worcestershire
countycouncil

PENSIONS BOARD
3 MARCH 2023

ACTUARIAL VALUATION AND FINAL PENSION FUND STRATEGY STATEMENT (FSS)

Recommendation

1. **The Chief Financial Officer recommends that the Board note and comment on:**

    a) **The outcome of the Funding Strategy Statement consultation and the proposed final FSS (Appendix 1);**

    b) **The update to the Climate change funding level scenario analysis within the FSS;**

    c) **The Initial draft of the 2022 Valuation rates and adjustment certificate which will be presented to the Pensions Committee; and**

    d) **The current negotiations taking place with Housing associations relating to deferred debt agreements and / or debt spreading arrangements, noting that the Fund is seeking to delegate this to the appropriate officers of the fund in consultation with the Chairman of the Pensions Committee.**

Background

2. As detailed in the November 2022 report, every three years, in line with legislation, the Fund Actuary, Mercer, carries out a full Actuarial Valuation of the Fund to calculate how much the employers in the Scheme need to contribute going forward to ensure that its liabilities, the pensions due to current and future pensioners, will be paid as they fall due.

3. The purpose of the Funding Strategy Statement ("FSS") is to set out a clear and transparent funding strategy that will identify how each Fund employer's pension liabilities are to be met going forward.

4. The FSS was agreed at Pension Committee on the 13 December 2022 and any further updates were delegated to Fund officers on the proviso that the FSS was not expected to change fundamentally in between now and when the actuarial valuation is signed off by the actuary on the 31 March 2023.

5. The updated FSS is provided at Appendix 1 and includes the following changes which have been shown via tracked changes.

- Additional wording Section 6 to explain the Climate Change analysis being performed.
- Additional wording in Appendix D to facilitate review of the termination policy for employers without a guarantor during times of extreme events, such as a material shift in market conditions or shift in economic/fiscal policy.

- Made some other small changes.

FSS Consultation Outcome
6. The consultation on the draft FSS was sent to Employers in November 2022 and they were asked to respond by 27 January 2023. The Fund received no responses to the proposed FSS and therefore the FSS provided to the December Committee together with those highlighted within this report will provide the final published FSS. It is worth reiterating the Key updates made to the FSS agreed in December 2022.

Key updates made to the FSS agreed at December 2022 Pension Committee

7. The key updates that were highlighted in the FSS provided in December 2022 are as follows:-.

CPI inflation assumption
8. A key assumption which drives the projected benefit cashflows (the Pension Fund liabilities) is the inflation rate. This is derived based on year-on-year projections based on market outlook and expectations from the Bank of England and represents the average inflation rate over a long period (50+ years). This is set by the Fund, based on advice from the Actuary and at this valuation the inflation assumption has increased to 3.1% p.a. at the valuation date which compares to 2.4% p.a. at the 2019 valuation. This reflects the increased inflation outlook at this valuation. The actual April 2023 increase to benefits is expected to be based on the September 2021 to September 2022 CPI inflation which was 10.1%. This is subject to confirmation by the Government. As part of the proposed valuation assumption we have also adjusted the benefit cashflows for the actual observed inflation over the 6 months from September 2021 to 31 March 2022.

Discount rate (average expected return) basis for past service liabilities (funding target)
9. A key assumption which drives the value of the Pension Fund liabilities (the future benefit payments) and therefore deficit is the discount rate. This is set by the Fund, based on advice from the Actuary, to reflect the overall investment return which the Fund expects to achieve on its assets over the long term with a suitable and necessary allowance for prudence. In terms of setting contributions, the relationship of the expected investment return on assets compared to the rate of expected future increases in benefit payments (i.e. CPI inflation) is critical (in other words we need to reflect the "real" investment return expected on the Fund assets)

10. The discount rate reflects the "real" expected asset return above the CPI baseline assumption when assessing the long-term solvency target. This is a challenge for this valuation given the current significant increase in inflation which increases the liabilities as the benefits are inflation linked and potentially reduces the "real return" on assets. A judgement is needed as to how persistent this period of higher inflation could be, with the risk that understating its duration in this valuation will transpire into higher contributions at the next valuation in 2025 taking into account the material volatility we have seen since the valuation date. This is to ensure the right balance between affordability and sustainability of employer contributions is struck.

11. The Actuary has proposed to reduce the expected level of real return above CPI by 0.15% from the 2019 valuation to CPI+1.50% per annum for the Growth pot, to maintain an appropriate level of prudence (as in the probability of achieving the discount rate).

This results in a gross discount rate of 4.6% p.a. (3.1% + 1.5%) at the valuation date. The Medium Pot and Cautions Pot have also been reviewed with proposed assumptions of CPI+1.25% per annum and Gilts+0.75% per annum, respectively.

Discount rate (average expected return) basis for future service liabilities

12. The future service liabilities (which determine an employer's Primary Contribution Rate) are calculated using the same assumptions as the funding target except that a different financial assumption for the discount rate is used to provide stability in the primary/future service contribution rate (as per the Regulations) and reflect the different characteristics of these liabilities.

13. As future service contributions are paid in respect of benefits built up in the future, the future service contribution rate should take account of the market conditions applying at future dates, not just the date of the valuation, thus it is justifiable to use a slightly higher expected return from the investment strategy. In addition, the future liabilities for which these contributions will be paid have a longer average duration than the past service liabilities as they relate to active members only.

14. The Actuary's view is that the real return applied in 2019 could be too optimistic given the impact of inflation on investment returns and the challenging outlook since the valuation, and advises a discount rate of CPI +2.00% per annum be considered (a 0.25% reduction) for the Growth pot. This results in a gross discount rate of 5.1% p.a. (3.1% + 2.0%) at the valuation date. The Medium Pot and Cautions Pot have also been reviewed with proposed assumptions of CPI+1.75% per annum and Gilts+0.75% per annum, respectively.

Pay growth assumption (including increments)

15. Along with an employer's payroll, liabilities in relation to final salary benefits earned pre 2014 and the McCloud remedy are related to a members' final pay at retirement or leaving. The Fund therefore needs to make an assumption about future pay progression in the short and longer term. The long term pay growth is CPI+1.5% p.a. which is the same assumption as the 2019 valuation. In terms of short term pay growth over the 3 years from 1 April 2023, the intention is to adopt an average pay growth assumption option of 4% p.a. depending on employer category. Employers will be given the option which best suits their circumstances. For the purpose of the provisional results in paragraph 7 of this report we have used a 4% p.a. assumption for all employers

Demographic assumptions

16. The baseline and long-term trend in mortality has been adjusted to reflect the Fund's experience since 2019 and wider trends of the progression of life expectancy improvements. The analysis indicates that there has been a reduction in expected life expectancy versus the assumptions made at the 2019 valuation which has reduced the liabilities and future service rate.

17. The proposed assumption would result in an overall life expectancy at age 65 as follows for sample members (disclosed 2019 valuation life expectancies in brackets):

- Male pensioner currently age 65: 22.1 years (22.8 years)
- Male active member currently age 45: 23.7 years (24.5 years)
- Female pensioner currently age 65: 24.3 years (25.2 years)
- Female active member currently age 45: 26.4 years (27.2 years)

18. Some of the other demographic assumptions have also been changed at this valuation including the likelihood of leaving active service before retirement, the likelihood of a dependant's pension being paid and the level of pension being commuted for cash by members upon retirement. All of these changes have marginally increased the liabilities and future service rate but not significantly compared to life expectancy and other factors

Recovery periods (surplus and deficit)

19. When determining an employer's Secondary Contribution Rate we require a period over which to recover any deficit or run down any surplus to target full solvency i.e. a 100% funding level.

20. Where an employer is in deficit, there is a proposed reduction in the average deficit recovery period of 3 years, which is generally equivalent to a continuation of the 2019 deficit recovery plan. This would apply to employers, subject to covenant and affordability considerations as per the draft FSS. Where employers are in surplus (which is the majority at this valuation), the period over which the surplus can offset future contribution requirements will generally remain the same as the 2019 valuation (whether an employer was in deficit or surplus at that point). This approach supports the sustainability of future contributions along with the employers who choose to pay contributions above the minimum required as noted in paragraph 10

McCloud Judgment

21. The McCloud discrimination case relates to the protections provided to members close to retirement when the Fund benefits were changed in 2014, and the case determined that those not close to retirement should be afforded the same protections (subject to meeting certain criteria). The costs of the remedy were not included in the 2019 valuation balance sheet (as they were unknown) although the estimated cost of a potential remedy was allowed for in employer contributions where employers opted for this. The Government has now set out how the remedy should be treated at the 2022 valuation to ensure consistency (as the remedy Regulations have yet to be passed into law). Therefore in line with this recommendation, the Fund's approach has been to include amendments for all employers in the 2022 valuation to reflect the McCloud remedy when valuing past service liabilities. The McCloud benefit window ended on 31 March 2022 and so the judgement does not affect employer future service (Primary) contribution rates at the 2022 valuation.

Climate change funding level scenario analysis

22. An important part of the risk analysis underpinning the funding strategy will be to identify the impact of climate transition risks and physical risks on the potential funding outcomes. The impact of different scenarios at the whole Fund level versus the baseline (which assumes the funding assumptions are played out) is being considered as part of the valuation to ensure the funding strategy is sufficiently robust to the risks posed by climate change. This section of the FSS has been updated by the actuary on pages 19 and 20 of the attached FSS.

23. The actuarial assumptions (versus the best estimate) include a level of prudence which implicitly allows for the climate risk and other risks to support future contribution stability and the Actuary has concluded that the level of prudence is currently sufficient in the context of the scenarios considered. However, any climate related impacts will

potentially put significant stress on the funding plan, especially when taken into account with other risk factors so the analysis will be further developed and be monitored over time. A summary of the output of the analysis will be set out in the Fund Actuary's report on the valuation

Other Fund policies

24. The only new policy in the 2022 FSS covers 'Notifiable Events'. It is best practice to have a defined set of notifiable events that employers are obliged to inform the Fund about as it may have a material effect on the covenant or the liability or membership profile. Whilst in most cases regular covenant updates will identify some of the key employer changes, under this new policy in some circumstances employers will be required to proactively notify the Administering Authority of any material changes. This policy sets out when this may happen and the notifiable events process.

25. The existing policies have all been reviewed. However, the majority of the content remains unchanged (except to reflect the 2022 valuation updates such as assumption and date changes etc.). We have also incorporated additional wording to allow flexibility to review the termination policy with the Fund Actuary in light of changes in market conditions and any review of fiscal or monetary policy by the Government or Bank of England, given the current gilt market volatility.

26. The final actuarial outcome for the whole Fund results (based on the proposed assumptions in the FSS) are a funding level of 100%, a surplus of £14m and a future service contribution rate of 18.8% of pay. The equivalent 2019 valuation results were a funding level of 90%, a deficit of £324m and average future service rate of 17.5% of pay. Overall the theoretical total average employer contributions are expected to fall at this valuation due to the improved funding position despite an increase in the future service rate. The outcomes will vary materially between employers although the major councils will broadly follow the total Fund

Initial draft of the 2022 Valuation rates and adjustment certificate

27. The actuary will provide an initial draft of the 2022 valuation rates and adjustment certificate for Committee on the 22 March 2022. Please note this will be a working draft and therefore subject to adjustment up to the point of sign off (31 March 20223), for any amendment to the employer contributions that may be agreed as well as confirmation of auditor requirements for certifying prepayment contributions. For this version, the actuary will currently use the same approach that was used for the 2019 valuation to certify a 3-year deficit lump sum prepayment i.e. certifying this as a 3-separate lump sum amounts in respect of each contribution year. The actuary will also ask the Committee to note there may be some further formatting changes and adjustment to the notes as they finalise the draft report.

Current negotiations taking place with Housing associations relating to deferred debt agreements and / or debt servicing agreements

28. Within the Funds FSS, the termination policy provides flexibilities for the Fund at its discretion to consider spreading exit payments over an agreed period and Deferred Debt Agreements (DDA).

29. The Fund's policy for spreading exit payments (referred to as payment plans) is as follows:-

a) The default position is for exit payments to be paid immediately in full (adjusted for interest where appropriate) unless there is a risk sharing arrangement in place with a guaranteeing employer in the Fund whereby the exiting employer is not responsible for any exit payment; and
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b) Exit payment spreading and DDAs will always be discussed with employers, whether at the employer's request or not. However, spreading an exit payment, or a DDA will only be agreed at the discretion of the Administering Authority, subject to the termination policy within the FSS.

30. If an employer wants the Fund to agree to spread an exit payment or a DDA, they must make a request in writing covering the reasons for such a request. The Administering Authority will assess whether the full exit payment is affordable, and whether it is in the interest of the Fund to adopt either of the approaches. In making this assessment the Administering Authority will consider the covenant of the employer and also whether any security is required and available to back the arrangements.

31. Any costs (including necessary actuarial, legal and covenant advice) associated with assessing this will be borne by the employer and will be invoiced to the employer by the Fund or added to the contribution plan (for a DDA) or exit payment (where the exit payment is to be spread).

32. 3 Housing associations are currently looking to exit from the Fund and are in discussions regarding exploring spreading exit payments over an agreed period and / or Deferred Debt Agreements (DDA) with officers and our actuary.

33. The Fund is seeking delegated responsibility to the appropriate officers of the fund in consultation with the Chair of the Pensions Committee to look at negotiating and concluding these arrangements with the 3 Housing associations. If approved, officers will bring back quarterly progress updates to Committee.

Contact Points

Rob Wilson
Pensions Investment, Treasury Management & Capital strategy manager
Tel: 01905 846908
Email: RWilson2@worcestershire.gov.uk

Supporting Information

- Proposed final Funding Strategy Statement (Appendix 1)

Background Papers

In the opinion of the proper officer (in this case the Chief Financial Officer) the background papers relating to the subject matter of this report are

Funding Strategy Statement Committee report December 2022