Leicestershire County Council

**LOCAL PENSION COMMITTEE - 1 DECEMBER 2023**

**REPORT OF THE DIRECTOR OF CORPORATE RESOURCES**

**FUNDING POSITION UPDATE**

**Purpose of the Report**

1. The purpose of the report is to inform the Local Pension Committee about the Fund's estimated Funding Position as at 30 September 2023.

**Background**

2. Leicestershire Local Government Pension Scheme is required to complete a Pension Fund Valuation every three years. The most recent valuation took place on 31 March 2022, setting the employer contribution rates for the period 1 April 2023 to 31 March 2026.

3. At the earlier 31 March 2019 valuation, the Fund was 89% funded. At the 31 March 2022 valuation the Fund was 105% funded, meaning there was a surplus of assets over liabilities at the time of the valuation, and marks a significant improvement in the overall funding level. This was primarily driven by strong investment returns over the period.

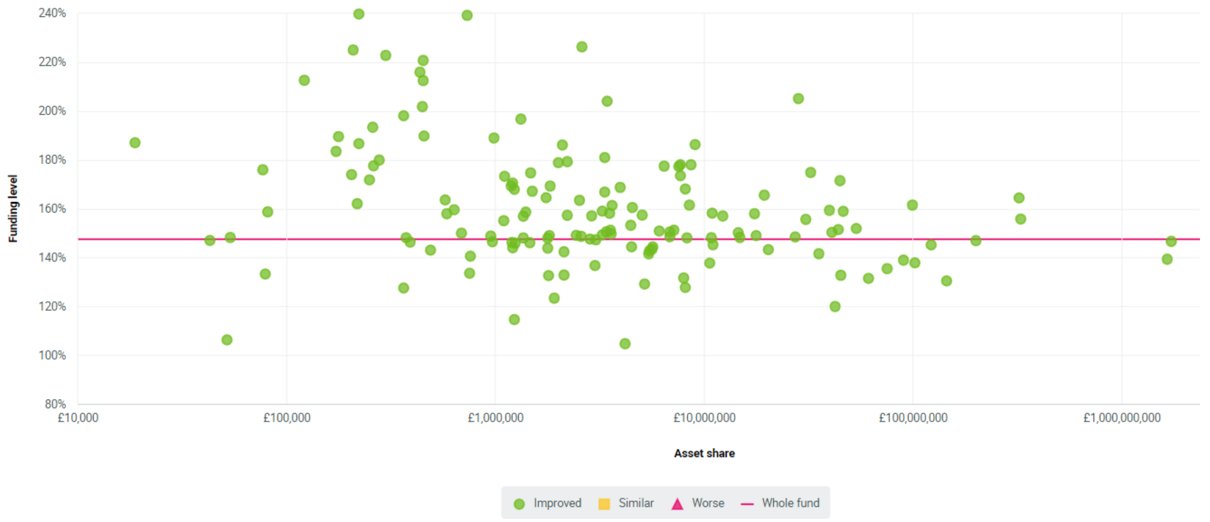
4. The next Fund valuation is on 31 March 2025. However, Fund Officers requested the Fund's Actuary Hymans Robertson, provide a mid-valuation funding position to assess progress since the last valuation, and to provide a guide on the likely outcome at the 2025 valuation.

5. It is important to note that any funding update (including the formal valuation) is only a snapshot in time. The funding level is therefore extremely sensitive to the choice of assumptions and market movements, in particular the expected future investment return assumption.

6. 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"). The funding position is only in respect of past service benefits.

7. The mid-valuation funding position as at 30 September 2023 shows an increase in overall funding level to 149% funded (see Section 1.1 of the Appendix).

8. Funding levels are calculated separately for each employer, and it is expected that the majority of employers will experience a similar improvement in funding level since 31 March 2022 with the majority of employers now expected to be fully funded. The chart below shows the funding levels at 30 September 2023 for individual employers.




Change in funding level between last valuation and 30 Sep 2023

9. The mid-valuation exercise is not as thorough as the full valuation exercise (for example, no detailed pension data has been provided by the Fund or full calculations completed by the Actuary) hence there is potential for changes to the results to allow for actual membership experience (or any changes in assumptions) by 2025.

10. There is also potential for the funding level to materially change by 31 March 2025 depending on changes in investment markets (assets) and economic projections (liabilities).

**<u>Key Funding Measures</u>**

11. The Fund Actuary, Hymans Robertson, has provided a document, an Update on Funding Position as at 30 September 2023. This is attached as an Appendix to this report.

12. Rather than duplicate much detail from this document, this report concentrates on the key changes since the 2022 valuation.

13. Since the 2022 valuation, the key funding measures estimated to have changed after allowing for market conditions to 30 September 2023 are:

- Past service funding position has improved from 105% to 149%
- Expected future returns have risen from 4.4% pa to 6.6% pa
- Required future return (to be fully funded) has increased from 4.2% pa to 4.3% pa.

- Likelihood of the Fund achieving the required return has increased from 78% to 92%.

These measures are explained in greater detail below.

14. **Past Service Funding Position**. The past service funding position as at 30 September 2023 has improved since the formal funding valuation as at 31 March 2022 from 105% to 149% funded – see the Appendix for details. The value of assets held by the Fund is broadly the same as in 2022. However, the improvement in funding has been driven by a significant change in investment outlook (as noted below).

15. **Investment outlook**. The economic environment has changed significantly since 31 March 2022 formal funding valuation – in particular the rise in future expected returns.

    At the 2022 formal funding valuation, the fund assumed a future expected return of 4.4% pa based on a 75% likelihood of achieving these returns. Future investment returns, at this same level of prudence (75% likelihood of being achieved), are now expected to be 6.6% pa.

16. **Required return assumption (% pa) for funding level to be 100% and associated likelihood of success**. At the 2022 valuation, future investment returns of 4.2% pa were required to be 100% funded. There was estimated to be a 78% likelihood of achieving these required returns.

    The mid-valuation update at September 2023 shows future investment returns of 4.3% pa are now required to be 100% funded. However, the likelihood of the Fund's assets achieving this level of required return is now 92%.

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

## Investment Risk

17. The past service position represents a snapshot of the funding level on a specific day on a given set of assumptions. The liabilities are extremely sensitive to the choice of assumptions and market movements, in particular the expected future investment return assumption.

18. The discount rate used to calculate the liabilities as at 30 September 2023 is markedly higher than at 31 March 2022, as noted in the Appendix (Section 3.4). The higher discount rate reflects higher expected future investment returns, which has been largely driven by an increase in interest rates since 2022. In isolation, this serves to place a much lower value on the past service liabilities calculated at 30 September 2023.

19. If expected future returns were assumed to be lower, the value placed on liabilities would increase and the funding level would reduce. The actuary

estimates that 1% pa lower assumed return (discount rate) would reduce the funding level by around 20%.

20. While the strong funding position is good news for the Fund, it is important to remember that this position is only in respect of past service benefits and investment markets (and inflation) remain volatile.

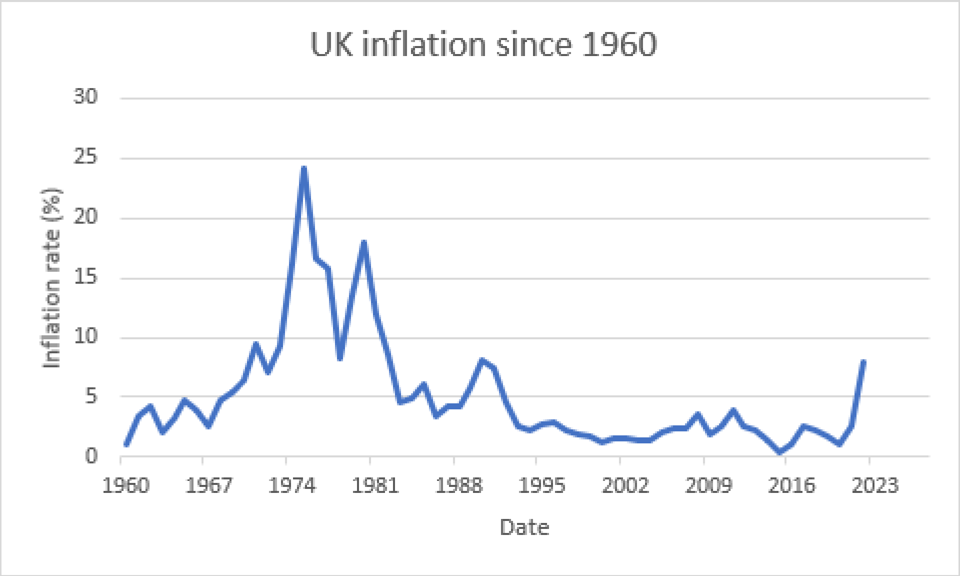
**Inflation Risk**

21. Actual realised inflation since the 2022 valuation has been higher than assumed. The updated funding position allows for the 10.1% increase to pensions in April 2023. The pension increase order in April 2024 is expected to be 6.7% (based on September 2023 CPI) which will serve to reduce the funding level by around 4%.

22. Short-term inflation remains high however, the pension increase assumption over the longer-term, has fallen from 2.9% pa in 2022 to 2.5% pa (as noted in the Appendix), which has improved the funding position.

23. The assumption for future pension increases is that this will tend towards the Bank of England CPI target of 2.0% per annum over the longer-term. To recognise increased levels of uncertainty around future inflation, the Fund currently allows for an additional 0.2% pa margin above the “best estimate" long term inflation assumption, as inflation protection.

24. Current expectations are that higher short-term inflation will continue to fall. However, if inflation persisted at higher levels this would reduce the funding position (all else being equal). Historically there have been prolonged periods of higher inflation (as shown in the chart below), which demonstrates why inflation is a key risk for the Fund to monitor.




25. In the event that future inflation was materially higher than the current long-term assumption of 2.5% pa this would increase liabilities and reduce the

funding level. For example, the Actuary estimates that an increase to 3.5% pa would reduce the funding position by around 20%.

26. Member benefit payments are directly linked to inflation and so significant higher inflation has a direct impact on the cashflows paid out each year by the Fund. Despite the high short-term increases to pensions, the Fund remains in a strong positive cashflow position (where contribution income exceeds benefits). The Fund will continue to monitor cashflow risk closely over the inter-valuation period and at the next valuation.

**Indicative Impact on Future Employer Contribution Rates**

27. Employer rates are split into two, primary and secondary rates.

- The Primary rate covers the cost of future benefit accrual.
- The Secondary rate covers the cost of benefits already accrued.

Hymans indicate the cost of future benefit accrual has reduced since 31 March 2022, which is likely to reduce the cost of the Primary rate. This is mainly due to the increase in future expected returns as noted above. This, coupled with the improved past service position will have a positive impact. The improved past service position will reduce the cost of the Secondary rate for benefits that have already been accrued.

28. It is difficult to predict with any certainty the overall impact on the employer rates at the current time. However, the current improved funding position and improved future investment outlook suggest contribution rate reductions may be possible for employers at the 2025 valuation.

29. Employers are grouped into separate categories and those presenting a greater risk to the Fund, are assessed further. The fund is likely to maintain the same funding approach, as outlined in the funding strategy statement, when assessing employer contribution rates as part of the 2025 formal funding valuation.

30. The mid-valuation exercise is designed as a check for Officers to assess funding level progress. It also supports forward planning of investment and funding strategy. The results as of 30 September 2023 indicate there is no immediate action required by the Fund. However, officers have begun discussions with the Fund Actuary to plan ahead for the 2025 valuation.

31. At the 2025 valuation, the Fund will seek to balance longer-term security and stability with employer affordability while also considering the possible impact of pertinent risks, such as inflation and climate risks.

32. Officers and the Fund actuary are considering the best use of funding levers:

- Maintaining a funding cushion to protect against market volatility and funding uncertainties.
- Provide contribution reductions to employers where appropriate.

- Increase prudence to provide security against future risks that may be harder to quantify (for example, climate risks).
- Reduce investment risk where appropriate.

The Fund will seek to maintain the existing framework as outlined below.

**Employer Contribution Rate Reductions**

33. During the 2022 valuation exercise, Officers consulted with the employers on the Fund's Funding Strategy Statement (FSS). This included setting a framework around employer contribution rate reductions.

34. Where an employer has a past service funding surplus, as calculated by the Fund actuary on the appropriate funding basis, a reduction in contribution rate may be permitted by the administering authority.

35. The following framework is included in the Fund's February 2023 FSS, as a guide.

| Employer Funding Level | Total contribution rate |
|---|---|
| Less than 100% funded | Employer pays a contribution rate to increase their funding level |
| Between 100% and 110% funded | Employer pays a contribution rate to continue to build up their funding level to between 110% and 120% |
| Between 110% and 120% funded | Employer pays a contribution rate to maintain their funding level between 110% and 120% |
| Greater than 120% funded | Employer is allowed to benefit from a contribution rate reduction, to gradually reduce their funding level down to 120%, where applicable |

36. Hymans' calculations indicate an improving funding position for the majority of employers. This is likely to result in more employers being greater than 120% funded at the 2025 valuation.

37. Officers are keen to point out that when the Fund was in deficit, the Fund did not increase employer rates significantly. Instead, rates were stepped gradually to reduce the deficit. As the funding position continues to improve, Officers do not want to make significant reductions to employer rates. Instead, Officers plan to gradually reduce rates down where applicable.

38. Officers consider this a fair approach which was approved at the 2022 valuation and will remain in place for the 2025 valuation.

**Timeline for the 31 March 2025 Valuation**

39. The following table provides a guide to the estimated timeline for the 31 March 2025 valuation, when Officers intend to split the employers into two

groups. This is simply designed to assist administration. It allows the Pension Section to deal with one group of employers first, then move onto all the other employers. Group one is the stabilised employers, and these tend to be the larger tax raising employers, for example,  Leicestershire County Council, Leicester City, the Borough and District Councils, Police and Fire. Group two are all the other employers.

| Date | Topic | Action or Awareness |
|---|---|---|
| December 2023 | Mid-valuation funding update | Committee |
| September 2024 | Provide Hymans with stabilised employer data | Pension Section |
| September/October 2024 | Calculate indicative stabilised employer rates | Hymans |
| November 2024 | Agree principles for the 2025 assumptions. | Committee |
| March 2025 | Results of the stabilised employer modelling | Committee |
| April 2025 | Provide the stabilised employers with their indictive rates. 1 April 2026 to 31 March 2029 | Pension Section/Stabilised employers |
| June 2025 | Agree final valuation assumptions. | Committee |
| August 2025 | Provide Hymans with all Fund data | Pension Section |
| July/September 2025 | Review selected employer’s financial health | Pension Section |
| September 2025 | Calculate Fund results | Hymans |
| September/October 2025 | Whole Fund valuation results | Committee/Board |
| October/November 2025 | Provide the other employers with their indicative rates. 1 April 2026 to 31 March 2029 | Pension Section/Fund employers |
| December 2025 | Changes to Fund Funding Strategy Statement and Investment Strategy Statement | Pension Section/Fund employers |
| February 2026 | Funding Strategy Statement and Investment Strategy Statement | Committee/Board |

| | | |
|---|---|---|
| March 2026 | Final valuation report produced with final employer rates | Hymans |
| April 2026 to March 2029 | Employer rates implemented | Pension Section/Fund employers |

## Recommendation

40. Members of the Committee are asked to note the report.

## Equality Implications

There are no equality implication arising from the recommendations in this report.

**Human Rights** Implications

There are no human rights implications arising from this report.

## Appendix

Update on Funding Position as at 30 September 2023

## Officers to Contact

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