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LOCAL PENSION COMMITTEE – 18 NOVEMBER 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

PENSION FUND VALUATION - INDICATIVE WHOLE FUND RESULTS

Purpose of the Report

1. The purpose of this report is to inform the Local Pension Committee of 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 many 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.

Assumptions – June 2022

4. 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 due to the economic uncertainty.

5. The assumptions were then presented to the Local Pension Board on the 17 August 2022 for noting. 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

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

7. A proposed change to the 2.7% CPI assumption along with the whole fund indicative results were considered by the Local Pension Board on the 26 October 2022.

Assumption - Inflation

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

9. 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 10.1% is likely, based on September 2022 CPI inflation, which was announced in mid-October 2022. The actual 2023 'Pension Increase Order' will be laid before parliament in March 2023 – it is possible that HMT will set it a lower amount.

10. Prevailing expectations at the valuation date were 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.

11. The CPI inflation assumption proposed at the 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.

12. Since the valuation date, there has been increasing evidence of inflation pressures broadening out, with ongoing increases in core inflation and upwards pressure on wages. The risk of high inflation persisting for longer than consensus expects has increased, primarily driven by tight labour markets and ongoing inflationary wage rises. Due to these factors, the Fund's actuary and officers have agreed that it would be prudent to add an 'inflation protection' margin of 0.2% pa to the 2022 valuation assumption. The revised assumption is therefore proposed to be 2.9% pa.

13. Whilst current uncertainty over inflation is a concern with increases pushing up the value of the Fund's liabilities, the Fund invests 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.

14. Most 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.

15. 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.

16. Looking ahead, 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. Understanding the impact of inflation on future cashflows (and Fund liquidity) is important – the Fund will bring analysis on this to the Pensions Committee in the first quarter of 2023.

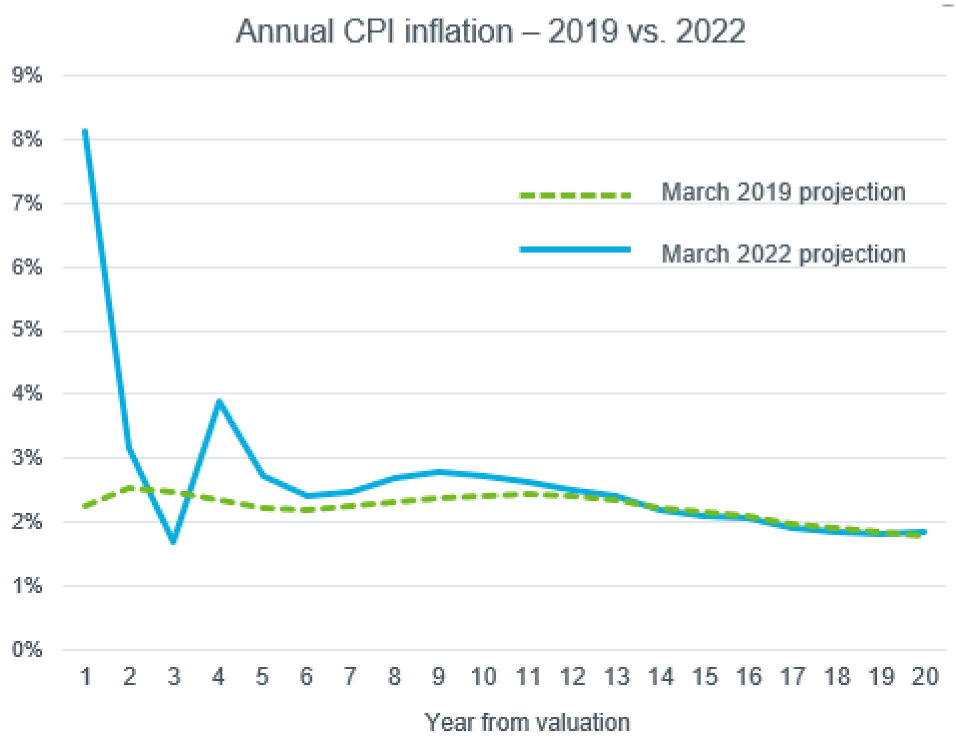

Chart shows median expected annual CPI inflation from the Fund actuary's ESS (Economic Scenario Service) model.

Indicative Whole Fund Result

17. Using the assumptions that were provisionally approved in June 2022, including the earlier 2.7% CPI assumption, 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.

18. Using the assumption that were provisionally approved in June 2022, but with the amended 2.9% CPI assumption, the indicative funding position for the whole Fund is 105% at the 31 March 2022 valuation.

19. The Fund's Indicative Whole Fund Valuation Results based on the earlier CPI assumption of 2.7% pa are attached as the Appendix to this report (for and on behalf of Hymans Robertson LLP). The Actuary has commenced modelling indicative individual employer results using 2.9% CPI and the other assumptions agreed in June 2022.

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. 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.

23. Employers that are over 120% funded will be considered for a possible reduction in rates over the longer-term as detailed in the draft Funding Strategy Statement (FSS). The FSS is included in a separate report in the meeting agenda pack, so has not been included here to avoid duplication.

24. 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.

25. Certain individual employers' funding positions far exceed the funding level of the Whole Fund. Whilst the increased CPI to 2.9% reduces this, it is expected a number of employers will still far exceed 120% funding. The range is highlighted in Appendix.

26. Officers plan to bring additional detail to the March Local Pension Committee on the impact of inflation on future cashflows (and fund liquidity).

Timeline

27. 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	Pension Section/Stabilised employers – **done**

	2026	
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 – **current stage**
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 Funding Strategy Statement and Investment Strategy Statement (subject to possible amendments for the climate strategy)	Pension Section/Fund employers
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

28. The full draft Funding Strategy Statement (FSS) and Investment Strategy Statement (ISS) are included in a separate report to the Local Pension Committee.

29. 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.

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

Recommendation

31. It is recommended

    a) That a rise in the Leicestershire Pension Fund's CPI assumption from 2.7% to 2.9% be approved;

    b) That it be noted that the indicative whole fund valuation result as at 31 March 2022 was 105% funded.

Equality and Human Rights Implications

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

Appendix

Appendix – Fund's Indicative Whole Fund Valuation Result

Background Papers

Report of the Local Pension Board on 26 October 2022 "Pension Fund Valuation – Whole Fund indicative results 2022"

https://politics.leics.gov.uk/documents/s171746/FSS%20and%20Whole%20Fund%20Results.pdf

Report of the Local Pensions Committee on the 10 June 2022 "Pension Fund Valuation"

https://politics.leics.gov.uk/documents/s169465/Local%20Committee%20Report%20-%20Valuation%20June%202022%20f2.pdf

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