was made available). The analysis revealed that the assumption was not materially different to the actual experience of retiring members, over all funds that we analysed.

Therefore, for the 2019 valuation, we propose an assumption that members retire at the average of each tranche retirement age, weighted by pension, which is the same method assumed in 2016.

Transfer out decrement

No allowance was made for transfers out at the 2016 valuation, as it was judged to be immaterial. **We will carry out an analysis of transfers out over the previous three years using data from our LGPS fund clients to determine whether this approach remains appropriate for the 2019 valuation.**

Pre-retirement decrements (withdrawals, ill-health retirement, death in service and salary scales)

At the 2016 valuation, we used assumptions that were equal to those assumed by GAD when they carried out their 2013 valuation of the LGPS for "dry-run" Section 13 purposes. The rationale for these was generally that it was in line with the most recent study of national LGPS experience that they had carried out.

GAD has since updated the experience analysis and tables used as part of their 2016 valuation of the LGPS for cost management purposes (currently draft at the time of writing).

Death in service

Analysis will be carried out as part of the mortality investigation to ensure the goodness of fit of GAD's pre-retirement mortality tables to the experience of the Fund.

Ill-health retirement

GAD's analysis of the overall LGPS experience in the three year period to 31 March 2016 also suggests a drop in numbers of ill-health retirements compared to the assumptions used for their 2013 valuation of the LGPS.

GAD's updated assumption takes into account the six years of experience from 2010 to 2016 (and therefore recent experience is smoothed out with earlier data).

Salary scale

As discussed in the "Salary Increase" section, we propose to remove our salary scale assumption and include promotional increases within our general salary increase assumption.

Therefore, we currently plan to adopt the updated GAD assumptions used as part of their 2016 valuation of the LGPS for cost management purposes, with the exception of the salary scale assumption, which we propose to remove.

50:50 membership

Some active members may elect to reduce their accrual rate in return for paying lower contributions. Actual take-up of this has been very low (initial analysis of our funds' data suggests around 0.5% of active members). We are aware of the work being undertaken by SAB to encourage take up of membership in the 50:50 scheme but at the moment we do not consider there to be enough evidence to change our assumption from that used in 2016.

We will assume that members will continue to participate in their current section and this is the same assumption that was used in 2016.

Commutation

At the 2016 valuation, we assumed that members would, on average, exchange pension to get 50% of the maximum available cash on retirement.

We have performed an analysis using the data for the two years to 31 March 2018 for the LGPS funds that we advise (where data was made available). **The analysis suggested that 50% continues to be an appropriate assumption for the LGPS funds we advise**. We will revisit this analysis later in the year when we have data from more funds available.

Family statistics

At the 2016 valuation, we assumed that 75% of males and 70% of females have an eligible dependant at retirement or earlier death. This was based on ONS projections to 2023 (published as at 2014). The ONS published a snapshot of population data in 2017 for married or cohabiting partners and this appears broadly in line with the assumption made at the 2016 valuation. **Therefore we propose to maintain this assumption for the 2019 valuation.**

We will also assume that male members are three years older than their partners and this is the same as at the 2016 valuation.

Summary of assumptions

In this paper we have summarised the assumptions at 31 March 2019 (based on market conditions up to and including 30 June 2019) that we would propose to use for the 2019 valuation. We have also considered in each case an appropriate neutral assumption. The assumptions used previously and discussed in this document are given overleaf.

The longevity analysis is still underway and the results of the analysis will be included alongside our final assumptions advice.

Assumption	2016 valuation	2019 valuation, neutral	2019 valuation, proposed
Market date	31 March 2016 (market conditions known to 30 June 2016)	31 March 2019 (market conditions known to 30 June 2019)	31 March 2019 (market conditions known to 30 June 2019)
CPI inflation	2.4% p.a.	2.6% p.a.	2.6% p.a.
Salary increases	3.9% p.a. with a short term overlay for salaries to increase in line with CPI until 31 March 2020	3.6% p.a.	3.6% p.a.
Discount rate	5.5% p.a.	5.7% p.a.	5.3% p.a.
Post-retirement mortality Base rate Model Long-term rate	 80%/85% of S2 tables CMI_2015 1.5% p.a.	 TBC CMI_2018 1.25% p.a.	 TBC CMI_2018 1.25% p.a.
Retirement assumption	Weighted average	Weighted average	Weighted average
Transfer out assumption	None	TBC	TBC
Pre-retirement decrements (excl ill-health)	GAD 2013 scheme val	GAD 2016 scheme val (no salary scale)	GAD 2016 scheme val (no salary scale)
50:50 assumption	Member data	Member data	Member data
Commutation	50% of Max	50% of Max	50% of Max
Family statistics % with qualifying dependant Age difference	 75% (M), 70% (F) 3 years	 75% (M), 70% (F) 3 years	 75% (M), 70% (F) 3 years

Final comments

This document has been provided as background information to the triennial valuation of the Fund and detailed information regarding the funding model and the assumptions proposed.

The assumptions are subject to change following further discussions with the administering authority and the Fund's investment advisers, where appropriate. The demographic assumptions will be tested for suitability against experience in the Fund once the longevity analysis is complete and the financial assumptions will be based on market statistics to 30 June 2019.

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Agenda Item 9

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Agenda Item 12

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