2022 valuation update and FSS review

Address and purpose

The below wording has been requested by Oxfordshire County Council in its capacity as Administering Authority to the Oxfordshire Pension Fund. It has been prepared by Hymans Robertson LLP (as Fund Actuary) to summarise the initial results of the 2022 Valuation (as issued on 22 August 2022) and the changes made as part of the regular review of the Fund's Funding Strategy statement to the Pension Committee.

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For and on behalf of Hymans Robertson LLP
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Funding Strategy Statement (FSS)

Background

Under LGPS Regulations, all funds have a statutory obligation to produce an FSS. It is key document for the Fund, in two ways:

1 The inputs it requires: the Fund's officers and Pensions Committee need to go through a process to be satisfied that the Fund is managing funding risks and will be collecting an appropriate level of contributions from all employers in the Fund. The FSS provides a helpful framework for organising this process and covering all the necessary areas.

2 The outputs it gives: the finalised FSS itself should be a clear and transparent reference point for the Fund's stakeholders, to set out how the Fund manages funding risks and provide proof that the contribution arrangements are solidly derived, fair and consistent. It will also help in any future discussions with employers, perhaps where an approach is queried or questions are raised.

The FSS is prepared in collaboration with the Fund Actuary and forms an integral part of the framework within which to carry out the triennial valuation to set employer contributions. The FSS also outlines how the funding strategy fits in with the investment strategy.

The current FSS was approved by the Pensions Committee in the December 2020 meeting following updates to allow for regulation amendments for exit credits and employer flexibilities.

2022 FSS review

The 2022 review has focussed on adapting the FSS to fit in with the changing environment and circumstance within which the Fund operates.

The evolving challenges, increasing diversity of employers and the growing complexity and regulation in the LGPS over the last few years has meant the FSS has become increasingly unwieldy. While the purpose of the FSS is to act as a compliant and robust reference document, it is acknowledged that a more streamlined document and modular approach to policies would enhance the accessibility and useability - ultimately making it more practical for all stakeholders (particularly employers).

The revised structure is a streamlined "core" FSS document which is complemented by a number of "satellite" policy documents. The core document includes all the funding information required by LGPS Regulations and

Statutory Guidance. It has also been restructured into sections within an LGPS employer's lifecycle (ie arrangements on joining, calculating assets and liabilities, setting contributions, arrangements on leaving, etc)

The satellite policies work both to complement the FSS and as standalone documents in their own right. These documents set out the Fund's policies with regards to specific elements of strategy and include more details on process and practicalities. Working with the actuary we have created policies to cover: employer cessations, contribution reviews, contribution prepayment requests, bulk transfers, academies and "passthrough" employers.

Alongside the restructure there has been relatively few technical or regulatory updates required since the December 2020 FSS review. The most significant changes to bring to the Committee's attention include:

1. Review of funding parameters to focus on likelihood of achieving the funding target

As part of the 2019 valuation the Fund introduced a "risk-based" approach for setting employer contributions. This approach focusses on a suitable likelihood of each employer achieving their funding target at the end of a specified time horizon. As part of the 2022 valuation, the time horizon parameter has been set to 20 years for all employers which are open to new staff joining the Fund. Instead, the Fund will adjust the likelihood of achieving the funding target to allow for employer risk based on the strength of each employer's covenant and its funding profile.

2. Further Education (FE) Sector employers

The Office for National Statistics (ONS) announced on 31 May 2022 that they will review the sector classification of Further Education Corporations, Sixth Form College Corporations and Designated Institutions in England. Since 2012, these bodies have been classified as part of the private sector. A reclassification has potentially significant implications for the LGPS. With the current classification and no central government guarantee, there is a high risk of a poor outcome for the Fund if a FE body becomes insolvent. This poorer covenant means the Fund has taken a more prudent funding approach to FE bodies and set higher contributions than for academies or councils. One of the options DfE is considering for FE bodies, if reclassified, is to provide a guarantee similar to the guarantee already provided to academies.

However, the timeline of the potential reclassification and subsequent review makes it challenging to consider any significant covenant changes as part of the 2022 valuations. The FSS has therefore been drafted to allow for both review outcome scenarios. This will enable well-informed discussions and avoid rushed engagement, decisions and Funding Strategy Statement updates later in the year.

3. Risk-based cessations

When an employer ceases participation in the Fund with no guarantor, the LGPS Regulations suggest that any future deficit arising should be met via increased contributions from all other employers in the Fund. Therefore, when assessing the final funding position of the ceasing employer, the Fund has a duty to protect the interests of the other unconnected employers. The actuary allows for this added protection by assessing the ceasing employer's liabilities using a more prudent investment return assumption based on the yield available on UK government bonds of long duration at the cessation date i.e. a gilts basis.

However, the Fund does not have a different investment strategy for ceased employers, there is therefore a mismatch between the cessation basis (based on gilt markets) and the invested assets of the ceased employer (largely growth-oriented). In addition, there are supply and demand issues in the gilts market, which cause distortions to market yields – it is becoming more difficult to say that gilt yields represent a true 'risk-free' rate of return.

The actuary has therefore recommended updating the cessation approach to calculate the final funding position in a risk-based way, akin to the approach used for setting employer contributions. Under the approach, the cessation liabilities will be calculated using an investment return assumption that the Fund's assets could expect to achieve with a given level of likelihood. This allows the Fund and actuary more control over the incorporated level of prudence and ensures the cessation debt/credit is more predictable for employers to plan for (ie as it no longer be linked to gilt yields).

4. Climate risk

The Fund recognises that climate change is a key risk due to the open-ended time horizons of the liabilities. As part of the modelling analysis for reviewing the contribution strategy for the large employers in the Fund, the actuary stress-tested the results under additional climate scenarios. This has allowed climate risk considerations to be built directly into funding strategy decisions. This approach has been documented in the FSS to meet the regulatory requirements.

5. 'McCloud' judgement treatment

The benefits accrued by certain members between 2014 and 2022 are expected to increase following the McCloud case, which ruled that transitional protections introduced in 2014 for older members were discriminatory. At the 2019 valuation there was uncertainty around if and how to allow for the potential extra costs. The Fund made an approximate allowance for the potential impact in setting employer contribution rates by building in a slightly higher level of prudence. However, the Department of Levelling Up, Housing and Communities has since provided guidance (dated 22 March 2022). The actuary has therefore now been able to use the guidance to build the expected impact of the benefit improvements directly into the liability calculations. The extra prudence allowed for at 2019 can now be removed from the assessment of employer contributions.

6. Ill health risk management

If a member retires early due to ill-health, an additional funding strain will usually arise, which can be very large. Such strain costs are the responsibility of the member's employer to pay. The FSS has been updated to clarify the Fund's policy of protecting smaller employers (who are part of a pool) by sharing this risk with other employers within the pool. Employers who are not part of a pool are more exposed to this risk.

FSS Next steps

Once approved by Committee, a draft version of the FSS and policies will be issued to all participating employers in late September with any comments to be submitted within 6 weeks. Following the end of the consultation period, any comments received may lead to amendments to the document. The Committee will then be asked to approve the final version of the FSS at the December meeting thus allowing the Actuary to sign off the final valuation report in time for the statutory deadline of 31 March 2023.

2022 valuation update

Background

The 2022 valuation of the Fund is a Regulatory requirement and is used to determine contribution rates payable by participating employers for the period commencing 1 April 2023. The valuation is carried out under Regulation 62 of the Local Government Pension Scheme Regulations 2013.

Fund officers are currently working with the actuary to progress the valuation. To date this has included: contribution modelling analysis and discussion with the large employers (Councils and Oxford Brookes University); assumptions analysis (as approved by the Committee at the June meeting); and provision and cleansing of membership and cashflow data. The actuary has now used the data to calculate the initial results of the Fund as a whole.

Initial whole fund results

A key output of the valuation is a measurement of past service liabilities at the valuation date to determine the funding level. To calculate a current funding level, the actuary compares the market value of assets against a value of the benefits accrued to date. The value of assets is easily obtained via market valuations. Placing a single value on the liabilities requires a single set of assumptions about the future, so it is important to acknowledge the results are very sensitive to the choice of assumptions.

Using this approach, a high-level snapshot of the funding position on 31 March 2022 is below:

Valuation Date	31 March 2022	31 March 2019
Past Service Liabilities	**(£m)**	**(£m)**
Employees	945	790
Deferred Pensioners	745	631
Pensioners	1,260	1,125
Total Liabilities	**2,951**	**2,546**
Assets	**3,280**	**2,515**
Surplus/(Deficit)	**329**	**(31)**
Funding Level	**111%**	**99%**

As at 31 March 2022, the past service funding position has improved from a funding level of 99% at the last valuation to 111%. This is based on assumed future investment returns of 4.6% pa.

The future investment return the Fund would need to generate to be 100% funded is now 4.0% pa (compared to 4.4% pa at 2019). The likelihood of the Fund's investment strategy achieving this required return of 4.0% pa is now 77% (there was a 66% of the Fund achieving the required 4.4% pa at 2019). Put another way, the Fund is putting less reliance on future investment return to pay for benefits already accrued by members than at 2019.

The main factor driving the funding position improvement is stronger than expected investment returns since the 2019 valuation. These have more than offset the increase in liabilities due to the short- to medium-term inflation expectations. Despite the Covid-19 pandemic, the funding impact of mortality experience has not been significantly different from expectations.

However, it is important to understand reported funding level does not directly drive employers' contribution rates. Contribution rates consider how assets and liabilities will evolve over time in different economic scenarios and reflect each employer's funding profile and covenant.

Outlook for employer contributions

Every employer is responsible for their own 'share' of the pension fund. While individual employer results will be varied depending on each employer's own membership, the main drivers of change such as investment performance and market conditions effect all employers to a similar degree. Therefore, we expect most employers will see improvements in their funding positions.

Being 100% funded in a scheme like the LGPS which is both open to future accrual and new entrants, is not the endgame. For the average fund employer, two-thirds of the benefit payments made over the next 50 years will be in respect of future service benefits, i.e. benefits yet to be earned. This will include benefits earned by existing members (new accrual) and benefits earned by new members who begin service in the LGPS after the valuation date (new joiners). The assets held today only cover past service benefits – we still need to fund those benefits yet to be earned.

The worsening future economic outlook, notably short-term inflationary pressures, will lead to upward pressure on the cost of future benefit accrual (Primary contribution rates). The improvement in past service funding position may see a reduction in Secondary contribution rates for most employers. The net impact on total contributions will vary across employers. The contribution modelling analysis carried out for the Fund's larger employers has supported contribution freezes or moderate reductions.

Valuation next steps

The next major step in the valuation process is to calculate the funding positions and set the contribution rates for all employers in the Fund. The results will then be issued to employers who will be invited to ask questions and comments as part of an employer consultation period, including at the planned employer forum.

As above, this consultation process is already underway for the Councils and Oxford Brookes University.

The outcome of these discussions and final contribution rates will be presented to the Committee for approval at the March meeting. The contribution rates will then come into payment from 1 April 2023.