Member briefing - funding update at 31 March 2021

Executive summary

Since the 2019 valuation, the key funding measures are estimated to have changed after allowing for market conditions to 31 March 2021. These measures are:

- **Past service funding position**: The past service funding shortfall has decreased from £537m to £15m. This notional funding position is based on the Fund targeting annual future investment returns which have a 80% likelihood of being achieved. The reduction in shortfall has been largely driven by strong investment performance since 31 March 2019 (which has been 17.2%)
- **Expected future investment return**: The outlook for future investment returns (over the next 20 years) is broadly the same as the 2019 formal valuation. At 31 March 2021, we estimate that the Fund's asset allocation has a 80% likelihood of achieving an annual return of at least 3.8% p.a. (at 31 March 2019, the equivalent return was also 3.8% p.a.).
- **Fully funded required rate**: The Fund is now fully funded (exactly 100%) using a future investment return assumption of 3.8% p.a. As above, we estimate that the Fund's asset allocation has a 80% likelihood of achieving these returns (over the next 20 years). At the 2019 formal valuation future investment returns of 4.5% p.a. were required to be fully funded, and the likelihood of achieving these returns was only 70%.
- **Indicative impact on future contributions**
  - **Secondary rate contributions:** the improved past service funding position will have a positive impact on Secondary rate contributions, all else being equal.
  - **Future service cost (Primary rate contributions):** The cost of future benefit accrual has increased. While future investment return expectations (over the next 20 years) remain broadly the same as at the 2019 valuation, future market conditions (particularly those beyond 20 years) for valuing benefit costs are expected to be more challenging and are applying upward pressure to the future service cost (compared to March 2019).

Purpose and scope

This paper has been commissioned by and is addressed to Leicestershire County Council as Administering Authority of the Leicestershire County Council Pension Fund ("the Fund").

Its purpose is to provide the Fund's Pension Committee ("the Committee") and Pension Board ("the Board") with a high level summary of funding strategy, including an update on the overall fund level funding position as at 31 March 2021 and how it compares to the position at the last formal valuation of the Fund (31 March 2019).

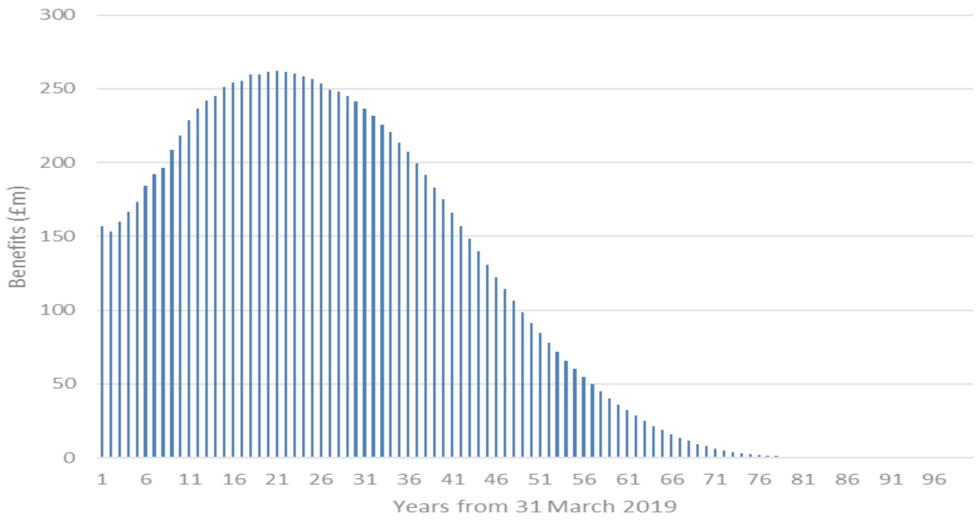
This paper relies on information and results contained within the 31 March 2019 formal valuation report and the Funding update report at 31 March 2021 previously provided to the Fund. Further information regarding the data, assumptions, methodology, funding risks and professional standards associated with the results within this paper are contained within these two reports and are available on request.

Funding position

The funding position is only a snapshot in time and is based on a single set of assumptions about the future. To measure the funding position, we compare the value of the Fund's assets on that date against the expected cost (including an allowance for future investment returns) of all the future benefit payments accrued up to the valuation date (the liabilities).

The Fund's liabilities are the future benefit payments due to members in respect of their service accrued in the Fund. Actual benefit payments in the future will be in respect of both service accrued up to today ("past service") and service that will be accrued in the future ("future service"). However, the funding position traditionally presented is only in respect of **past service** benefits.

The chart below shows the future benefit payments in respect of service accrued by all members in the Fund at 31 March 2019.



Using an assumption about the future investment return generated from the Fund's assets allows a value to be placed on these payments in today's money; the liabilities. The higher the assumed future investment return, the lower the liability value and therefore the higher the funding level (and vice versa). The value placed on the liabilities is extremely sensitive to the future investment return assumption.

Future investment return assumption

The funding position results are more meaningful when stakeholders can understand the likelihood, and hence the level of prudence, attached to them. Furthermore, the Fund's funding strategy is required to include a margin of prudence to provide security of member benefits.

For the purpose of reporting a funding level and an associated funding surplus/deficit for the 2019 valuation, an investment return of 3.8% p.a. was used. Based on the Fund's investment strategy, at 31 March 2019 it was estimated that the Fund's assets had a 80% likelihood of achieving this return of 3.8% p.a. (over the next 20 years).

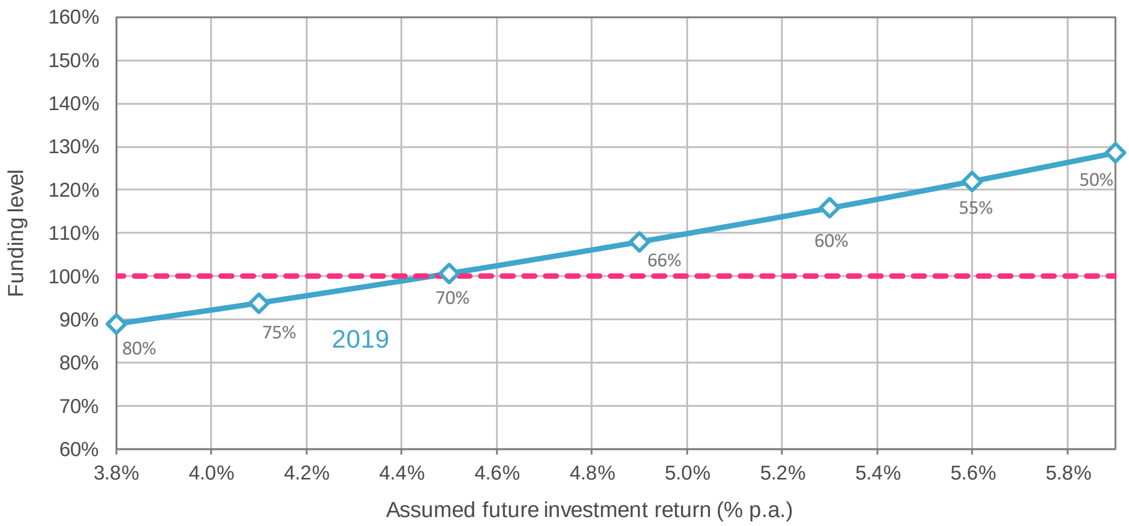
In reality, the Fund's assets are expected (on average) to deliver returns which are more in line with 'best estimate' returns. The funding strategy assumes lower returns to safeguard against various risks (including investment risk). However, the investment strategy will typically seek to achieve the highest possible returns for the given strategic allocation. Note, the 'best estimate' return (i.e. a 50% chance of being achieved over the next 20 years) at 31 March 2019 was 5.9% p.a.

2019 valuation recap

At 31 March 2019 the funding position was a deficit of £537m. This past service funding position was calculated using a future investment return assumption of 3.8% p.a. As described above, there was an 80% likelihood that the Fund's assets will achieve these returns.

Valuation Date	31 March 2019
Total Liabilities (£m) Assets (£m)	4,849 4,312
Surplus / (Deficit) (£m)	(537)
Funding Level	89%

Of course had the Fund adopted a different future investment return assumption, the funding position would be higher or lower than the 89% reported at 31 March 2019. The chart below shows how the funding level varies under different future investment return assumptions. The likelihood of achieving these returns is noted next to each point of the chart.



From the chart we can see that the Fund could have reported a fully funded position at 31 March 2019 if a 4.5% p.a. future investment return assumption was used (instead of 3.8% p.a.). However, the likelihood of the Fund's assets achieving 4.5% p.a. (on average over the next 20 years) is 70% and this assumption would therefore be less prudent.

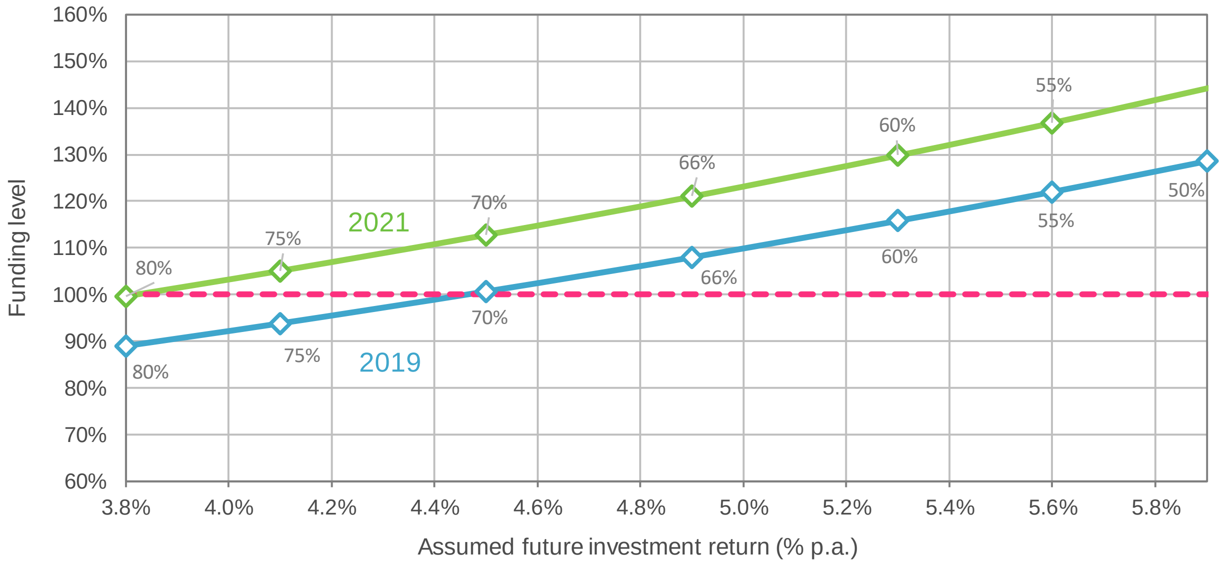
Funding update at 31 March 2021

At 31 March 2021 the estimated funding position has improved with the deficit reducing to £15m.

Valuation Date	31 March 2021	31 March 2019
Total Liabilities (£m) Assets (£m)	5,145 5,130	4,849 4,312
Surplus / (Deficit) (£m)	(15)	(537)
Funding Level	100%	89%

To maintain consistency with the approach adopted at 31 March 2019, the funding update was calculated using a future investment return assumption with an 80% likelihood of being achieved, i.e. to keep the same level of prudence in the reported funding position.

At 31 March 2021 we estimate that the Fund's asset allocation has a 80% likelihood of achieving an annual return of at least 3.8% p.a. (at 31 March 2019, the equivalent return was also 3.8% p.a.), i.e. the outlook for future investment returns is broadly the same as the last formal valuation, as illustrated in the chart below.



From this chart, we can see that the likelihood of achieving any given future investment return remains broadly the same as 2019. However, regardless of the investment return assumption used, there has been an improvement in the funding position at 31 March 2021 compared to the 2019 valuation, reflecting an increase in assets held today per pound of benefit to be paid out in future. This improvement has been driven by strong investment performance over the period (17.2% since 31 March 2019).

Change since 2019 valuation

At the 31 March 2019 valuation, the Fund's assets were insufficient to pay all future benefit payments based on an assumed investment return of 3.8% p.a.. To have sufficient monies, it was estimated that the Fund would need either:

- an additional £537m of assets as at 31 March 2019; or
- future investment returns of at least 4.5% p.a. (which were estimated to be achievable in c.70% of future outcomes).

Comparing both of these figures to the equivalent as at 31 March 2021 we note that:

- the past service funding shortfall has decreased from £537m to £15m; and
- the required investment return to be fully funded has fallen from 4.5% p.a. to 3.8% p.a. The likelihood of the Fund's assets achieving the required level of return has increased from 70% to 80%.

The Fund is now more likely to have sufficient assets to meet earned benefit payments than at the previous valuation.

Impact on future contributions

The LGPS Regulations require employer contribution rates to be broken down into:

- the Primary contribution rate – defined as the actuarial cost of new benefits being earned by current employees (active members) expressed as a percentage of pensionable pay; and
- the Secondary contribution rate – any adjustment to the primary contribution rate (such as additional contributions to repair any deficits).

Employer contributions are reviewed and certified every 3 years at formal valuations. The next formal valuation of the Fund will be at 31 March 2022. Therefore, the impact on employer contributions described below is purely indicative based on the funding update at 31 March 2021. Any changes in markets before the next formal valuation will affect these projections.

Secondary rate contributions

Secondary rate contributions are paid by employers to target a funding position over an agreed time horizon (as detailed in the Fund's FSS). Employers have their own funding plans within the Fund with varying funding positions and time horizons.

At 31 March 2021, the Fund is now notionally fully funded. Therefore, it can be inferred that the improved past service funding position is likely to have a positive impact on Secondary rate contributions at the next valuation for the average employer, all else being equal.

Of course any changes in funding position (and any impact on contributions rates) will be varied across the Fund's employers and is dependent on each individual employer's membership.

Primary rate contributions

As discussed above, the past service funding position has improved. However, being 100% funded in a scheme like the LGPS which is both open to future accrual and new entrants, is not the endgame. For the average fund, two-thirds of the benefit payments made over the next 50 years will be in respect of benefits yet to be earned. This will include benefits earned by existing members (new accrual) and benefits earned by new members who begin service in the LGPS after the valuation date (new joiners). The assets held today only cover past service benefits – we still need to fund those benefits yet to be earned.

While future investment return expectations (over the next 20 years) remain broadly the same as at the 2019 valuation, future market conditions (particularly those beyond 20 years) for valuing benefit costs are expected to be more challenging and are applying upward pressure to the future service cost (compared to March 2019).

The increased cost of future accrual will lead to increased Primary contribution rates. For the average employer any increases in Primary contribution rates may be partially (or wholly) offset by reductions in Secondary contribution rates.

Summary

As at 31 March 2021, the **past service** funding position has improved primarily due to the Fund's investment outperformance since 31 March 2019. However, the **future service** position has deteriorated.

Combining both these factors together, if the Fund's funding strategy and investment strategy remained static, we may expect funding plans to remain broadly unchanged at the next formal valuation (31 March 2022).

However, there are many moving parts and as such the following caveats apply:

- the funding position and cost of future benefit accrual may change when an allowance is made for RPI reform and the resulting impact on future inflation expectations;
- the impact on the rates of different employers will vary depending on their membership profile;
- legal judgements such as McCloud and Goodwin will impact employers differently (the above analysis doesn't make any allowance for these matters); and
- any change to market conditions and the outlook for future returns will impact contributions requirements.

Other considerations

COVID-19

The COVID-19 pandemic has severely disrupted investment markets. At the beginning of the pandemic (in early 2020), the expected future investment return on the Fund's assets had worsened (relative to the 2019 valuation). As described above, this position has recovered and future returns are now expected to be broadly in line with the 2019 valuation expectations.

Given the increased market volatility, we would be happy to provide Members with further updates in the future to monitor the ongoing position of the Fund as the pandemic, macroeconomic environment and the efficacy of vaccination programmes continue to affect the future outlook for both investment returns and inflation.

Our funding projections make no allowance for actual membership experience or updates to longevity assumptions as a result of the pandemic or otherwise.

GAD Section 13

The Government's Actuary's Department (GAD) carried out benchmarking analysis across all LGPS funds at the 2019 valuation. This report reviewed several funding risk indicators to draw comparison between funds and to raise concerns with any funds that failed on any given risk metric. We are pleased to report that GAD raised no concerns about the Fund's funding position and funding policies in its review.

Using GAD's standardised national funding assumptions, the Fund was c103% funded at the 2019 valuation - an increase from the 89% reported by the Fund in its 2019 valuation report under the local assumptions described within this paper. It is worth noting that GAD's assumptions are only suitable for comparison between funds and each fund has discretion to set its own funding plans.

The results contained within this paper have no direct correlation with the GAD funding basis. However, as the improvement in past service funding has been driven by better than expected investment returns it is reasonable to expect the GAD funding basis would also show an improvement of a similar magnitude, all else being equal. Note, GAD do not carry out any analysis of funds in the period between triennial valuations.

Funding versus accounting assumptions

The actuarial assumptions adopted by the Fund for funding purposes are different to those prescribed for preparation of accounting disclosures. In particular, the funding discount rate (future investment return) assumption is currently higher than the discount rate adopted for accounting purposes. All else being equal, this places a higher value on pension liabilities when using accounting assumptions compared to the funding assumptions. This means that, for the average LGPS employer, their accounting balance sheet will be worse than their funding position.

It is important to note that cash contribution requirements are set by the Fund with reference to the employers' funding positions only; the accounting position does not affect the cash contributions that an employer needs to pay to the LGPS.

Reliances and limitations

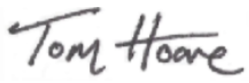
This paper has been prepared for Leicestershire County Council as Administering Authority of the Leicestershire County Council Pension Fund for the purpose described above. It has not been prepared for use for any other purpose and should not be so used. The paper should not be disclosed to any third party except as required by law or regulatory obligation or with our prior written consent. We accept no liability where the paper is used by or disclosed to a third party unless we have expressly accepted such liability in writing. Where this is permitted, the paper may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

The following Technical Actuarial Standards are applicable in relation to this advice, and have been complied with where material and to a proportionate degree:

- TAS100

This report together with the formal valuation report for the Fund (issued March 2020), the Fund's Funding Strategy Statement and the Funding update report at 31 March 2021 set out the aggregate of our advice.

Prepared by:-

Richard Warden FFA   Tom Hoare FFA

12 July 2021

For and of behalf of Hymans Robertson LLP

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