PENSIONS COMMITTEE

14 DECEMBER 2022

REPORT TITLE:	DRAFT FUNDING STRATEGY STATEMENT
REPORT OF:	DIRECTOR OF PENSIONS

REPORT SUMMARY

The LGPS Regulations require each administering authority to prepare and publish a Funding Strategy Statement (FSS). The draft FSS (attached as Appendix 1) has been produced and issued for consultation with employers. It incorporates the initial proposals on the funding strategy. Given the detail included, the draft FSS has been streamlined for 2022 to make it easier for all parties to navigate to the key areas that are pertinent to them.

The principal decision areas for the Committee in consultation with employers are the actuarial assumptions adopted, deficit and surplus recovery plans and the policies within the FSS.

The draft FSS is based on preliminary information so will need to be finalised once the valuation analysis is complete. The consultation with employers took place from 31st October to 2nd December 2022 with key changes presented to employers during dedicated employer forums and at the employer conference on 17th November.

RECOMMENDATIONS

That the Pensions Committee be recommended to approve the draft Funding Strategy Statement and delegate the refinement of the final version to the Director of Pensions and the Fund Actuary within the statutory deadline of 31 March 2023, following due consideration of the employer consultation and final valuation results.

SUPPORTING INFORMATION

1.0 REASONS FOR RECOMMENDATIONS

1.1 It is the responsibility of the Pension Committee to agree the Funding Strategy.

2.0 OTHER OPTIONS CONSIDERED

2.1 Not relevant for this report.

3.0 BACKGROUND INFORMATION

3.1 The Local Government Pension Scheme (LGPS) Regulations provide the statutory framework under which the Administering Authority is required to prepare and publish a Funding Strategy Statement (FSS) alongside each actuarial valuation. The Fund Actuary must have regard to the FSS as part of the actuarial valuation process.

3.2 The FSS sets out all the key assumptions which the actuary has used in preparing the actuarial valuation at 31 March 2022, together with the Administering Authority's policies in the areas where the Administering Authority has discretion to manage the funding position of the Fund. The FSS must be revised and published whenever there is a material change in either the policy set out in the FSS or the Investment Strategy Statement. As a matter of good governance, it will also be reviewed on an annual basis to ensure it remains up to date with changing legislation or other requirements.

3.3 Any material change should be brought to Committee for approval and employers would be consulted on the changes as necessary.

3.4 A draft FSS was prepared and sent to employers as part of the consultation and all responses were required by 2nd December 2022. The draft FSS has been streamlined for 2022 to make it easier for all parties navigate. It will be formatted and incorporates the following updates:

a) <u>CPI inflation assumption</u>

A key assumption which drives the projected benefit cashflows (the pension Fund liabilities) is the inflation rate. This is derived from 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. As expected, Government confirmed that the actual April 2023 increase to benefits will be based on the September 2021 to September 2022 CPI inflation which was 10.1%. 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.

b) <u>Discount Rate (average expected return) basis for past service liabilities (funding target)</u>

The key assumption which drives the present 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 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).

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. Judgment 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.

The Actuary has proposed reducing the expected level of real return above CPI by 0.25% from the 2019 valuation to CPI+1.50% per annum, to maintain an appropriate level of prudence (as in the probability of achieving in the discount rate). This results in a gross discount rate of 4.6% p.a. at the valuation date.

c) <u>Discount Rate (average expected return) basis for future service liabilities</u>

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.

As future service contributions are paid in respect of benefits built up in the future, the future service 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.

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). This results in a gross discount rate of 5.1% p.a. at the valuation date.

d) <u>Pay Growth assumption (including increments)</u>

Liabilities in relation to final salary benefits earned pre 2014 and the McCloud remedy are related to a member's final pay at retirement or leaving. The Actuary must make an assumption about future pay progression in the short and longer term. In terms of long-term pay growth the proposal is to retain 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 either 3% p.a. or 4% p.a. depending on employer choice. Employers will be given the option which best suits their circumstances.

e) <u>Demographic Assumptions</u>

The baseline and short-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 slight increase in expected life expectancy versus the assumptions made at the 2019 valuation which has had broadly no change on the liabilities but a small increase in the future service rate.

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

Male pensioner age 65: 21.3 years (20.8 years)
Male active member age 45: 23.0 years (22.4 years)

Female pensioner age 65: 23.8 years (23.9 years)
Female active member age 45: 25.9 years (25.8 years)

Some of the other demographic assumptions have also been changed at this valuation including the likelihood of a dependant's pension being paid and the level of pension being commuted for cash by members upon retirement has been updated, both of these changes have marginally increased the liabilities and future service rate.

f) <u>Recovery periods (surplus and deficit)</u>

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.

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 (subject to other factors such as contract length and the expected remaining working lifetime of the members). This would apply to employers, subject to covenant and affordability considerations as per the draft FSS. Where employers are in surplus, the period over which the surplus can offset future contribution requirements will 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.

g) <u>McCloud judgment</u>

The McCloud discrimination case relates to the protections provided to members close to retirement when the Fund benefits were changed in 2014. The costs of the remedy (as it was unknown) was not included in the 2019 valuation balance sheet 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 it does not affect employer future service contribution rates at the 2022 valuation.

h) <u>Climate change funding level scenario analysis</u>

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 is not finalised as we are still waiting on agreement on the principles of what should be included at this valuation.

i) Other Fund policies

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, liabilities or membership profile. Whilst in most cases regular covenant updates will identify some of the key employer changes, in some circumstances, employers are required to proactively notify the Administering Authority of any material changes. This policy sets out when this may happen and the notifiable events process.

The existing policies have all been reviewed and streamlined to enable stakeholders to read and understand the information more clearly. However, much of the content remains unchanged (except to reflect the 2022 valuation updates such as assumption and date changes etc). The termination policy will be subject to further review in view of the current gilt market volatility.

3.5 There are some areas which need refinement due to insufficient information being available (e.g. the principles around the scenarios to consider in relation to the funding effect of climate change). It is recommended that the Director of Pensions is given delegated powers to finalise the FSS having received full advice from the Actuary, should there need to be any changes as a result of further development on these matters or as a result of the outcome of the consultation.

3.6 Once the draft FSS has been approved by the Committee, it will be refined and finalised by the Director of Pensions in conjunction with the Fund Actuary to allow for the outcome of the consultation and final valuation results. The final FSS must be completed prior to the deadline for the actuary to certify the valuation results by 31 March 2023.

4.0 FINANCIAL IMPLICATIONS

4.1 As set out in the report.

5.0 LEGAL IMPLICATIONS

5.1 The Local Government Pension Scheme (LGPS) Regulations provide the statutory framework under which the Administering Authority is required to prepare and publish a Funding Strategy Statement (FSS) alongside each actuarial valuation. The Fund Actuary must have regard to the FSS as part of the actuarial valuation process.

6.0 RESOURCE IMPLICATIONS: STAFFING, ICT AND ASSETS

6.1 Further analysis by the Fund Actuary and discussion with Fund Officers is required to determine the appropriate assumptions to adopt within the termination policy.

7.0 RELEVANT RISKS

7.1 The actuarial valuation is a vital Governance tool to control the risks relating to the funding position and employer contributions; requirements which can have a material impact on budgets and local services. The funding strategy, (along with the investment strategy) used to inform the actuarial valuation, is a key determinant of the overall financial risk levels in the Fund. The FSS is a crucial document setting out the overall governance and controls in place to manage these risks on a whole Fund and individual employer level.

8.0 ENGAGEMENT/CONSULTATION

8.1 A consultation with employers on the key changes to the FSS took place from 31 October to 2 December 2022.

9.0 EQUALITY IMPLICATIONS

9.1 Department for Levelling Up, Housing and Communities (DLUHC) and the Pensions Regulator undertake equality impact assessments regarding the provisions of the LGPS Regulations and the administration and governance of public service pension schemes.

9.2 The Equality Statement published on the introduction of the Local Government Pension Scheme 2014 can be viewed at: https://mpfund.uk/lgpsequalitystatement

9.3 The differing characteristics and financial strength of employers have been reviewed to ensure that appropriate contribution easements have been applied equitably across all employers to prevent adverse risk falling on any individual employer.

10.0 ENVIRONMENT AND CLIMATE IMPLICATIONS

10.1 The Fund continues with its digital strategy across all operational areas and communications with stakeholders, with the aim to improve service delivery and to reduce its internal carbon footprint.

11.0 COMMUNITY WEALTH IMPLICATIONS

11.1 There are none directly arising from this report.

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APPENDICES

Appendix 1 - Draft Funding Strategy Statement

BACKGROUND PAPERS

Mercer Demographic Summary Report

https://www.merseysidepensionfund.org.uk/Member/pdf/demogfx2022.pdf

SUBJECT HISTORY (last 3 years)

Council Meeting	Date
Standing Agenda Item The Funding Strategy Statement is reviewed at least triennially with the last review taking place following amendments to the LGPS regulations effective from 23 September 2020	**21 February 2021**