Leicestershire County Council

LOCAL PENSION COMMITTEE - 6 SEPTEMBER 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

FUNDING RISK UPDATE AND 2025 VALUATION PLANNING

Purpose of the Report

1. The purpose of the report is to provide the Local Pension Committee with an update on changes to the funding environment since the 2022 valuation, the risks currently faced by the Fund and the actions to be taken to help manage these risks as part of the 2025 valuation.

Background

2. Leicestershire Local Government Pension Scheme (LGPS) is required to complete a Pension Fund Valuation every three years. The purpose of the valuation is to check the ongoing solvency of the scheme - assets held versus accrued benefits (liabilities) – and to set employer contribution rates for the following three years.

3. The next formal valuation will take place on 31 March 2025. The valuation will be completed by 31 March 2026 with new employer contribution rates being certified for the period 1 April 2026 to 31 March 2029.

4. Early planning is important to deliver a smooth and successful valuation for all stakeholders. Key decisions on funding strategy and policies will be brought to committee over the coming year to ensure governance best practice.

5. Fund officers have already begun planning discussions with Hymans Robertson, the Fund Actuary. As part of these discussions Hymans Robertson has prepared a paper which forms the annex to this report and which considers the current funding risk environment and outlines the key considerations for the Fund heading into the 2025 valuation.

Updated funding position

6. The funding position of the Leicestershire County Council Pension Fund as at 30 June 2024 is 150%. This represents an improvement in funding level of 105% at the 31 March 2022.

7. Whilst this improved funding position is good news, there are limitations to the usefulness of the funding level metric because it is based on a single set of assumptions about the future and asset values at a single point in time. It also

only recognises benefits earned to date ("past service") and not the cost of future benefits.

What has happened since the 2022 valuation?

8. The Fund's assets have increased slightly since the 2022 valuation with investment returns being around 10% since March 2022. This relatively modest level of returns means that the Fund currently holds a similar amount of money to pay each pound of pension as they did at the 2022 valuation date.

9. Inflation has risen sharply since the valuation date. Benefits have increased by 10.1% in 2023 and 6.7% in 2024, increasing the value of the Fund's liabilities (in isolation). This has also had an impact on the Fund's cashflow profile as current outgoing benefits has also increased in line with the above pension increases.

10. However, despite these modest investment returns and higher inflationary pressures, the funding level has still improved. The improvement in funding level has largely been driven by an improved investment outlook due to a sharp rise in global interest rates (leading to higher expected future returns across all asset classes), which has more than offset the high inflationary pressures. It is important to note at this point however that future investment returns are not guaranteed within the backdrop of higher interest rates.

11. As at 30 June 2024, Hymans Robertston now estimates that the Fund will achieve a higher investment return of 6.4% pa (with a 75% likelihood of being achieved), compared to a return of 4.4% at 31 March 2022 (with the same likelihood).

12. Higher expected future investment returns lead to a lower value being placed on the Fund's future benefit payments (liabilities). This means that the improved funding level is reliant on the Fund achieving higher investment returns in the future as opposed to holding more assets today (per pound of pension).

13. The improved funding position remains highly sensitive to the future investment return assumption. If future returns are 1% pa lower than assumed, the funding level would be around 20% lower.

14. Future returns may be lower than predicted if central banks reduce interest rates quicker than assumed or if higher returns fail to materialise despite the current higher interest rate environment. Therefore, the Fund should remain cautious of the improved funding position and set appropriate longer term surplus management policies to benefit and protect all stakeholders.

Key funding risks

15. There remains uncertainty in financial markets and material risks facing the Fund. There has been a significant shift in the economic environment since

the 2022 valuation and the Fund is now facing new risks and opportunities. The key funding risks that the Fund continues to manage are:

- Investment risk
- Inflation risk
- Cashflow risk
- Longevity risk
- Climate risk
- Employer covenant risk

Investment risk

16. All assumptions (especially those on future investment performance) remain uncertain, especially during periods of increased market volatility. The funding position is based on future returns with a 75% assumed likelihood of being achieved. In other words, there is still a 25% chance that returns will be lower than we assume. Fund officers will review prudence levels (namely the assumed likelihood of achieving returns) at the 2025 valuation.

17. All employer assets are invested in a strategy with a mix of investments held across broadly three areas: growth (such as equities), protection (such as bonds) and income (such as property).

18. The investment strategy has a robust refresh annually to balance the risks and opportunities the Fund faces. It considers funding level and the appropriate investment risk (and by implication investment return) to position the fund for whilst reviewing existing investments suitability.

Inflation risk

19. Inflation is a key risk for pension funds to manage. Higher inflation increases the cost of benefits, which increases longer term funding costs but also has an immediate impact on shorter term cashflow (pensions in payment).

20. Inflation has recently fallen back to around 2% (which is the Bank of England's long-term target) however, future inflation is uncertain. Persistently higher inflation remains a key risk for pension funds given the current economic climate. For example, if pension increases are 1% per annum higher than the current long term assumption of 2.5% per annum, this will reduce the funding level by around 20%.

21. Fund officers will continue to monitor inflation trends and will include stress tests on funding strategy and future cashflow modelling to help understand and manage this risk.

Cashflow risk

22. The Fund is currently in a cashflow positive position (monthly contribution income exceeds monthly pension payable) by around £50million per annum.

23. Due to rising inflation and the significant increases in benefits since the 2022 valuation (10.1% in April 2023 and 6.7% in April 2024), the focus on cashflow across the LGPS is greater than before. However, the Fund is likely to remain cashflow positive in the short-to-medium term so cashflow is not an immediate concern.

24. Becoming cashflow negative itself is not unexpected for a pension fund; the assets that have been accrued are for the purpose of paying benefits. However, if the transition to becoming cashflow negative is not monitored and managed effectively, it can pose a liquidity and administration risk.

25. Any changes in employer contribution rates or the investment strategy as part of the 2025 valuation will also have an impact on the projected cashflow position of the Fund. Therefore, Officers will regularly monitor the Fund's cashflows as part of cashflow management best practice.

Longevity risk

26. Recent longevity trends have seen increased deaths in recent years. In 2020 and 2021, these deaths were a result of the Covid-19 pandemic, however the cause of these excess deaths in 2022 and 2023 is less clear cut.

27. Understanding these demographic trends and setting appropriate mortality assumptions is key to managing longevity risk. The Fund's longevity assumptions will be reviewed as part of the 2025 valuation.

28. With increased levels of uncertainty on the lasting impact of the pandemic and future longevity, the Fund may consider maintaining a funding cushion to help manage these uncertain outcomes.

Climate risk

29. Climate risk is now widely regarded as one of the main sources of risk for pension schemes, with potential implications for future inflation, investment returns and longevity.

30. At the 2022 valuation, the Fund carried out scenario analysis representing a broad range of possibilities for how the world might respond to climate change. Despite imposing significant stresses and big increases in volatility, the impact on funding metrics of these scenarios was quite modest.

31. However, climate change has the potential to make severe outcomes more likely, therefore it is important to consider these risks when assessing the impact of climate risk. As part of the 2025 valuation, Hymans Robertson will model new 'severe' scenarios (complementing the existing scenarios) allowing the Fund to assess the impact of more severe climate change outcomes on funding strategies.

32. Ahead of the 2025 valuation, the Fund will review its approach to managing climate risk, including setting objectives, capturing views and beliefs, carrying

out scenario modelling and integrating existing climate objectives and beliefs within the funding and investment strategies.

Employer covenant

33. Although the recent improvement in funding is good news, employers continue to face a wide variety of challenges from the evolving economic, demographic and regulatory environment. Higher inflation, interest rates and pay awards are all adding financial pressures on organisations.

34. As part of the 2025 valuation, the Fund will assess employer covenant risk to ensure early engagement with employers and appropriate risk categorisation. The Fund will also consider how this risk categorisation impacts on its holistic approach to setting employer funding strategies.

2025 valuation planning

35. As part of the preparatory work to help inform the Fund's funding and investment strategy in this new economic environment., the Fund is reviewing the following areas:

- Employer contributions
- Investment strategy
- Prudence levels
- Treatment of surplus
- Risk management for other sources of uncertainty and volatility.

36. Given the current cost pressures facing employers, there may be a desire for contribution rate reductions at the 2025 valuations. However, the Fund will need to consider how to manage any contribution rate reductions against the potential need to increase contribution rates in the future. The impact of any contribution reductions on the Fund's cashflow needs will also be considered.

37. Given the likely improvement in funding at 31 March 2025, many employers may now want an opportunity to manage volatility in their funding position by reducing their exposure to investment risk.

38. The Fund should review the prudence levels in the funding strategy to help explore if the current market conditions and recent increased levels of volatility and uncertainty around certain risks warrant management by increasing levels of prudence.

39. Ahead of the 2025 valuation, officers will:

- Engage early with employers and other stakeholders to plan the valuation effectively;
- Monitor employer funding and covenant risks, including early engagement with high risk employers;
- Engage with all employers ahead of the valuation to build up appropriate messaging around the current economic environment;

- Consider options for funding and investment to help manage the current surplus including a review of current prudence levels; and
- Carry out contribution rate modelling for the long-term, secure employers to inform budget setting.

Timeline for the 31 March 2025 Valuation

40. For the 2025 valuation, Officers intend to split the employers into two working groups. This is simply designed to assist administration. It allows the Pension Section to deal with one group of employers first (the stabilised employers), then moving onto all the other employers. The stabilised employers tend to be the larger tax raising employers, for example, Leicestershire County Council, Leicester City Council, District Councils, and Police and Fire.

41. The following table provides a guide to the estimated timeline for the 31 March 2025 valuation. Note, these dates are intended to provide the LPC with an awareness of the upcoming milestones, however, at this stage the exact timing of each item remains under discussions with fund officers and Hymans Robertson.

Date	**Topic**	**Stakeholder(s)**
September 2024	Funding risk update & 2025 valuation planning	LPC
October/November 2024	Calculate indicative stabilised employer rates	Hymans
November 2024	Agree funding strategy and assumptions principles for the 2025	LPC
March 2025	Results of the stabilised employer modelling	LPC
March/April 2025	Review funding policies and employer risk management	Pension Section
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	LPC
August 2025	Provide Hymans with all Fund data	Pension Section
September 2025	Calculate Fund results	Hymans
September/October 2025	Whole Fund valuation results	LPC/Local Pension Board (LPB)

Date	Topic	Stakeholder(s)
October/November 2025	Provide the other employers with their indicative rates. 1 April 2026 to 31 March 2029	Pension Section/Fund employers
November/December 2025	Changes to Fund Funding Strategy Statement and Investment Strategy Statement	Pension Section/Fund employers
February 2026	Finalise funding Strategy Statement and Investment Strategy Statement	LPC/LPB
March 2026	Final valuation report produced with final employer rates	Hymans
April 2026 to March 2029	Employer rates implemented	Pension Section/Fund employers

Recommendation

42. It is recommended that the Local Pension Committee note the report.

Equal Opportunities Implications

None specific

Appendix

Appendix – Funding risks update & 2025 valuation planning

Officers to Contact

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