Agenda Item 7

LOCAL PENSION COMMITTEE – 25 MARCH 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

2022 FUND VALUATION – RESULTS OF THE STABILISED EMPLOYER MODELLING

Purpose of the Report

1. The purpose of the report is to inform the Committee of the results of the stabilised employer modelling. The Committee will also receive a presentation by the Fund Actuary, Hymans Robertson (Appendix A) regarding the results.

Background

2. The Leicestershire Local Government Pension Scheme is required to complete a Pension Fund Valuation every three years. The most recent valuation took place on the 31 March 2019 and the next valuation will take place on the 31 March 2022.

3. A report was taken to the Committee on the 10 September 2021 that laid out the valuation timeline.

4. As detailed in the valuation timeline the stabilised employers have been modelled earlier using prior membership data. This enables these employers to receive their expected employer rates approximately seven months early, assisting them with their financial planning.

5. The next stage in the 2022 valuation is to inform the stabilised employers of their expected contribution rates for the period 1 April 2023 to 31 March 2026.

6. The stabilised employers are the larger tax raising employers, namely Leicestershire County Council, Rutland County Council, Leicester City Council, the Borough and District Councils, Police and Fire authorities.

7. The Fund's Funding Strategy Statement permits stabilisation if:

   - the employer satisfies the eligibility criteria based on tax raising status, financial security and time horizon in the Fund set by the Administering Authority and;
   - there are no material events which cause the employer to become ineligible, e.g., significant reductions in active membership (due to outsourcing or redundancies), or changes in the nature of the employer

(perhaps due to Government restructuring) or changes in the security of the employer.

8. Stabilisation is permitted in the expectation that the employer will be able to meet its obligations for many years to come. Stabilised employer contributions are limited to smaller annual increases and decreases regardless of any larger fluctuations in the markets thereby improving stability and affordability of contributions for the longer term. See page five of the Actuary's presentation in the Appendix.

Modelling

9. The Actuary have modelled the results for the stabilised employers using a 14-year deficit recovery period. The Government Actuaries Department remain focused on deficit recovery periods being reduced wherever possible. The Actuary is confident using a 14-year deficit recovery remains reasonable, but Officers recognise other Funds may opt to keep longer recover periods.

10. The Actuary and Officers agreed to model seven of the 12 stabilised employers based on discussions around employers with similar characteristics such as maturity (percentage of liabilities in respect of active members), gearing (liabilities vs payroll OR deficit vs payroll) and net cashflow (contributions vs pensions paid). The results for the remaining employers apply equally to the similar employers they have been grouped with. See page 14 of the Actuary's presentation in the Appendix.

11. The Actuary modelled three scenarios for the stabilised employers' future contribution rates and 5,000 economic scenarios for future investment return (and inflation) as these are unknown and volatile. The three contribution scenarios are:

    - Freeze the employers 2022/23 contribution rate until 2026
    - Step down of 1% p.a. from their 2022/23 contribution rate
    - Increase of 1% p.a. from their 2022/23 contribution rate

12. Under each of the above contribution scenarios, the contribution rates within the model from 2026 onwards are then stabilised with future changes being limited to +/-1% p.a. (reacting to market conditions in each of the 5,000 economic scenarios within the model).

13. Under a given contribution scenario modelled, the stabilised employers need to meet a 75% likelihood of being fully funded in year 14 to pass the Fund's assurance test. See pages 15 and 16 of the Actuary's presentation in the Appendix.

14. The modelling looked at total contributions required (i.e., Primary Rate for the cost of future benefit accrual plus Secondary Rate for the cost of benefits already accrued).

15. Given the current uncertainty of climate change, Covid, rising inflation and the Ukraine conflict, further stress test modelling was completed on asset shock and climate risks. This modelling was done to provide a greater level of assurance to Officers when setting short term employer contribution rates and to ensure that the stabilisation mechanism remains appropriate in the longer term.

Future Investment Returns

16. As detailed to the Committee in November 2021, at the 2019 valuation there was high level of uncertainty regarding a pending legal challenge, based on age discrimination in Public Sector Schemes favouring older active scheme members. This is known as McCloud. Following the conclusion of the legal process a decision was made by Government to amend Public Sector Schemes to remove the age discrimination. This had the effect that all eligible members with both final salary and career average benefits, would receive the higher of the two benefits for a period between 2014 and 2022.

17. In 2019 the cost for the McCloud remedy was unclear and the Scheme Advisory Board's guidance at the time instructed LGPS funds to consider and reflect in their Funding Strategy Statement, how this risk had been allowed for. Officers and the Actuary decided to adopt a higher level of prudence in the future investment return assumption to allow for McCloud uncertainty. Instead of using 75% likelihood of achieving target investment returns, an additional 5% margin of prudence was included, so 80% likelihood of achieving future investment return was adopted.

18. There is now greater clarity on McCloud costs and the expected impact is likely to be much lower than originally thought. The estimated costs will now be included directly in the estimate of liabilities at the 2022 valuation.

19. To avoid double counting the McCloud impact, in the on 26 November 2021 the Committee approved a proposal to reduce the required likelihood of achieving future investment return from 80% to 75% in the 2022 valuation. By doing so, this increases the future return assumption over the next 20 years from 3.8% per annum to 4.1% per annum, based upon the current Strategic Asset Allocation and economic outlook at 31 March 2021. The consequence is there will be a net improvement to the funding position. Although the Fund is taking on a greater level of investment risk this is not at a concerning level. The 75% likelihood target for future returns is consistent with the 2019 target once the McCloud margin is removed.

Other Fund Employers

20. For the non-stabilised employers Officers are keen to try and reduce the risk by disconnecting the deficit recovery period on previously accrued benefits from the exposure on future accrual. The Primary Rate (future accrual costs) could be modelled on a longer time horizon (up to a maximum of 17 years, as

per the current Funding Strategy Statement) and the secondary contributions (existing debt) could be modelled over a shorter period.

21. This is designed to strike a balance between fairness to the employers on affordability grounds but also allow the Fund to reduce the debt more quickly. It also aligns with the Government Actuary Department's view to reduce deficit recovery periods.

22. For the stabilised employers this approach cannot be used as the total contribution rate is modelled (not split between Primary and Secondary). However, the stabilised employers' benefit from smaller annual increases and decreases, regardless of any larger fluctuations in the markets thereby improving stability and affordability of contributions for the longer term.

23. Whilst the approach for non-stabilised employers differs to the stabilised employers, Officers feel the different approaches benefit both groups and the Fund.

Government Actuary Department

24. In November 2021 The Government Actuary's Department (GAD) published its Section 13 report that relates to Local Government Pension Fund valuations in England and Wales as at the 31 March 2019. The purpose of the Section 13 report of the Public Service Pensions Act 2013 was to consider issues of compliance, consistency, solvency and long terms cost efficiency across the various LGPS Funds.

25. Each Fund was assessed across the several categories and scored using a "coloured flag" to highlight material issues, warnings or satisfaction against each Fund's position.

    a. Red flag – indicates a material issue that may result in the aims of Section 13 not being met.
    b. Amber flag – indicates a potential material issue that funds should be aware of. In isolation this would not usually contribute to a recommendation for remedial action.
    c. White flag – an advisory flag that highlights a general issue but one which does not require an action in isolation.
    d. Green flag – indicated that there are no material issues that may contribute to a recommendation for remedial action.

26. Specific areas covered in the GAD Section 13 report and its appendix include.

    a. How the ranking of local funding levels varies when results are restated onto the Scheme Advisory Board (SAB) standardised basis.

   i. As at the 31 March 2019 using the fund specific basis the Leicestershire Fund was 89% funded, however using the SAB standardised basis this increases to 103% funded.

b. Pre-retirement discount rates
c. Assumed asset out performance with discount rates
d. Commutation assumptions for pre and post 2008 benefits
e. Solvency measures
f. Long term cost efficiency measures by Fund

27. The Leicestershire Fund scored a green flag in all areas. This demonstrates no drastic changes in approach are required. However, Officers are aware that relative to other Funds, Leicestershire is in the bottom half of the results, highlighting the Fund is less insulated from unforeseen events. It therefore remains important to maintain a focus on improving the funding level without creating undue risks.

28. Officers will continue to work with the Fund Actuary, throughout the valuation, to assess the Fund's scores to see if changes should be made in any of the areas, to further improve the Funds overall position. Further detail will be provided to the Local Pensions Committee throughout 2022 as part of the valuation exercise.

Fund Administrative Costs

29. A percentage is added to employer contributions to fund staffing, IT, actuarial and support services of the Pension Service.

30. For the last two valuations (previous six years) this has been broadly 0.3%.

31. There are several challenges facing the Pension Service in the coming three years especially implementation of the McCloud remedy and implementation of the national pension dashboards.

32. Officers remain focused on keeping administration costs down whilst continuing to provide an efficient and effective service but there is a reality that a small increase to 0.4% (a 0.1% rise) is needed to assist fund these additional requirements. Officers feel this still represents good value and is still lower than most Funds of a comparative size.

33. The calculation methodology applies 0.4% against the size the Fund's pensionable pay which is approximately £680M, broadly equating to £2.7M. This is not an efficiency measure as it is only based upon active payrolls and does not capture the full cost driver, e.g., pensioners and dependants or unavoidable costs such as National Insure increases. This will be included in the Fund's value for money statement to be presented to the Committee later in 2022.

Indicative Results

34. The modelling demonstrates; with a 75% likelihood of being fully funded in year 14 with a freeze on their contributions until 2026, three of the employers exceeded 75%.

35. All the other stabilised employers bar one under the 'freeze' scenario, fell below 75%, but with a 1% increase in year one and no increases in years two and three, they reached an acceptable position with both Officers and the Actuary.

36. Only one stabilised employer remains below 74%, and Officers propose a 1.5% increase in year one and no increases in years two and three.

37. Further comfort is gained that the stabilised employers meet the 75% assurance test with the shortened time horizon to 14 years, as explained in paragraph 13. This adds an additional layer of prudence. Officers are confident that applying theses changes to the stabilised employers, it will act positively in bringing them all to a closer funding position.

38. Officers are aware of the financial pressure employers are under and need to balance this against the long-term financial sustainability of the Fund. Officers are confident these proposed changes to the employer rates provide a reasonable balance for both employers and safeguards the Fund against the current uncertainties' such as climate change, Coronavirus, inflation and Ukraine.

39. None of the stabilised employers are sufficiently funded to receive a reduction to their employer rates.

40. Subject to there being no material changes Officers feel confident with the proposed stabilised employer results and will discuss with the stabilised employers on the proposed employer rates. See pages 18 and 19 of the Actuary's presentation within the Appendix.

Timeline for the 31 March 2022 Valuation

41. The updated valuation timeline is as follows.

Date	**Topic**	**Action or Awareness**
August/September 2021	Mid-valuation funding update	Board/Committee – **complete**
September 2021	Provide Hymans with stabilised employer data	Pension Section - **complete**
September/October	Calculate indicative	Hymans – **complete**

2021	stabilised employer rates	
November 2021	Agree principles for the 2022 assumptions	Committee - **complete**
March 2022	Results of the stabilised employer modelling	Committee – **current position**
April 2022	Provide the stabilised employers with their indictive rates. 1 April 2023 to 31 March 2026	Pension Section/Stabilised employers
June 2022	Approve final valuation assumptions	Committee
August 2022	Provide Hymans with all Fund data	Pension Section
August/September 2022	Review selected employer's financial health	Pension Section
August/September 2022	Calculate Fund results	Hymans
September/October 2022	Whole Fund valuation results	Committee/Board
October/November 2022	Provide the other employers with their indicative rates. 1 April 2023 to 31 March 2026	Pension Section/Fund employers
December 2022	Changes to Fund Funding Strategy Statement and Investment Strategy Statement	Pension Section/Fund employers
February 2023	Funding Strategy Statement and Investment Strategy Statement finalised	Committee/Board
March 2023	Final valuation report produced with final employer rates	Hymans
April 2023 to March 2026	Employer rates implemented	Pension Section/Fund employers

Recommendation

It is recommended that the Committee note;

a. the proposed changes to the stabilised employer contribution rates from 1 April 2023 to 31 March 2026, subject to there being no material changes.

b. that discussions are due to be held with stabilised employers regarding the proposed rates from 1 April 2023 to 31 March 2026.

c. the expected increase in administration charge by 0.1%, from 0.3% to 0.4% from 1 April 2023 to 31 March 2026.

Equal Opportunities Implications

None specific

Appendix

Appendix A – Hymans slides on the proposed stabilised employer results

Background Papers

Local Pension Committee 26 November 2021- 2022 Fund Valuation Assumptions

Local Pension Committee 10 September 2021 – Funding Position 31 March 2021

Officers to Contact

Ian Howe
Pensions Manager
Telephone: (0116) 305 6945
Email: Ian.Howe@leics.gov.uk

Declan Keegan
Assistant Director of Strategic Finance and Property
Telephone: (0116) 305 6199
Email: Declan.Keegan@leics.gov.uk