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Leicestershire County Council Pension Fund

Cessation corridor approach

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20 January 2026
For and on behalf of Hymans Robertson LLP

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Addressee

This paper is addressed to the Pension Committee of the Leicestershire County Council Pension Fund ("the Fund").

Purpose

As part of the 2025 formal valuation, the Fund has reviewed its cessation policy. The purpose of this paper is to explain the introduction of a 'corridor' for ceasing employers that have no guarantor and are valued using the Fund's low-risk exit basis.

The 'corridor' affects cessation valuations in the round, so any decision will impact both cessation debt payments due to the Fund from a ceasing employer (if the valuation identifies a deficit) and potential exit credits (if the valuation identifies a surplus).

This policy change will be documented in the FSS and consulted on in line with LGPS Regulations and guidance.

1. Background to current cessation approach

Background to the current cessation approach

The Fund's cessation approach for the low-risk exit basis was last reviewed as part of the 2022 valuation exercise.

Following this review, the Fund's low-risk exit basis switched from a "gilts-based" methodology to a risk-based approach. This aligns with the approach used to determine the future investment return for the ongoing basis and the approach used for contribution rate setting purposes.

Notably, it was agreed that the level of future investment return under the Fund's low-risk exit basis would target a **90% likelihood** of being achieved over a 20-year time horizon. In other words, the prudence margin was set at 90%. This is captured in the Fund's current FSS (see excerpt opposite).

The approach was approved by Committee in November 2022 as part of the funding strategy review for the 2022 formal valuation and has since been used for any cessation calculations for employers ceasing on the low-risk exit basis.

FSS: Appendix D – Actuarial assumptions

D5 What assumptions apply in a cessation valuation following an employer's exit from the Fund?

Where there is a guarantor the following exit basis will apply:

- **Admission bodies (TABs)** – where the liabilities will be passed back to the letting authority on exit, the contractor exit basis will apply (see below)
- **Other employers** - in specific circumstances an exiting employer may have a guarantee provided by another employer within the Fund or by a parent company etc. If the Fund is satisfied with the covenant of this guarantee the liabilities may be calculated on the ongoing basis.

Contractor exit basis

The financial and demographic assumptions underlying the contractor exit basis are equal to those set for calculating contribution rates. Specifically, the discount rate is set equal to the risk-free rate at the cessation date, plus a margin equal to that set to allocate assets to the employer on joining the Fund.

Low risk exit basis

Where there is no guarantor, the low-risk exit basis will apply.

The financial and demographic assumptions underlying the low-risk exit basis are explained below:

- The discount rate used for calculating the funding position will be higher than the ongoing funding basis, specifically that there is a 90% likelihood that the Fund's assets will achieve future investment returns over the 20 years following the date of the calculation.
- The CPI assumption is based on Hymans Robertson's ESS model plus an 'inflation protection' margin of 0.2% pa. The median value of CPI inflation from the ESS was 2.7% pa on 31 March 2022, giving an overall CPI assumption of 2.9% pa.

The cessation policy is reviewed regularly as part of the Fund's ongoing risk management processes

Why review the cessation policy now?

The economic environment has changed significantly since 2022. This has resulted in improved funding positions for employers, and less concern around affordability of the scheme and exit costs.

This has increased the number and urgency of employers seeking exit from funds across the LGPS. It has also shifted the focus from debt management to the possibility of the employer receiving an exit credit. This has seen increased activity from employer-appointed independent advisers, who are challenging the cessation approach, often to seek a higher exit credit.

The current cessation approach presents the following two challenges:

- Risk of insufficient assets - a high exit credit results in less assets being left behind in the Fund, increasing the risk that these assets won't be sufficient to meet the liabilities of the ceased employer in the future (if the assets don't earn the assumed level of future investment return).
- Uncertainty for employers - it remains difficult for employers to plan for future cessation events, whether in surplus or in deficit, as their assets and liabilities are sensitive to market movements that are shifting continuously.

In this paper, we discuss an alternative approach which would help both the Fund and the employers plan future cessation events with more cost certainty and ensure exit credits are only paid out where there is a high level of confidence of sufficient monies remaining in the Fund.

Furthermore, since the Fund has decided to increase prudence in its ongoing basis from a 75% to 80% likelihood of success as part of the 2025 valuation funding strategy, it makes sense to review the cessation policy for consistency.

2. Risk-based cessation ‘corridor’ approach

Extending current approach to use a likelihood 'corridor'

As mentioned in the previous section, the current cessation approach leads to two key challenges for the Fund.

To address these challenges, a cessation likelihood "corridor" can be added which works as follows:

1. The Fund sets the bounds of the corridor, namely a minimum and maximum required likelihood of achieving the investment return as part of its funding strategy;
2. For each cessation valuation, we would use our in-house model (the Economic Scenario Service ("ESS")) to generate the assumed investment returns on the cessation date, using the Fund's investment strategy and a time horizon of 20 years;
3. We would then calculate two liability values using the assumed investment returns that could be achieved with the minimum and maximum likelihoods. These two liability values then represent the bounds of the likelihood "corridor";

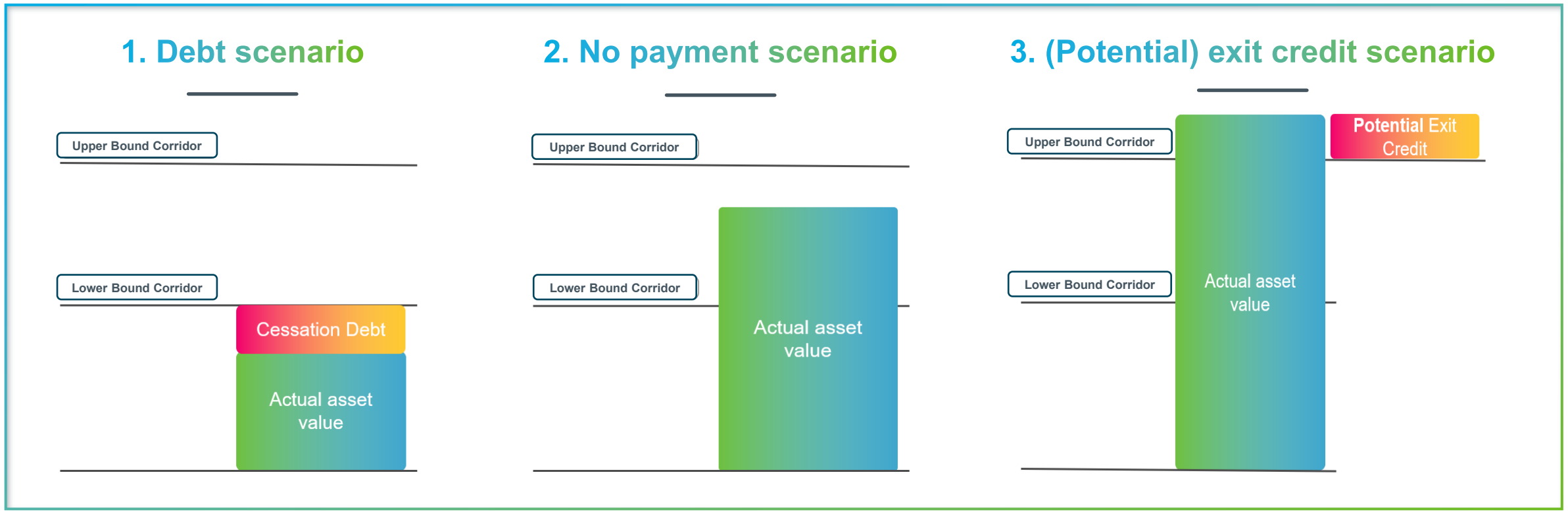
The choice of the upper and lower bound of the corridor is at the Fund's discretion. It would be documented within the Funding Strategy Statement and subject to employer consultation. The likelihood associated with each bound would remain fixed for all low-risk exit basis cessation calculations until the cessation policy is next formally reviewed.

The following page illustrates the operation of the likelihood 'corridor' in each scenario.

4. The actual asset value at the point of cessation is then compared to the lower and upper bound of the liabilities, leading to one of the following three potential outcomes:

- **Debt scenario**: If the actual asset value falls below the lower bound of the corridor, then a cessation debt is payable by the exiting employer, equal to the difference between the lower bound and the actual asset value. This ensures the employer's asset share meets at least a minimum required level.
- **No payment scenario**: If the actual asset value falls within the upper and lower bounds of the corridor, then no cessation debt or exit credit is payable. This is because the employer's asset share is within the required corridor and therefore deemed broadly sufficient.
- **(Potential) credit scenario:** If the actual asset value falls above the upper bound of the corridor, then no cessation debt is payable by the exiting employer. An exit credit **may** be payable, of no more than the excess above that upper bound in order to limit the employer's asset share to no more than the maximum required level (and noting that under LGPS Regulations there are additional factors to take into account when determining the amount of an exit credit).

Risk-based cessation corridor approach



The actual asset value at the point of exit is compared to the lower and upper bound of the liabilities

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3. Choice of corridor bounds

Cessation corridor parameters

The key parameters are as follows:

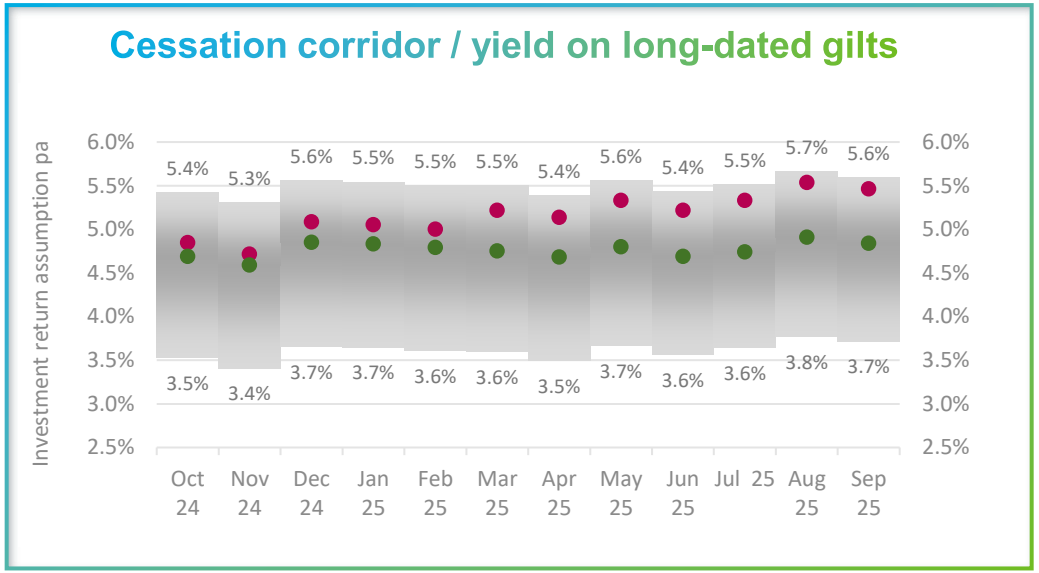
- **Lower bound** – the level below which an exit debt may be payable. This would be set equal to the value of the liabilities calculated with reference to the X% likelihood return assumption (e.g. 85%, 90%)
- **Upper bound** – the level above which an exit credit may be payable. This would be set equal to the value of the liabilities calculated with reference to the Y% likelihood return assumption (e.g. 90%, 95%)

The discount rates (likelihood return assumption) for the lower and upper bounds are set with reference to the returns expected from the Fund's assets, based on the investment return assumptions generated from our ESS model. Whilst these assumptions vary over time due to changes in asset return expectations, the upper and lower bound likelihoods would remain fixed.

The chart to the right shows the 85% to 95% discount rate corridor at month-ends between October 2024 and September 2025 (the grey shaded area), along with the 90% discount rates (the **green dots**) and the yield on long-dated government bonds at each month-end (the **pink dots**). The rationale for using the yield on long-dated government bonds as a reference point is that this is viewed as the least-risky asset class and is how the Fund used to define the low-risk exit basis before the current risk-based approach was adopted. While the upper and lower bound discount rates are not set with reference to the yield available on long-dated government bonds, the discount rate set based on a high likelihood of occurrence can be similar to the gilt yield at any point in time, and these can change in a similar (but not identical) way.

From this we can make the following observations:

- The likelihood of the Fund's assets generating returns at least equal to the gilt yield has ranged been between 86% to 89% (i.e. the gilt yield has been broadly similar to the 90% likelihood discount rate).
- The average range of the future expected returns for a 90%-95% corridor over this period is 1.2% pa (equivalent to a difference in liability value of c.15-20%).
- The average range of the future expected returns for an 85%-95% corridor over this period is 1.9% pa (equivalent to a difference in liability value of c. 25-30%).



Discount rate (pa)	Min	Max	Average
85% likelihood	5.3%	5.7%	5.5%
90% likelihood	4.6%	4.9%	4.8%
95% likelihood	3.4%	3.8%	3.6%
Gilt yield	4.7%	5.5%	5.2%

Considerations for cessation corridor parameters

When considering the bounds for the cessation corridor, the following are relevant:

- The upper and lower bound discount rates can provide a wide range over which an employer can be 'fully funded' for cessation purposes (e.g. the range of an 85% to 95% corridor has been c1.9% pa which is equivalent to a change in liability values of c.25-30%). This helps reduce the volatility of cessation valuations and provides more certainty to employers when planning for future cessation events. Any narrowing of the range of the corridor (e.g. 90% to 95%) would lessen the benefit of this reduced volatility in cessation valuations.
- One of the Fund's objectives should be to design an approach that is fair to employers. Any choice of parameters which lead to a higher likelihood of a cessation debt being payable, or which reduces the cessation surplus, may be deemed unfair by employers. Careful considerations around the implementation timetable and the communication of such a change would be required if the parameters were to change in this way.
- A key source of volatility in the discount rates and width of corridor, is the nature of underlying assets themselves. An asset allocation with less risk would inherently reduce both.

Other considerations

- **Source of prudence** – does the Fund wish to apply further prudence in any of the other actuarial assumptions, which may be valid due to uncertainty in these assumptions, or to reflect any emerging evidence that future experience may be detrimental compared to the current assumption?
- **Ongoing review** – Regular reviews of the cessation approach and parameters would be good practice: these could be annual (to capture changes in market conditions), or triennial (to tie in with the funding valuations and reviews to the Funding Strategy Statement).
- **Consistency with 2025 valuation -** Funding Strategy is under review as part of the 2025 valuation. The Fund have adopted a higher prudence margin as part of that assumption setting process. Increases in prudence may also be appropriate within any cessation corridor parameters.

Following discussions, officers propose to introduce a corridor with bounds of 85% and 95%

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Appendices

APPENDIX 1

Reliances and limitations

This paper is addressed to Leicestershire County Council as Administering Authority to the Leicestershire County Council Pension Fund ("the Fund"). It has been prepared in our capacity as actuaries to the Fund and is solely for the purpose of explaining the risk-based corridor cessation approach for the Fund's low-risk exit basis. It has not been prepared for any other purpose and should not be used for any other purpose.

The Administering Authority is the only user of this advice. Neither we nor Hymans Robertson LLP accept any liability to any party other than the Administering Authority unless we have expressly accepted such liability in writing.

This paper may not be passed onto any other third party except as required by law or regulatory obligation, without prior written consent of Hymans Robertson LLP.

In circumstances where disclosure is permitted, the advice may only be released or otherwise disclosed in its entirety fully disclosing the basis upon which it has been produced (including any and all limitations, caveats or qualifications).

The following Technical Actuarial Standards are applicable in relation to this advice, and have been complied with where material and to a proportionate degree:

- TAS100
- TAS300

APPENDIX 2

Economic Scenario Service (ESS)

The ESS uses statistical models to generate a future distribution of year-on-year returns for each asset class e.g. Property. This approach is also used to generate future levels of inflation (both realised and expected). The ESS is also designed to reflect the correlations between different asset classes and wider economic variables (e.g. inflation). In the short-term (first few years), the models in the ESS are fitted with current financial market expectations. Over the longer-term, the models are built around our long-term views of fundamental economic parameters e.g. equity risk premium, credit-spreads, long-term inflation etc. The ESS is calibrated every month with updated current market expectations (a minor calibration). Every so often (annually at most), the ESS is updated to reflect any changes in the fundamental economic parameters as a result of change in macro-level long-term expectations (a major calibration).

The following table shows the calibration at 30 September 2025.

		Annualised total returns											
		Cash	Index Linked Gilts (medium)	Fixed Interest Gilts (medium)	UK Equity	Developed World ex UK Equity	Property	CorpMedium A	Inflation (RPI)	17 year real yield (RPI)	Inflation (CPI)	17 year real yield (CPI)	17 year yield
5 years	16th %'ile	3.4%	1.6%	2.2%	0.1%	-0.5%	-0.1%	2.3%	1.6%	1.7%	0.6%	1.8%	5.1%
	50th %'ile	4.2%	4.4%	4.2%	8.1%	7.9%	6.9%	4.6%	3.1%	2.7%	2.2%	2.7%	6.2%
	84th %'ile	5.0%	7.3%	6.1%	16.3%	16.4%	14.3%	6.8%	4.6%	3.6%	3.7%	3.6%	7.5%
10 years	16th %'ile	3.7%	2.8%	4.4%	2.5%	2.2%	2.3%	4.6%	0.9%	1.0%	0.5%	1.0%	4.2%
	50th %'ile	4.7%	4.8%	5.6%	8.7%	8.5%	7.5%	6.1%	2.6%	2.3%	2.1%	2.2%	5.6%
	84th %'ile	5.9%	7.0%	6.7%	14.6%	14.7%	12.8%	7.4%	4.2%	3.5%	3.8%	3.5%	7.4%
20 years	16th %'ile	3.2%	3.1%	5.4%	3.9%	3.7%	3.6%	5.7%	0.8%	-0.5%	0.6%	-0.4%	1.7%
	50th %'ile	4.6%	4.8%	6.2%	8.5%	8.4%	7.4%	6.7%	2.3%	1.3%	2.1%	1.3%	3.6%
	84th %'ile	6.4%	6.7%	6.8%	13.1%	13.2%	11.4%	7.6%	4.0%	3.0%	3.7%	3.0%	6.3%
	Volatility (Disp) (1 yr)	0.3%	6.6%	5.4%	16.0%	16.7%	16.8%	6.3%	1.4%		1.4%		

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