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Leicestershire County Council Pension Fund

2019 Valuation: Salary growth assumption

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For and on behalf of Hymans Robertson LLP

1   Contents

2   Introduction

This paper has been commissioned by and is addressed to Leicestershire County Council in its capacity as Administering Authority to the Leicestershire County Council Pension Fund ("the Fund"). It has been prepared in my capacity as an Actuary to the Fund.

The next actuarial valuation of the Fund takes place as at 31 March 2019. This paper has been prepared to facilitate discussions on funding strategy for the 2019 valuation. In particular, this paper summarises the factors influencing the choice of salary growth assumption at the 2019 valuation.

This paper has been prepared solely for the use of the Administering Authority to the Fund, to assist in setting the salary growth assumption at the 2019 formal valuation. This document should not be released or otherwise disclosed to any third party without our prior consent, in which case it should be released in its entirety. Hymans Robertson LLP accepts no liability to any other party, or for any other use, unless we have expressly accepted such liability.

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3   Background

One of the key actuarial assumptions used to estimate the cost of benefits is that relating to future salary growth. This assumption comes in two parts;

- Annual 'inflationary' salary awards, historically set in order for employees' pay to at least keep up with the cost of living

- Promotional salary awards or those awarded as part of a defined salary scale.

This paper considers the first element of the salary growth assumption only. The scale used to determine promotional salary awards will be determined as part of the demographic analysis conducted as part of the 2019 valuation.

At the 2016 valuation, the assumption for 'inflationary' increases needed to take into account:

1   A large proportion of the Fund's overall past service liabilities were still linked to final salary i.e. those benefits accrued before 31 March 2014; and

2   The Government's 2015 Summer Budget announced that funding would only be provided to meet public sector salary increases of 1% p.a. up to March 2020.

Therefore the 2016 valuation salary increase was based on an underlying assumption of short term restraint (1% p.a.) to 31 March 2020, followed by long-term increases in line with Retail Prices Index (RPI) inflation plus 1% p.a.. The single equivalent rate based on these assumptions, allowing for the expected run-off of final salary liabilities, was RPI% p.a.. Please see our report on the 2016 pay growth assumption, dated 30 November 2015, for further details.

It is good governance to review all actuarial assumptions as part of each triennial valuation to ensure they reflect current expectations of the future.

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4 2019 salary growth considerations

Run-off of final salary liabilities

Future pensions in respect of service accrued in the Fund up to 31 March 2014 will be determined based on members' eventual final pay at retirement (or earlier withdrawal). Benefits accrued from 1 April 2014 are based on the members' pay over each year of accrual and future Consumer Prices Index (CPI) increases (unless protected by the Final Salary underpin). When considering the relevance of future pay growth on the Fund's past service liabilities, only benefits accrued up to 31 March 2014 ("final salary benefits") need be considered.

The chart below shows the expected run-off of the Fund's pre-2014 active member liabilities from the Fund's 2016 valuation analysis i.e. the proportion of final salary liabilities remaining at each future year. The chart starts at 100% and falls eventually to zero as current active members with final salary benefits leave active status (due to retirement, withdrawal or death).
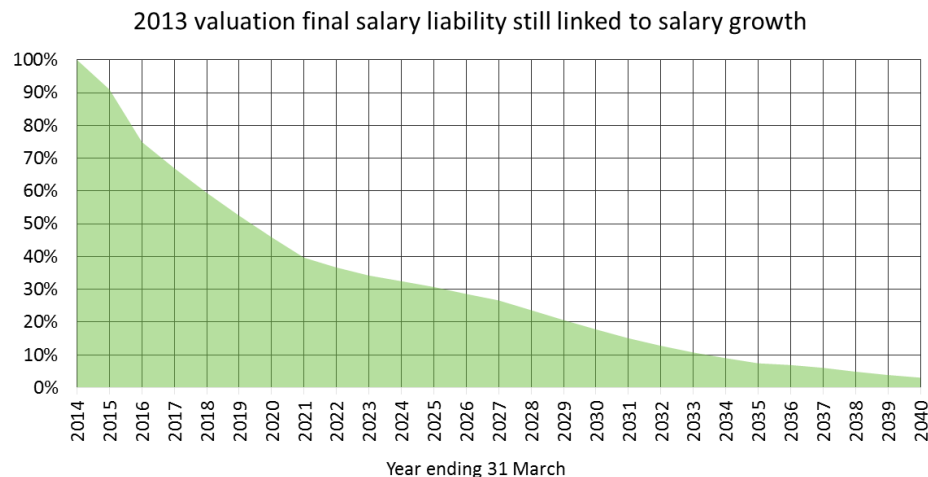
The declining proportion of active liabilities with a link to salary increases means that the importance of the salary growth assumption decreases over time, at least as far as the liability value is concerned. By 2019, around half of the pre-2014 active liability will no longer be active. Furthermore, from 2019 onwards the run-off becomes more gradual.

The chart below shows the run off from 2019 onwards based on the 2016 valuation membership data.

2016 valuation final salary liability still linked to salary growth

Year ending 31 March

The more gradual run-off means that the importance of short term salary growth expectation is less than it was at 2016. Therefore, whilst it is important to allow for any short term restraint in the assumption adopted at the 2019 valuation, more weight should be placed on longer term pay expectations compared to the 2016 valuation.

2013 valuation final salary liability still linked to salary growth

Year ending 31 March

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Future pay progression

Public sector pay increases were suppressed for many years following the 2008-09 economic crisis and the introduction of austerity policies, and this restraint had been expected to continue until at least 2020. Until 2017, central government operated a 1% cap on pay which was broadly mirrored in local government. However, with higher inflation and low unemployment the pressure to increase wages has risen markedly in recent years, particularly as public sector pay lagged behind the private sector. The government announced in July 2018[1] that it was awarding the highest pay increases in ten years to a range of public sector workers including teachers, NHS workers and the armed forces, perhaps signalling a return to 'normal' pay increases with a closer link to price inflation.

However, pay increases in local government are determined by local councils rather than central government, and the effects of austerity are still being felt in strained local authority budgets. It may therefore be reasonable to expect some continued restraint in the short term albeit higher than the 1% previously assumed.

As for long term pay increases, similar arguments apply now as at the previous valuation in 2016. In the long term, increases are likely to fall between two extremes:

- Pay is increased substantially from current levels in order for public sector pay to 'catch-up' with historic averages (and the private sector).

- Continued low real pay rises reflecting, for example, higher inflation, economic uncertainty, outsourcing to private sector contractors, etc.

In practice, long term public sector salary growth beyond 2020 will depend on a variety of factors and it is extremely difficult to predict with any certainty what it is likely to be. Some possible scenarios are discussed in section 5.

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[1] BBC News, Public sector workers: Pay rises announced for a million people, 24 July 2018

5   Pay scenarios modelled

In order to help discussions around the setting of an 'inflationary' salary growth assumption at the 2019 valuation, we have considered three scenarios. Note that the salary growth assumption should be a best estimate assumption. Prudence in funding plans is explicitly allowed for elsewhere:

1   The first scenario has a short term rate of **2.5%** pay growth to 2020 and **CPI** increases per annum thereafter.

2   As per 1, but allowing for a long term assumption of **CPI + 0.5% p.a.**

3   As per 1, but allowing for a long term assumption of **CPI + 1% p.a.**

Scenarios 2 and 3 provide some understanding of the sensitivity to changes in the longer term assumption to aid discussions around the choice of suitable assumption.

In all cases, we have calculated a single equivalent salary growth assumption which allows for the projected run-off of the final salary linked past service liabilities. For each scenario, the equivalent flat assumption gives the same overall revaluation over the period when any pre-2014 benefits are expected to remain linked to salary growth (approximately 40 years). This is the same approach as used when setting the assumption for the 2016 valuation.

Summary of scenarios

The scenarios modelled can be summarised as follows:

% p.a.	Scenario 1	Scenario 2	Scenario 3
Short term until	2020	2020	2020
Short term rate	2.5%	2.5%	2.5%
Long term rate	CPI	CPI plus 0.5%	CPI plus 1.0%
Nominal long term rate*	2.3%	2.8%	3.3%

*Based on market conditions as at 31 March 2019. See Appendix 1 for further details. CPI at 31 March 2019 is 2.3% p.a.

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6   Results and conclusion

Based on the run-off of final salary liabilities in section 4 and the scenarios described in section 5, we have calculated the following equivalent flat rate assumptions for each scenario.

The results also show approximately what impact the new assumption will have at the 2019 valuation, by showing the approximate impact on the funding position. This allows for the run-off of final salary liabilities as well as the change in salary growth assumption, but makes no other allowances (e.g. for changes in market conditions). The actual impact at the 2019 valuation will depend on the actual membership data and assumptions at 31 March 2019.

% p.a.	Scenario 1	Scenario 2	Scenario 3
Short term until	2020	2020	2020
Short term rate	2.5%	2.5%	2.5%
Long term rate	CPI	CPI plus 0.5%	CPI plus 1.0%
Flat rate assumption	**CPI**	**CPI plus 0.5%**	**CPI plus 0.9%**
Approximate change to 2019 funding level*	2%	1%	0%

*compared to 2016 valuation assumption of RPI p.a.(equivalent to CPI plus 1% p.a.).

At the 2016 valuation the salary growth assumption was changed significantly to reflect the closure of the final salary scheme and the long period of expected pay restraint. This change led to a relatively large improvement in the funding position at the 2016 valuation due to the amount of final salary linked liabilities.

Relative to the change between 2013 and 2016, the impact on the overall whole fund funding position in 2019 under any of the scenarios will be lower. However, for employers with large proportions of active members and/or large proportions of final salary linked liabilities, the impact of any change to the assumption will be greater than shown above.

Consideration of the salary growth assumption should go beyond the impact on the past service liability value. The salary growth assumption is also an important factor in estimating the size of future payroll and contributions. Given the increased gearing (ratio of accrued benefits relative to payroll) in the LGPS, a realistic estimate of the future payroll is more important to help assess the most appropriate contribution and investment strategy for the Fund and its participating employers.

Assumption for 2019 valuation

For the purpose of the 2019 valuation it is important to set a future pay growth assumption that reflects likely future experience. Each scenario presented in this paper is plausible and we attach no probability to them.

My recommendation is that the long term single pay growth assumption is discussed with Fund officers in the first place. I would be comfortable in adopting any of the above three scenarios, provided the eventual rate was realistic in the view of those closest to the Fund employers. Any such agreed position would then be presented to the Pensions Committee for formal approval.

I have only considered three specific scenarios in this paper. I can carry out further analysis in order to advise on the effect of alternative scenarios if required.

Appendices

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Appendix 1 – Data and assumptions

Summary of membership data

The data underlying the results in this paper is a subset of the data used for the 2016 formal valuation. A summary is shown below, and further details can be found in the 2016 formal valuation report.

	31 March 2016
Number of active members	24,989
Total full-time equivalent salaries (£000)	£572,826
Total final salary pensions (£000)	£75,950

The figures above are based only on those members who had any pre-2014 service at the 2016 valuation. Members who joined after 31 March 2014 and who have no final salary benefits are excluded from the analysis.

Assumptions

The liability charts shown in this paper are as at 31 March 2016 and use the assumptions adopted for the 2016 formal valuation. Please see the formal valuation report dated March 2017 for further details.

Projections of future pay growth were based on the following assumptions, derived in the same manner as at the 2016 formal valuation but updated for market conditions as at 31 March 2019:

Financial assumptions (% p.a.)	31 March 2019
RPI inflation	3.3%
Gap between RPI and CPI inflation	(1.0%)
CPI inflation/Deferred revaluation	2.3%

Appendix 2 – Professional Notes

Reliances and limitations

I have based my calculations on the data and assumptions used for the purposes of the 2016 formal valuation. For further details please see the 2016 formal valuation report, dated March 2017.

The following limitations apply in relation to this advice;

- No allowance has been made in this analysis for service accrued from 1 April 2014 for members aged 55 or over on 1 April 2012 and therefore entitled to the final salary benefit underpin. Due to the nature of these liabilities, (these members are expected to have left active service prior to 2022) this is expected to have only a negligible impact on the shape of the active liability run-off and the outcomes derived from this analysis.

- No allowance has been made in the analysis for the possible impact of the recent McCloud judgement. At this stage it is too early to say what this impact will be and how it will be felt.

- No allowance is made in the analysis for early retirements (except as already allowed for in the 2016 retirement age pattern), ill health retirements or any other pre-retirement exits such as death or refund of contributions.

- The analysis is based on the withdrawal assumptions set out in the 2016 formal valuation report. Although these assumptions are likely to be revised at the 2019 valuation, I do not expect this to have a material impact on the outcomes from this analysis.

- The analysis is based on membership data from the 2016 valuation, which was validated at the time. If there are any material errors or omissions in the data they could affect the results, particularly if they affected how quickly final salary benefits were expected to run off.

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- The impact on the funding level is approximate and allows only for the change in salary growth assumption and the expected run-off of final salary liabilities by 2019. The actual financial impact of any change in the assumption, measured at the 2019 valuation, may be higher or lower than given above, depending on finalised active membership details and market conditions at 2019.

Technical Actuarial Standards

The following Technical Actuarial Standards[2] are applicable in relation to this report and have been complied with where material:

- TAS 100

- TAS 300

This report should be read along with the Fund's 2016 formal valuation report, dated March 2017.

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[2] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council and set standards for certain items of actuarial work, including the information and advice contained in this report.