LOCAL PENSION BOARD - 26 OCTOBER 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

PENSION FUND VALUATION - FUNDING STRATEGY STATEMENT AND INDICATIVE WHOLE FUND RESULTS

Purpose of the Report

1. The purpose of this report is to inform the Board of the key policy changes in the Leicestershire Local Government Pension Scheme (LGPS) draft Funding Strategy Statement (FSS), the indicative whole fund valuation results, and the proposed change to the CPI assumption.

Background

2. Each LGPS administering authority has a statutory obligation to have an actuarial valuation carried out every three years and all Funds in England and Wales have a valuation carried out as of 31 March 2022.

3. The major purpose of the actuarial valuation is for the actuary to set employer contribution rates for a three-year period, that commences one year after the valuation date (i.e. for the period 1 April 2023 to 31 March 2026). To set these contribution rates the actuary must take account of a large number of factors, most of which are assumptions of what will happen in the future. The draft assumptions for use at the 31 March 2022 valuation were presented to Committee at the 10 June 2022 meeting.

4. In addition to the assumptions that remain under review, Officers must review and update the Fund's Funding Strategy Statement (FSS). The FSS underpins the Fund policies and includes a table detailing the Fund's framework for setting contribution rates for differing employer groups.

5. As part of the valuation process, employers must be made aware of the FSS and any key changes, and a consultation must take place with the employers. A timetable of the valuation process is included in the report.

Funding Strategy Statement

6. The Actuary and Fund Officers work collaboratively on the Fund's FSS. Officers have used this opportunity to review the "style and presentation" of the FSS, with the intention of making this easier to navigate for all parties.

7. The new style FSS, attached as Appendix A to this report, comprises two main sections; a core section and four appendices. The "core section" covers the following;

   - Welcome to the FSS
   - Calculation of employer contributions
   - Additional contributions that may be payable
   - Calculation of assets and liabilities
   - Employers joining the Fund
   - Bulk transfers of staff
   - Employers leaving the Fund
   - Statutory reporting

   Appendices to the core FSS, generally relate to Leicestershire Fund policies that cover the following;

   - Regulatory framework
   - Roles and responsibilities
   - Risks and controls
   - Assumptions
   - Pass-through policy
   - Academies policy
   - Contribution reviews
   - Cessation policy

8. Much of the information in the new style draft FSS remains the same as the Fund's previous FSS, but for ease the key changes are highlighted in yellow. These are detailed as follows;

   - Contribution reductions (Point 2.3). This sets out the Fund's proposal on how to deal with employer rates, especially with the improved funding position since the 2019 valuation, for those well-funded employers in surplus. The concept was taken to the Local Pension Committee on the 26 November 2021 for noting, and further information will follow in the final FSS in early 2023.

   - Prepayment of contributions (Point 2.9). There is no change to the Fund's current approach for the prepayment of contributions, however this is now more explicit in the FSS.

   - Early retirement on ill-heath grounds (Point 3.2). There is no change to the Fund's current approach to ill health risk mitigation, however this is now more explicit in the FSS.

- Risk and control – For best practice the FSS now includes a link to the Fund's risk register (Appendix C – C1). The risk register will continue to be reviewed by Officers.

- Employer covenant assessment and monitoring (Appendix C – C6). There is no change to the Fund's current approach, however this is now more explicit in the FSS.

- Climate risk and TCFD reporting (Appendix C – C7). This makes the Fund's approach more explicit in the FSS.

- The Fund has updated the assumptions applied at cessation following an employer's exit from the Fund (Appendix D – D5). This is a proposed change and moves away from a gilts-based cessation for employers exiting the Fund with no guarantor. Further information on this will be submitted to the Local Pension Committee.

Assumptions – June 2022

9. There are several assumptions used in the Fund Valuation. These were taken to Pensions Committee on the 10 June 2022 and were provisionally approved for the 2022 Fund Valuation, subject to any final amendments that may be necessary.

10. The assumptions were then presented to the Pension Board on the 17 August 2022 for noting. The full report and Hymans Robertson Assumption Paper are available in the background papers, but the key assumptions from June 2022 are summarised in the following table. The financial assumptions rely on market conditions on 31 March 2022 and are based on Hymans' economic scenario model.

Assumption	Approach
Longevity	A long-term trend of 1.5% annual improvements
Investment Return	4.4% p.a. assumed investment return over 0 to 20 years aiming to meet a prudent 75% success rate
Discount Rate	Beyond 20 years, use the Fund's agreed level of prudence of 75%
Benefit Revaluation and Pensions Increase	The median (average) CPI over the first 20 years of 2.7% p.a.
Salary Increases	0.5% above 2.7% CPI inflation
Others	Model using the Leicestershire Fund data and based on the Club Vita analysis

11. Since June 2022 there has been continued uncertainty in the markets and Officers and the Fund Actuary have discussed possible amendments to the 2.7% CPI inflation rate.

Assumption - Inflation

12. Due to the ongoing economic situation and more recent significant market fluctuations, inflation continues to be closely monitored by the Fund Actuary and Officers.

13. Current inflation is significantly above the Bank of England target (2% pa) and the assumption proposed in June 2022, for the 2022 valuation, was 2.7% pa. A high 2023 pension increase of around 10% is likely, based on the expected September 2022 CPI inflation, which is announced in mid-October 2022. However, prevailing expectations are that inflation pressures will be relatively short-term (1-2 years) and move back towards the Bank's target in the medium to longer term (3 years +). In the contribution modelling carried out by the Fund's actuary to set employer rates, the inflation assumption used reflects this pattern and allows for the short-term spike in the early years.

14. The CPI inflation assumption quoted in the FSS (and as proposed at June 2022 Local Pension Committee) of 2.7% per annum is an average of the short-term high levels and lower longer-term reversion to around 2% pa, over the approximate average period of the Fund's liabilities (see chart below). There remains uncertainty around both the level of future short-term inflation and how long the current period of higher inflation will last. However, whilst higher inflation pushes up the value of the Fund's liabilities, the Fund is currently invested in many asset classes that would be expected to provide a good level of protection against sustained periods of higher inflation, for example, growth assets such as equities are generally expected to perform better in an inflationary environment to provide similar levels of 'real' returns.

15. The vast majority of employers in the Fund are open employers with a long-term commitment to the LGPS. This means that the Fund (and the actuary) can take a longer-term view on risks such as high short-term inflation. This is similar to the long-term approach the Fund was able to take during the pandemic when asset values fell by over 10% (which would have a similar impact on funding). The Fund carried out in-depth asset liability modelling for the stabilised group of employers in quarter one 2022. The funding strategy was 'stress tested' for various risks, including climate transition risks, asset shocks and high inflation. The results evidenced that the current funding strategy is resilient to these risks at an acceptable level of prudence.

16. Employers planning on exiting the Fund soon (such as admission bodies with contract end dates) may be more concerned about the impact of short-term inflation on their funding position after the valuation date. Officers and the Fund actuary will be considering the future funding implications for this group closely at the valuation and will seek to engage early with affected employers. The wider impact to the Fund of this group is mitigated by (i) the

majority of short-term employers now participate on a passthrough basis with their pensions risk exposure retained by secure, longer-term employers, and (ii) many of the admission bodies (non-passthrough) are expected to be well funded at the 2022 valuation.

17. The Fund will continue to monitor actual and future expected inflation (and how the Fund's assets have performed in 'real' terms) as more information emerges. Officers are reviewing the proposed 2.7% per annum CPI valuation assumption and plan to bring additional detail to November meeting of the Local Pension Committee on the impact of inflation on future cashflows (and fund liquidity) once the 2023 pension increase order (which is based on September CPI) is known.

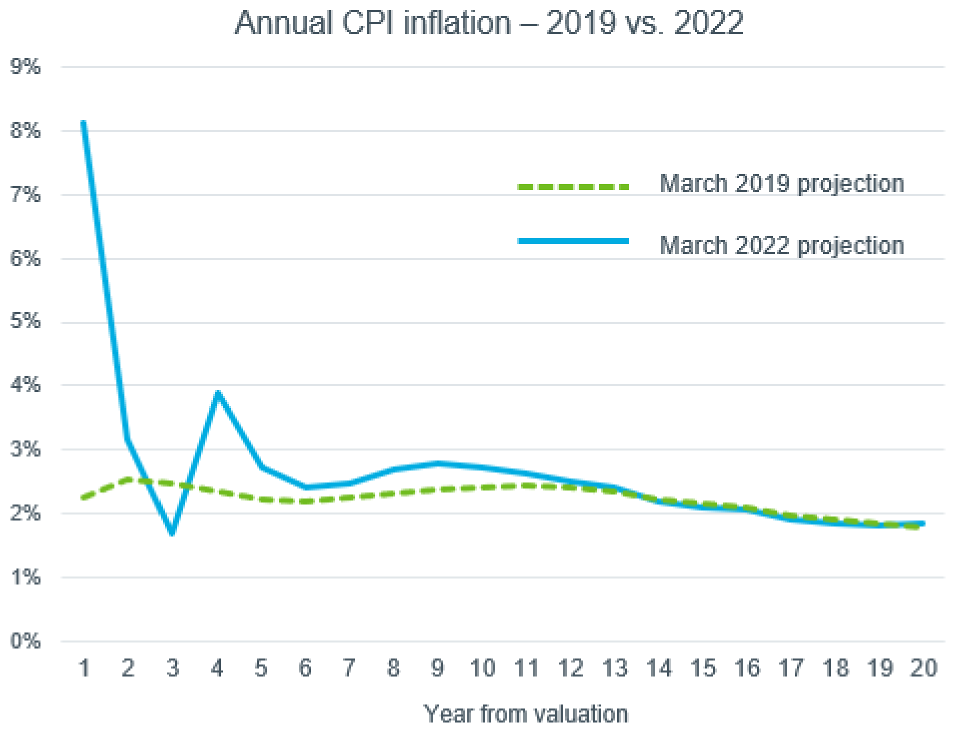

Chart shows median expected annual CPI inflation from the Fund actuary's ESS (Economic Scenario Service) model.

Indicative Whole Fund Result

18. Using the assumptions that were provisionally approved in June 2022, the indicative funding position for the whole Fund improved from 89% at the 31 March 2019 valuation, to 109% at the 31 March 2022 valuation.

19. The Fund's Indicative Whole Fund Valuation Results are attached as Appendix B to this report (for and on behalf of Hymans Robertson LLP).

20. The improvement from 89% in March 2019 to being fully funded (which is equivalent to being 100% or over) in March 2022 is welcome, but this brings additional points that need to be considered.

21. Most of the funding improvement was generated by higher-than-expected investment returns. Over the three-year valuation period (between 2019 and 2022) the expected investment return was 11.8% but the actual investment return was 34.3%, a difference of 22.5%, impacting on the funding position positively by £867m. This is not a guide for future investment growth.

22. See slide 16 of Appendix B -

23. It should be noted, the total funding level is only at a single point in time (31 March 2022) and the markets continue to fluctuate. Employers may incorrectly believe the overall improvement in funding is a right to pay lower contributions, and whilst some employers may be over 100% funded, this does not entitle employers to an immediate reduction in rate.

24. Employers that are over 120% funded will be considered for a possible reduction in rates over the longer-term as previously detailed in the draft FSS (see Appendix A Point 2.3).

25. Since March 2022 the markets have fallen, however this is likely to be offset by higher expected future returns driven by the rise in interest rates. Employer rates must be considered using a long-term approach and Officers should not react with immediate reductions to employer rates, especially so given the current turbulence in the markets. Therefore, a more prudent long-term approach needs to be taken.

26. The 109% whole fund result is calculated using the 2.7% per annum CPI assumption. Given the uncertainty around short-term inflation, Officers are considering an increase to the 2.7% per annum CPI assumption. If the CPI assumption increased to 2.9% per annum, the whole fund result would reduce to 105%. This would be more prudent given the current economic uncertainty and would serve to reduce certain employers' high funding positions.

27. See slide 19 of Appendix B.

28. Using 2.7% CPI and the whole fund's funding position of 109%, certain individual employers' funding positions far exceed 109% funding. The range is highlighted in Appendix B.

29. See slide 23 of – Appendix B.

30. Officers plan to bring additional detail to November's Local Pension Committee on the impact of inflation on future cashflows (and fund liquidity) once the 2023 pension increase order (which is based on September CPI) is known. This will help determine the CPI assumption to be used but it is expected that Officers will recommend an increase from 2.7% pa.

<u>Timeline</u>

31. The latest valuation timeline is detailed as follows.

Date	Topic	Action or Awareness
August/September 2021	Mid-valuation funding update	Board/Committee – **done**
September 2021	Provide Hymans Robertson with stabilised employer data	Pension Section - **done**
September/October 2021	Calculate indicative stabilised employer rates	Hymans Robertson – **done**
November 2021	Agree principles for the 2022 assumptions	Committee - **done**
March 2022	Results of the stabilised employer modelling	Committee – **done**
April 2022	Provide the stabilised employers with their indicative rates. 1 April 2023 to 31 March 2026	Pension Section/Stabilised employers – **done**
June 2022	Detail proposed valuation assumptions	Committee – **done**
August 2022	Provide Hymans with all Fund data	Pension Section – **done**
August/September 2022	Review selected employer’s financial health	Pension Section – **done**
September 2022	Review proposed key policy changes to the Funding Strategy Statement	Committee – **Meeting cancelled due to the Queen’s passing. Will now be taken to November Committee**
September/October 2022	Calculate Whole Fund results	Hymans Robertson - **done**
October/November 2022	Whole Fund valuation results	Board/Committee – **current stage**
November 2022	Investment Strategy Statement Draft Funding Strategy Statement (full)	Committee
November 2022 (through to January 2023)	Provide the other employers with their indicative rates. 1 April 2023 to 31 March 2026. Start a consultation with employers on the	Pension Section/Fund employers

	Funding Strategy Statement and Investment Strategy Statement (subject to possible amendments for the climate strategy)	
January 2023	Changes to Funding Strategy Statement and Investment Strategy Statement	Pension Section/Fund employers
February 2023	Final assumptions and Funding Strategy Statement and Investment Strategy Statement finalised	Committee/Board
March 2023	Final valuation report produced with final employer rates	Hymans Robertson
April 2023 to March 2026	Employer rates implemented	Pension Section/Fund employers

32. The full draft Funding Strategy Statement (FSS) and Investment Strategy Statement (ISS) will be reviewed and presented to Local Pension Committee in November 2022. This is reliant on completion of the Climate Strategy.

33. Officers will propose to start a consultation with employers on the FSS and ISS after the Committee meeting in November. To assist administration, this will commence at the same time employers receive their indicative employer rates.

34. The final assumptions will be taken to the Committee in February 2023 alongside the final FSS and ISS after completion of the employer consultation.

Recommendation

35. It is recommended that the Board notes;

- The recommended changes to the FSS.
- The indicative whole fund valuation result.
- The potential change to the future CPI assumption.

Equality and Human Rights Implications

36. There are no equality or human rights implications arising from the recommendations in this report.

Appendix

Appendix A – Fund's Draft Funding Strategy Statement
Appendix B – Fund's Indicative Whole Fund Valuation Result

Background Papers

Report of the Local Pension Board on 17 August 2022 "Pension Fund Valuation 2022"
https://bit.ly/3ezqB7m

Leicestershire County Council Pension Fund Actuarial valuation at 31 March 2022
https://bit.ly/3D5m5qS

Officers to Contact

Mr D Keegan, Assistant Director Strategic Finance and Property
Corporate Resources Department
Tel: 0116 305 7668 Email: Declan.Keegan@leics.gov.uk

Mr I Howe, Pensions Manager
Corporate Resources Department
Tel: 0116 305 6945 Email: Ian.howe@leics.gov.uk

This page is intentionally left blank