



PENSIONS COMMITTEE

14 DECEMBER 2022

REPORT TITLE:	UPDATE ON 2022 ACTUARIAL VALUATION
REPORT OF:	DIRECTOR OF PENSIONS

REPORT SUMMARY

This report informs Members that the Actuary has completed the calculations for the 2022 actuarial valuation based on membership and cashflow data provided by the Fund at 31 March 2022.

The purpose of the valuation is to set a funding plan that strikes a balance between Fund solvency, long-term cost efficiency of the scheme and affordable employer contributions for the financial period 1 April 2023 to 31 March 2026.

All individual employer results were provided to employers at the start of November setting out their initial valuation results.

The Draft Funding Strategy Statement to support the valuation process is a separate agenda item at this Committee meeting.

RECOMMENDATIONS

That the Pensions Committee be recommended to approve the valuation basis and authorise the Fund Actuary to certify the final valuation report containing employers' contributions payable for the period 1 April 2023 to 31 March 2026.

SUPPORTING INFORMATION

1.0 REASON FOR RECOMMENDATIONS

- 1.1 There is a requirement for Members of the Pensions Committee to be kept up to date with legislative developments as part of their decision-making role.

2.0 OTHER OPTIONS CONSIDERED

- 2.1 Not relevant for this report as the report is being shared for information only and it is good practice for the Committee to be aware of the Fund's deliberations.

3.0 BACKGROUND INFORMATION

- 3.1 The Local Government Pension Scheme Regulations 2013 provide the statutory framework for the valuation process. The regulations require an actuarial assessment of the Fund's assets against the current value of the pension liabilities, with a corresponding funding level to be declared every three years.
- 3.2 In order to undertake the valuation, the Actuary must have regard to the draft funding assumptions which went out for consultation with employers from 31st October to 2nd December 2022.
- 3.3 As part of the consultation employers were asked to consider the affordability versus sustainability of future contribution rates when deciding on the level of contributions payable when reviewing budgets. This is due to the continued uncertainty in relation to the economic and market outlook as well as inflation.
- 3.4 The level of employer contributions and the parameters set out in the draft Funding Strategy Statement (FSS) aim to achieve sustainability when taken in conjunction with the investment strategy. Whilst the Fund is responsible for setting the strategy to achieve this, employers also have a responsibility to consider the sustainability of contributions in the longer term when making decisions on the level of contributions at each valuation.

Valuation Results

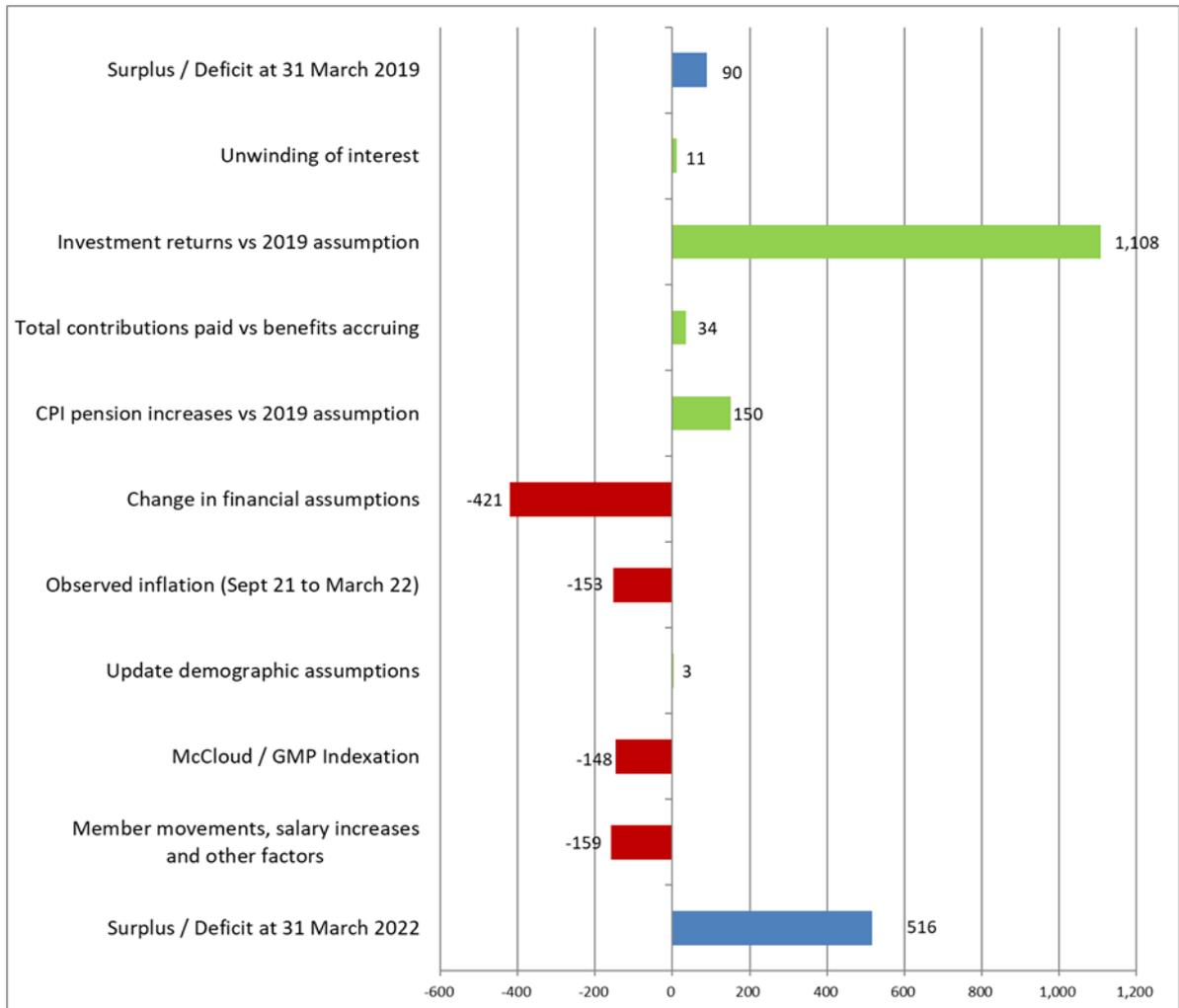
- 3.3 The final actuarial outcome will be certified following finalisation of the Funding Strategy Statement, however, preliminary whole Fund results (based on the proposed assumptions in the draft FSS) are set out below, alongside the results from 2019 valuation for comparison purposes:

	2019	2022
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ASSETS	£8,883m	£11,001m
LIABILITIES	£8,793m	£10,362m
SURPLUS	£90m	£639m
FUNDING LEVEL	101%	106%
AVERAGE EMPLOYER FUTURE SERVICE (PRIMARY) CONTRIBUTION RATE (% OF PAY)	16.8% of pay	18.5% of pay

- 3.4 The emerging preliminary whole fund results present a funding level of 106% with an associated surplus of £639m and an average employer future service cost of 18.5% of pay. The position presented follows in-depth discussions between the Fund Actuary (Mercer), officers and constituent employers in relation to the core financial and demographic assumptions.
- 3.5 These results will be subject to change as the valuation is completed for each employer, in particular, any changes to the assumption for short term pay (the results above assume an average pay award of 4% p.a. for the next 3 years) and the impact of some weaker covenant employers being assessed on the medium or lower risk bucket assumptions. The results will be disclosed within the 2022 valuation report.
- 3.6 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.
- 3.7 Analysis of the change in position during the inter-valuation period is set out below and commentary on the principal factors that influenced the improvement in the funding position:

Analysis of Change since 2019



- a) Positive investment returns** – The total investment return for the Fund was c25% for the three-year period to 31 March 2022. This was significantly higher than the expected return based on the assumptions adopted at 2019 (expected return of c13% for the 3 years to 2022) and so resulted in a gain of £1,108m for the Fund.
- b) Contributions paid** – The total contributions paid into the Fund were higher than the cost of the benefits that were accrued by members, this therefore improved the funding position by £34m.
- c) Change in discount rate** – 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 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 to reduce the expected level of real return above CPI by 0.25% from the 2019 valuation (from CPI plus 1.75% at 2019 to CPI plus 1.5% at 2022). This therefore increases the value of the liabilities and worsens the funding position by £421m.

d) Observed inflation – 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. This has increased the liabilities by £153m.

e) Change in demographic assumptions – The Actuary performed a review of the demographic assumptions as part of the 2022 valuation, based analysis of the Fund's membership. The outcome was:

a. 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 expected life expectancy (versus the assumptions made at the 2019 valuation) has changed as follows:

- a. a slight increase for males
- b. a slight decrease for females
- c. a material decrease for ill health pensioners and some dependant pensioners

Overall, this means there is a small reduction in liabilities due to the mix of different categories of member and their relative liability size. A more detailed breakdown is set out below.

b. 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.

Overall, this change in assumptions has improved the funding position by £3m as a result of the above changes.

f) McCloud – 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 impact of including McCloud increases the liabilities by £148m.

g) Member movements and other factors – There are a number of factors that are included within this figure, including general membership movements such

as allowance for salary growth, normal and ill health retirements, withdrawals from the Fund and deaths. Overall, these factors have reduced the funding position by £159m.

Future Service Contributions

3.8 The whole Fund future service contribution rate has increased at this valuation from 16.8% to 18.5% of pensionable pay. The material factors which result in the rising costs of future accrual are set out below (the balance relates to the change in membership):

a) Change in discount rate – 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). The reduction in the “real” discount rate has increased the future service rate by 1.3% of pay.

b) Change in demographic assumptions – As set out above, the Actuary performed a review of the demographic assumptions which has led to an update to the life expectancy, proportion married and commutation assumptions. As life expectancy assumptions have changed and members are likely to commute less pension than allowed for previously, this has led to an increase in the future service rate of 0.2% of pay. No change has been made to the ill health assumption. A more detailed breakdown is set out below.

Valuation Assumptions

3.9 The main financial assumptions adopted (for the higher risk bucket) are as follows:

	Past Service % p.a.	Future Service % p.a.
Investment return (pre & post retirement)	4.6	5.1
Long term salary inflation	4.6	4.6
Pension increases	3.1	3.1

Demographic Assumptions Update

3.10 As discussed above, there have been changes made to the non-financial assumptions adopted in the previous valuation. As referred to above, Mercer has undertaken an analysis of its local authority client base, with particular focus on Merseyside Pension Fund's experience relating to mortality, commutation, ill health retirements and proportion of married members.

The findings were incorporated into the preliminary actuarial valuation calculations with the impact on the whole fund deficit and future service rate as follows:

Assumption	% of Liabilities	Future service rate (% of pay)
Mortality post retirement	 -0.2%	 -0.2%
Commutation at retirement	 +0.3%	 +0.3%
Proportions married/partner	 +0.1%	 +0.1%
Mortality pre retirement	 -0.2%	 0.0%
Ill-health (no proposed change)	 +0.0%	 +0.0%
Total	 +0.0%	 +0.2%

Resultant Contributions

- 3.11 Employer contributions are calculated in two steps:
- Future service (primary) contributions (% of pay) - to cover the costs of future benefit accrual by active members and;
 - Deficit contributions or surplus offsets, both expressed as £ amounts, to arrive at the rate each employer is required to pay to attain the funding target
- 3.12 The contribution rates for individual employers reflect their own circumstances with regard to their employer status and strength of covenant, as these aspects determine the pace of funding in regard to the amount of deficit contributions payable and surplus offsets to future service contributions.
- 3.13 The notional recovery period used for the Fund as a whole is based on the recovery period that applied to each employer in the Fund (with an aim 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.

- 3.14 All individual initial employer results were provided to employers in November during dedicated employer forums which included one-to-one sessions with the Fund Actuary with the focus on contribution requirements and affordability. The results are subject to consideration of employer covenant and where necessary further meetings may take place upon completion of the covenant review. All balance sheets for employers now include McCloud.
- 3.15 Throughout the valuation process, the Fund has engaged with the Merseyside Finance Directors on the key assumptions and policies to ensure full transparency in the process to accord with budget planning.
- 3.16 As in the previous valuation, no advance allowance for early retirement (other than ill health) has been included in the calculations. Such retirements will be funded by additional payments (on top of the recommended employer's contribution rate) as and when they occur.
- 3.17 The final valuation position will be declared following approval of both the Funding Strategy Statement and Investment Strategy Statement. Individual employer contributions will be certified with the new rates taking effect from 1 April 2023.

4.0 FINANCIAL IMPLICATIONS

- 4.1 As set out in the report

5.0 LEGAL IMPLICATIONS

- 5.1 The Local Government Pension Scheme Regulations 2013 provide the statutory framework for the valuation process. The regulations require an actuarial assessment of the Fund's assets against the current value of the pension liabilities, with a corresponding funding level to be declared every three years.

5.0 RESOURCE IMPLICATIONS: STAFFING, ICT AND ASSETS

- 5.2 In discussions with the major councils, it has become apparent there is a need to consider budgetary constraints faced by employers as a result of reduced public sector funding, the high inflationary environment and the direct impact of increases to employer contributions on front line services. Consequently, Fund officers have explored various funding models and risk reduction strategies with employers to stabilise contributions which balance the administering authority's statutory responsibilities with regard to solvency and long-term cost efficiency against employer affordability.
- 5.3 The funding position of the Fund will be kept under regular review during the period to the next formal triennial valuation at 31 March 2025.

6.0 RELEVANT RISKS

- 6.1 It is imperative that the Administering Authority takes a prudent view when negotiating the financial and demographic assumptions for the 2022 Triennial Valuation, to secure the long-term solvency of the Scheme.
- 6.2 To achieve a successful outcome to the valuation there is a clear need to consider affordability of contributions and build in flexibility to the funding of employer contributions. There is a tangible risk that certifying unaffordable cash payments may lead to some employers exiting the Fund leaving irrecoverable debt.

7.0 ENGAGEMENT/CONSULTATION

- 7.1 In undertaking the actuarial valuation, Fund officers have engaged with employing bodies in order to strike a balance between sustainability and affordability.

8.0 EQUALITY IMPLICATIONS

- 8.1 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.
- 8.2 The Equality Statement published on the introduction of the Local Government Pension Scheme 2014 can be viewed at: <https://mpfund.uk/lgpsequalitystatement>
- 8.3 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.

9.0 ENVIRONMENT AND CLIMATE IMPLICATIONS

- 9.1 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.

10.0 COMMUNITY WEALTH IMPLICATIONS

- 10.1 There are none directly arising from this report.

11.0 COMMUNITY WEALTH IMPLICATIONS

- 11.1 Not relevant to this report.

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BACKGROUND PAPERS

Slides from the Valuation Meeting with Employers, November 2022

<https://www.merseysidepensionfund.org.uk/Member/pdf/valmeet2022.pdf>

SUBJECT HISTORY (last 3 years)

Council Meeting	Date
Standing Agenda Item 2019 Actuarial Triennial Valuation	3 February 2020