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Cumbria Local Government Pension Scheme

Pension Fund Committee Valuation Training

welcome to brighter

- Valuation and Funding Basics
- 2019 Valuation Recap
- Funding Update
- 2022 Valuation – Key Themes
- Questions?

Valuation and Funding Basics
Why do a valuation (1)?

LGPS Regulations

Reg. 62(6)(b)	Reg. 62(6)(d)
"The actuary must have regard .... to the desirability of maintaining as nearly **constant a primary rate** as possible".	"The actuary must have regard to the requirement to **secure the solvency of the pension fund** and the **long term cost efficiency** of the Scheme…"

Public Service Pensions Act 2013

Section 13(4)(c)

"A person appointed… is to report on whether… the rate of employer contributions is set… at an appropriate level to ensure

(a) the **solvency of the pension fund**, and

(b) the **long-term cost efficiency** of the Scheme…"

Valuation and Funding Basics

Why do a valuation (2)?

Past benefits

Has the Fund got enough assets to cover expected benefits built up to date

Depends on employer history, investment returns and past experience

End result:

SURPLUS/DEFICIT (ASSETS – LIABILITIES)

£ DEFICIT CONTRIBUTIONS (OR SURPLUS OFFSET?)

Future benefits

How much will the Employers have to pay to for benefits earned in the future?

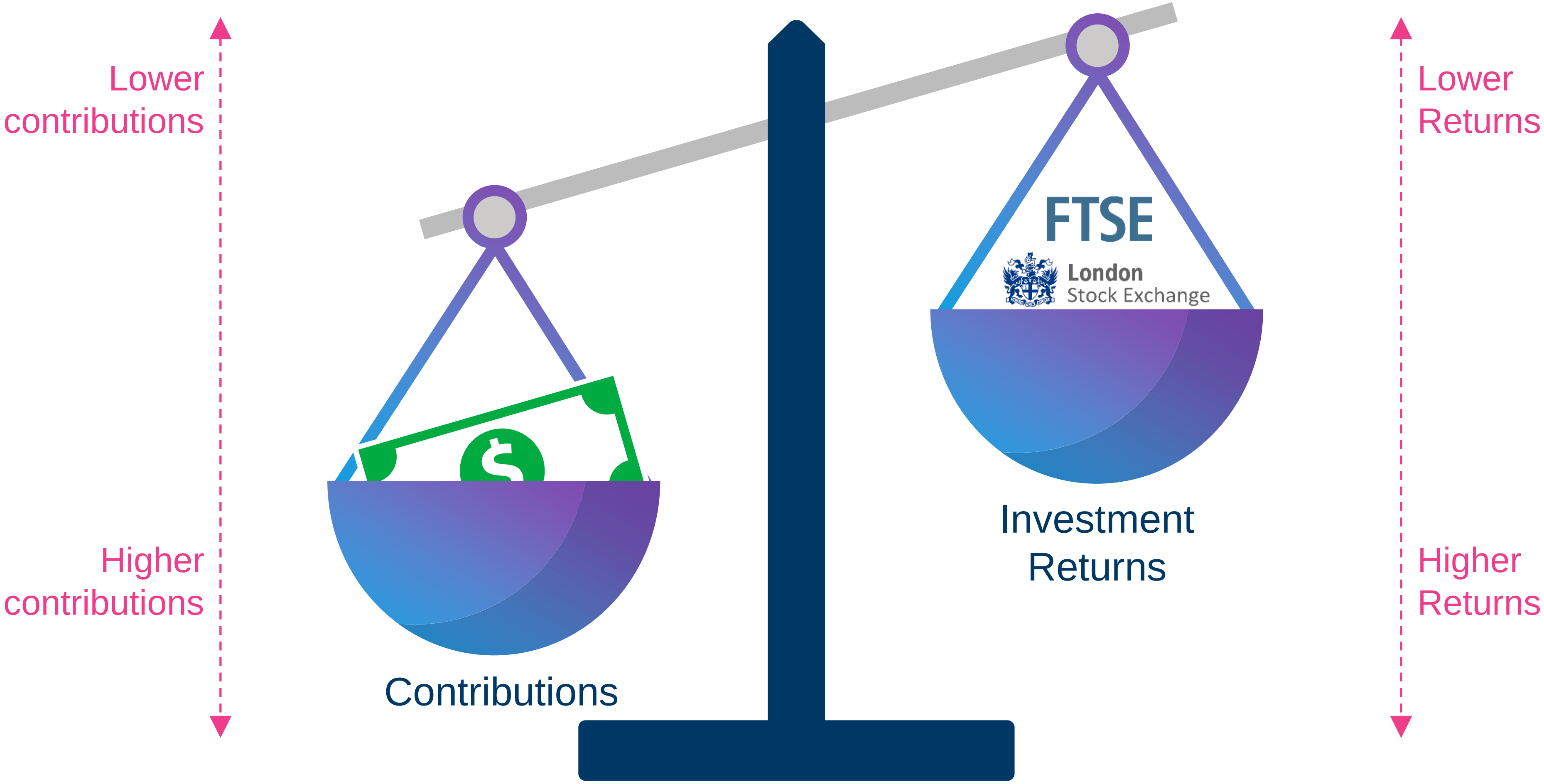
Depends on the profile of active members and any benefit changes

End result:

FUTURE SERVICE CONTRIBUTION RATE (% of pay)

Done for the Fund, but also at employer level – **each employer is responsible for their own members**

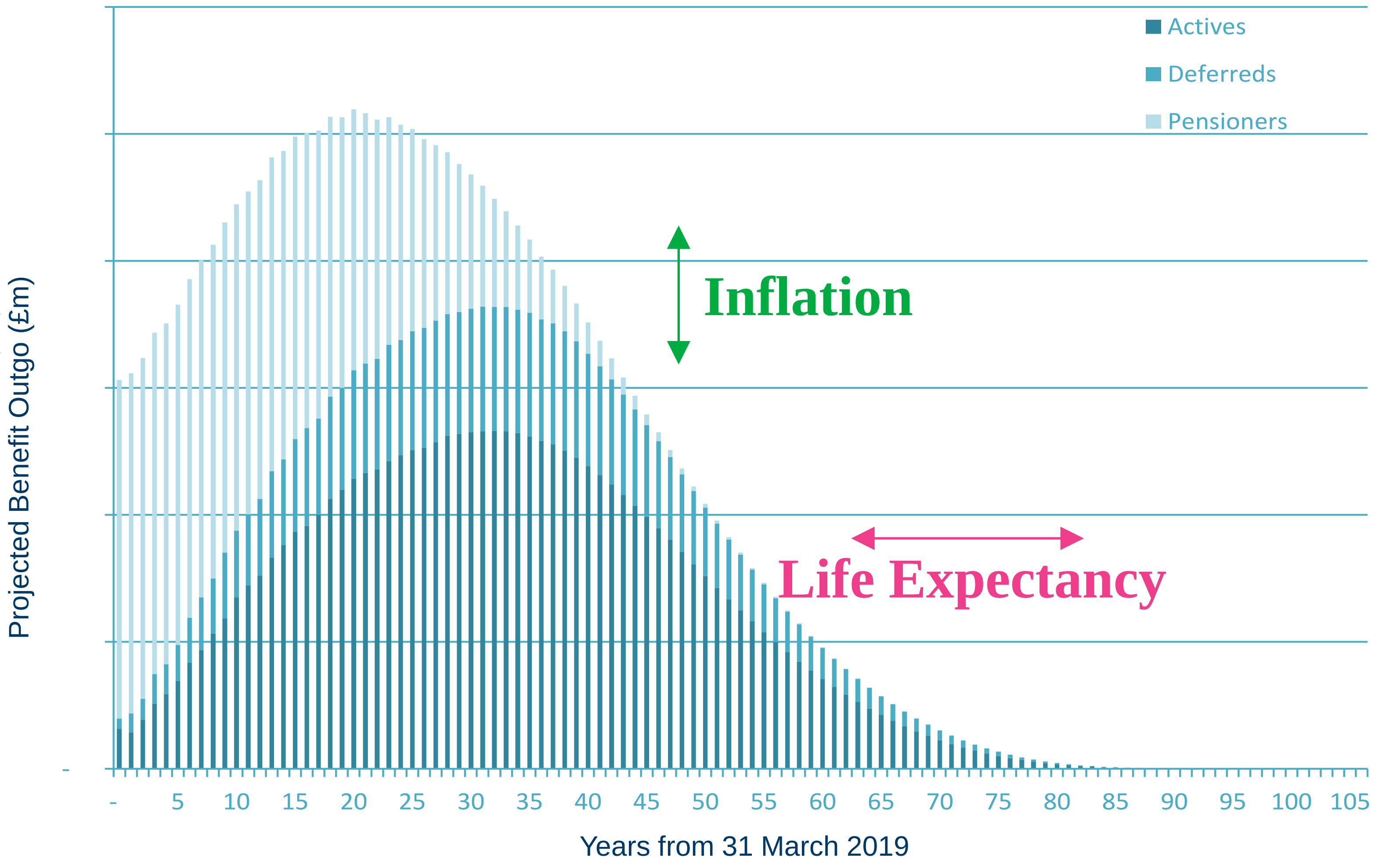
Valuation and Funding Basics
Financing the Benefits



Objective is to have sufficient assets to pay benefits as and when they fall due.

Valuation and Funding Basics

Liabilities…it's all about the cashflows



Valuation and Funding Basics
Actuarial Assumptions

Assumptions

- Normal / Early / Ill health Retirement
- Cash Commutation / 50:50 Take up etc
- Investment Return “Discount Rate”
- Inflation / Pension increases
- Life Expectancy
- Salary Increases
- Leavers

Valuation and Funding Basics

Assumption impact – what it means for contributions

Assumption	Impact on liabilities	Impact on contributions (% of pay)		
		Future service	Deficit	Total
Discount rate -0.25% pa	+4.5%	+1.4%	+2.6%	+4.0%
Inflation +0.25% pa	+4.3%	+1.4%	+2.5%	+3.9%
Salary growth +0.25% pa	+0.5%	Nil	+0.3%	+0.3%
Life expectancy improvements +0.25% pa	+0.7%	+0.2%	+0.4%	+0.6%

Valuation and Funding Basics

What about accounting figures?

Solely required to adhere to accounting disclosure requirements. Performed annually and disclosed in an Employer’s accounts.

Liabilities are assessed using a “prescribed” set of assumptions (i.e. discount rate linked to corporate bond yields not assets held), which differ from those used in the actuarial valuation.

Accounting liabilities are therefore directly affected by changes in corporate bond yields. Inflation assumption may also be derived differently (i.e. best estimate).

and maybe most importantly….

Does not impact on the Employer’s contribution requirements.

Roles of the different parties

Roles and responsibilities

COMMITTEE

- Set overall Fund objectives
- Approve Funding Strategy based on those objectives

FUND OFFICERS

- Day to day management (data, employer communications, etc)
- Develop strategies
- Decision making / agreeing details

BOARD

- Ensure regulatory compliance
- Assist Administering Authority
- (Not a decision making body)

FUND ACTUARY

- Advise on assumptions and funding strategy
- Perform calculations
- Sign off results

EMPLOYERS

- Feed into Fund strategies
- Decide on areas of flexibility
- Provide data / comply with Fund policies

Roles of the different parties
Division of Officer and Committee valuation responsibilities

Committee – main role relates to the setting of the overall strategy for the Fund, set down in the Funding Strategy Statement:

- Officers gather the views of the Committee via Committee meetings
- The Officers then develop the FSS, which then goes to the Committee for approval. The FSS is the key output of the valuation process (more so even than the valuation report), as it sets out how the Fund will balance its objectives for ensuring solvency and long term cost efficiency for employers, and so operate during the valuation and the following three years

Officers – role is to:

- Develop the overall objectives laid down by the Committee into a detailed Funding Strategy (taking advice from the Fund actuary)
- Set the assumptions and other parameters to be applied as part of the valuation, and working alongside the Fund Actuary to set the individual employer results and contribution rates
- Ensure the efficient management of the process, overseeing employer engagement, data issues, coordination between advisers, regulatory compliance, etc

Valuation and Funding Basics

2019 Valuation Recap

Funding Update

2022 Valuation – Key Themes

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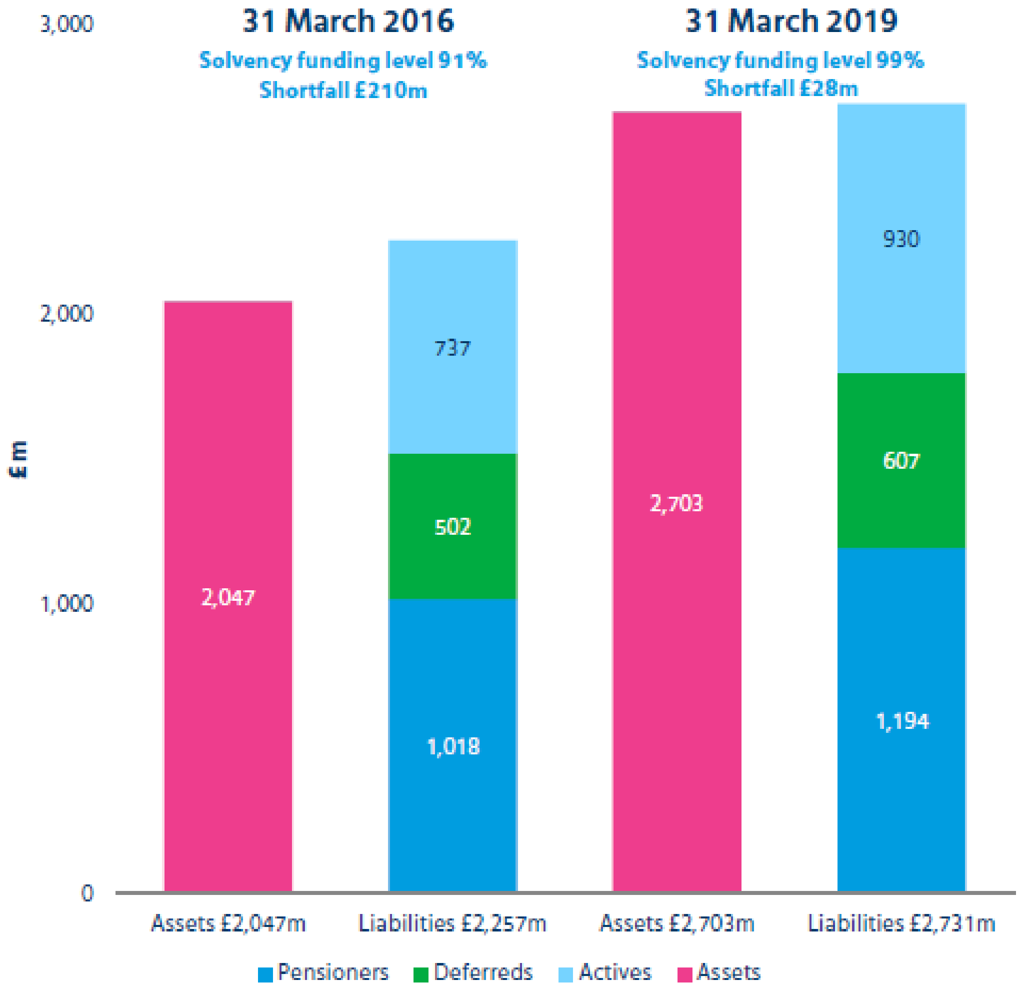
2019 Valuation Recap

Whole Fund Results as at 31 March 2019



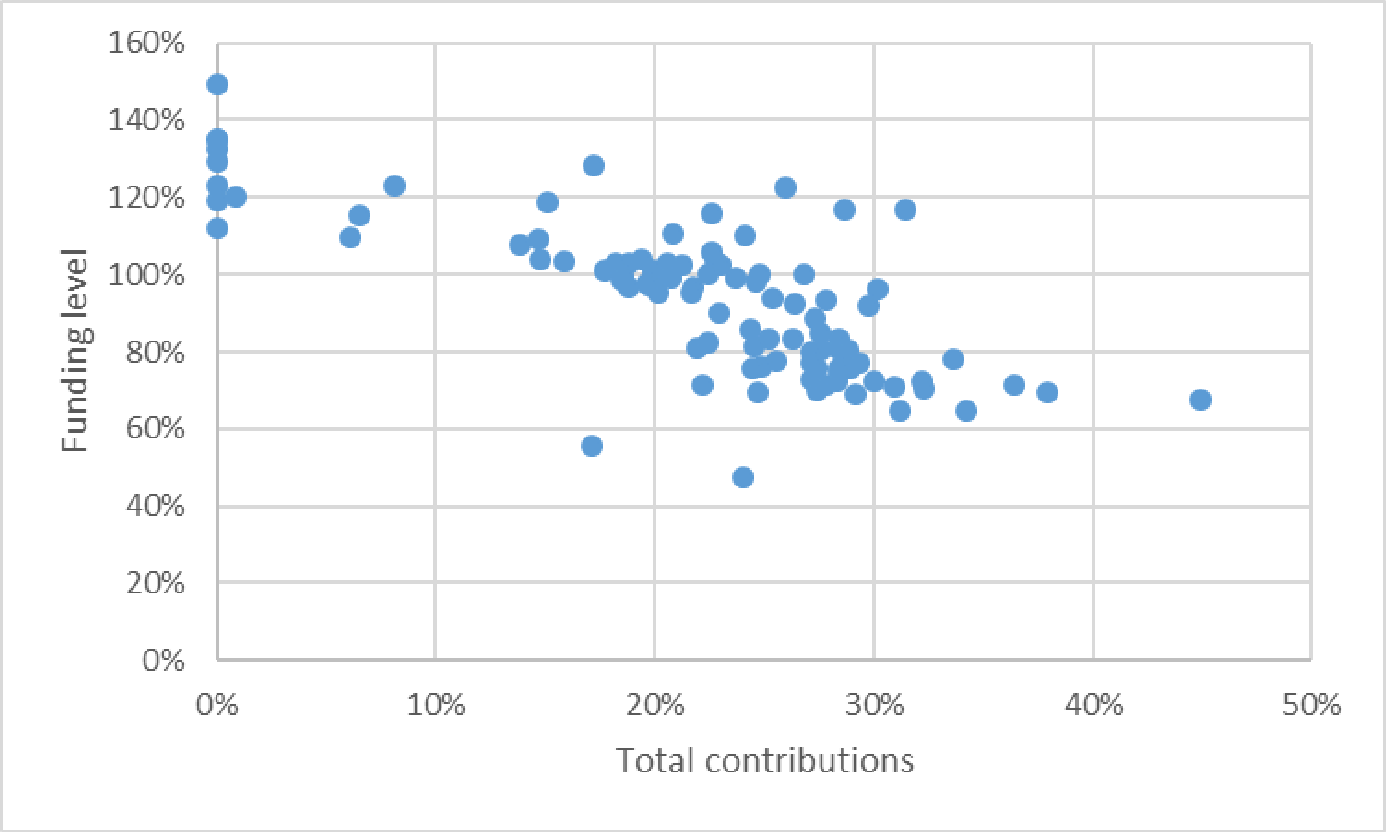
Average Future Service / Primary Rate for the Fund was **18.6%** of pay

Deficit / Secondary contributions of **c£6m p.a.**

Employers:

Each employer is responsible for their own position within the Fund, and have their own contributions rates – for example future service rates ranged up to **34.5%**

2019 Valuation Recap
Employer Variation

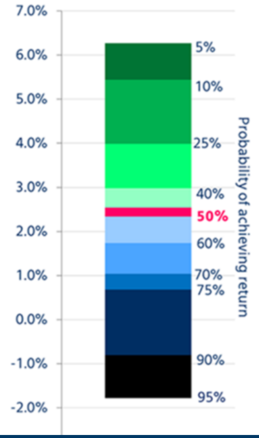


2019 Valuation Recap
Setting the (real) discount rate

Real discount rate - takeaways

- The Fund requires long term investment returns in excess of CPI - drives contribution rates and liability values
- So real discount rate is the single most important valuation assumption
- A lower rate means greater chance of exceeding target (and so less risk), but higher contributions – and vice versa

Range of outcomes



Best estimate return CPI + 2.3% p.a.

67% chance CPI + 1.25% p.a.

Key return percentiles	Real return
50% confidence	CPI + 2.3% p.a.
60% confidence	CPI + 1.7% p.a.
65% confidence	CPI + 1.4% p.a.
70% confidence	CPI + 1.0% p.a.

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2019 Valuation Recap

Funding strategy – key points

1. Discount rate for past service – CPI + 1.25% (67% chance of achieving)
   Discount rate for future service – CPI + 2.0% (54% chance of achieving)
2. Only minor variations in treatment of employers
   Same assumptions and investment strategy for all
3. Deficits recovered (or surpluses returned) over 12 years on average
4. Non-guaranteed employers: stronger assumptions on termination
   Fund pays exit credits on termination in surplus in some cases
5. Employers informed of potential McCloud costs, and margin within discount rate

2019 Valuation Recap
Section 13 review

Extract of the Fund Specifics

Funding levels					
	2019 local basis			SAB standard basis	
	99%			125%	

Long term cost efficiency measures					
Maturity (rank)	Relative considerations		Absolute considerations		
	Deficit period (rank)	Required return (rank)	Repayment shortfall	Return scope (rank)	Deficit recovery plan
8 (26)	N/A surplus	2.4% (12)	N/A surplus	1.2% (35)	Green

Solvency measures					
Maturity (rank)	Risks already present			Emerging risks	
	SAB funding level	Open Fund	Non-statutory employees	Asset shock	Employer default
8 (26)	125%	Yes	6.80%	N/A surplus	N/A surplus

Key areas of focus for 2022

McCloud

Covid-19 and Ukraine crisis impact

Climate Change

Definitions of the above terms are set out in the appendix.

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Valuation and Funding Basics

2019 Valuation Recap

Funding Update

2022 Valuation – Key Themes

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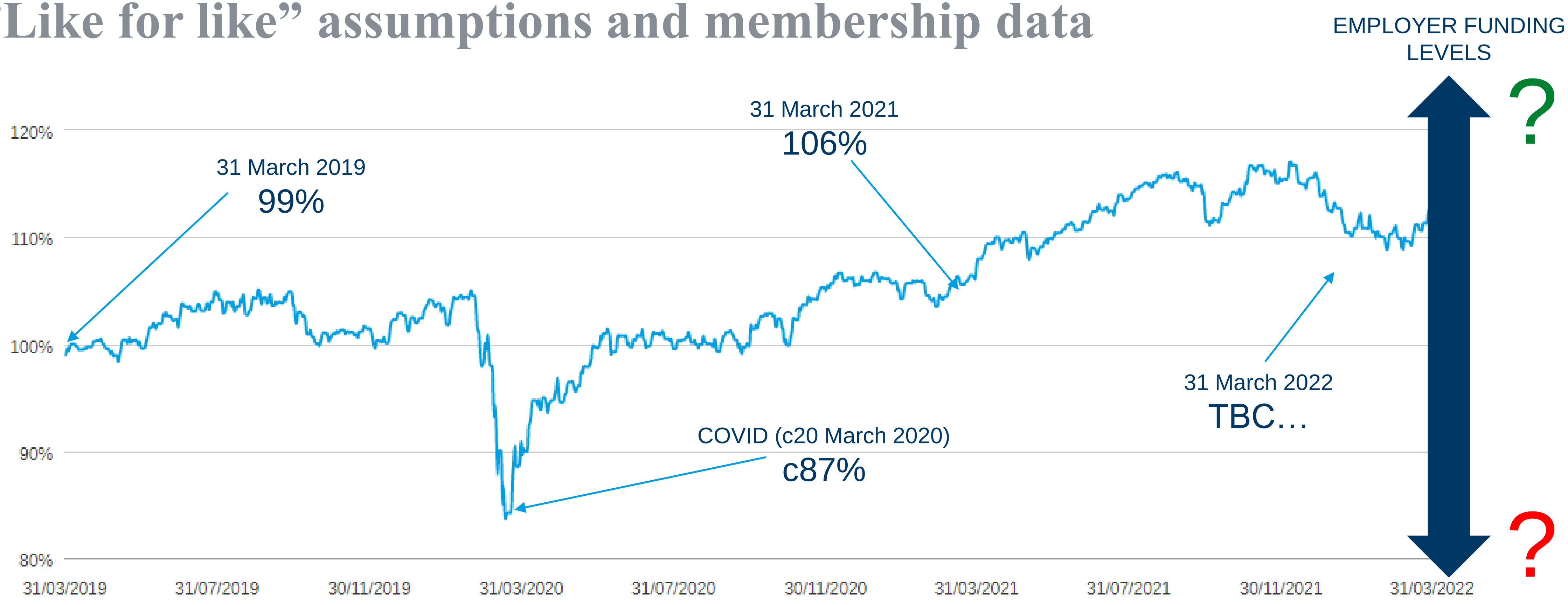
Funding Update
"Like for like" assumptions and membership data



The Fund has seen strong investment performance since 2019. This has caused the like for like (i.e. ignoring potential assumption changes) funding level to improve significantly.

At employer level the impact of this will vary **significantly** – better funded employers have more assets and so get more benefit

Funding Update
Market outlook

Investment markets and return/inflation outlook has the most material impact on the financial health of a pension fund. There have been significant changes since 2019, in economic outlook, inflation expectations and the Fund's investment strategy.

- **Market outlook:** While we have seen significant volatility since 2019, our view is that the overall outlook for expected investment returns on a like for like investment strategy is broadly similar to 2019

- **Inflation expectations:** Since 2019 market expectations of long-term CPI inflation have increased significantly, from 2.4% to over 3.0% at the valuation date. CPI is now expected to peak at 9%-10% in 2022, and the actual inflation already experienced since September has reduced the funding level by 3%-4% (to end of May). An environment of low growth/high inflation ("stagflation") leading to lower real returns over the valuation period could put pressure on contribution increases (or at least erode margins) at the next valuation. This must be considered when formulating the funding strategy, and puts pressure on the "real" discount rate

- **Investment strategy:** The investment strategy is designed to deliver long term growth over inflation and may offset some of the above factors to some degree, but this comes with volatility and risk. However, changes since 2019 have increased expected returns in our view

The choice of the real discount rate will be a key element of the 2022 valuation. Lower discount rates mean higher contributions, but also a lower "hurdle" for investments to beat meaning less chance of future increases. And vice versa. This is currently being assessed based on the Fund's long term investment strategy.

Valuation and Funding Basics

2019 Valuation Recap

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2022 Valuation – Key Themes

Where we are:

- The funding position is likely to be improved
- While there may be some consideration around increasing future service rates, some reductions in total contributions should be possible for the Fund as a whole…
- …although there will be significant variability between employers

Key decisions:

- **Discount rate assumptions:** Will have to be set in the context of market conditions at the valuation date, and we will need to be mindful of the risk of an extended period of lower growth and high inflation ("stagflation"). The future service discount rate in particular will need to be considered
- **Surplus management:** There may be surpluses in some cases, and a decision on how this is managed will be needed. This must allow for the fact that not all employers will be in surplus – for example retaining a funding buffer only above which surpluses are spread, which takes into account market falls/increased risk post the valuation date may be appropriate
- **Individual employer management:** How best to help those employers facing budgetary challenges, particularly where their results are less positive. And how to effectively communicate the likely wide range of outcomes
- **Council reorganisation:** The final results will need to allow for this, in particular attribution of the historic County Council liabilities

Looking Forward – 2022 Valuation

Timescales

- Jun 2022

- Preliminary results
- Discount rate and demographic analysis
- Initial consideration of funding position, assumption, contributions

Jun / Jul 2022

- Funding Strategy principles discussed with Committee
- Initial data work

Jul / Oct 2022

- Funding Strategy Statement agreed by committee in September
- Full data provided and results assessed for employers

Sep / Nov 2022

- Funding Strategy Statement consultation takes place
- Consideration of new Council's positions

Nov / Dec 2022

- Meetings and discussions with employers take place
- Feedback from employers collated

Jan / Mar 2023

- Employer contribution rates finalised
- Formal actuarial report finalised and signed by Actuary

Valuation and Funding Basics

2019 Valuation Recap

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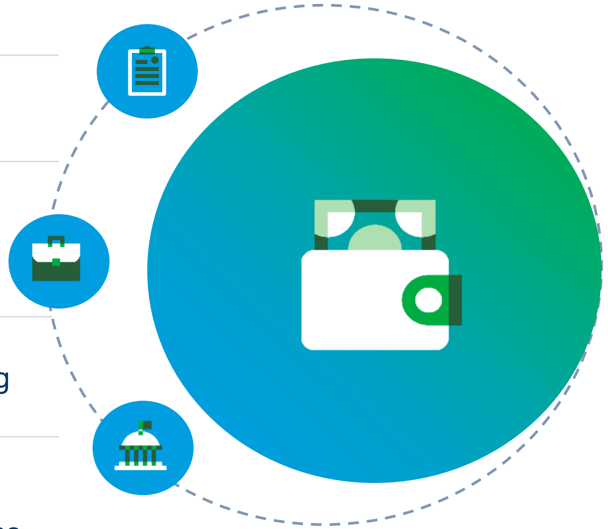
Appendix

Explanatory Terms
Long Term Cost Efficiency Measures

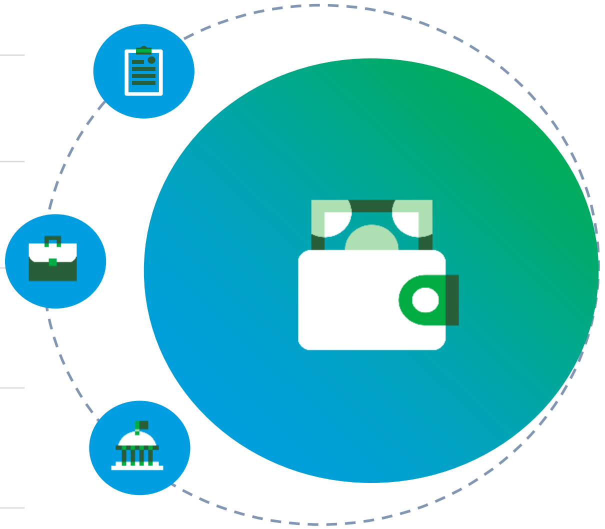
Deficit Period	Implied deficit recovery period calculated on a standardised best estimate basis
Required Return	The required investment return rates to achieve full funding in 20 years' time on a standardised best estimate basis
Repayment Shortfall	The difference between the actual contribution rate net of GAD's best estimate future service cost and the annual deficit recovery contributions (on a standardised best estimate basis and assuming deficit is paid off in 20 years), as a percentage of payroll
Return Scope	The required investment return rates as calculated in required return, compared with the fund's expected best estimate future returns assuming current asset mix maintained
Deficit Recovery Plan	Confirmation that the deficit period can be demonstrated to be a continuation of the previous deficit recovery plan, after allowing for actual fund experience



Section 13 Report:
https://www.gov.uk/government/publications/local-government-pension-scheme-review-of-the-actuarial-valuations-of-funds-as-at-31-march-2019

Explanatory Terms
Solvency Measures

SAB Funding Level	A fund's funding level using the SAB standard basis
Open Fund	Whether the fund is open to new members
Non-Statutory Members	The proportion of members within the fund who are employed by an employer without tax raising powers or statutory backing
Asset Shock	The change in average employer contribution rates as a percentage of Core Spending Power or financing data after a 15% fall in value of return-seeking assets
Employer Default	The change in average employer contribution rates as a percentage of payroll if all employers without tax raising powers or statutory backing default on their existing deficits



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