

**PENSION FUND COMMITTEE – 7 JUNE 2024**

**CASH FLOW, FUNDING RISK UPDATE & 2025 VALUATION PLANNING**

**Report by the Executive Director of Resources & Section 151 Officer**

**1. RECOMMENDATION**

**The Committee is RECOMMENDED to**

- a) note the updated funding position and the reasons for the change since the 2022 valuation,**
- b) note the key funding risks currently facing the Fund,**
- c) agree to the pre-2025 valuation planning actions to be taken by the Fund as set out in paragraph 42, and**
- d) consider the cash flow implication throughout the 2025 triennial valuation process and next strategic asset allocation review.**

**Executive Summary**

2. As set out in the Business Plan for this year, there are a number of inter-related issues which the Committee need to address during the forthcoming year, which ultimately will lead to the approval of revised Funding Strategy and Investment Strategy Statements, and the agreed approach for the 2025 Valuation. This report begins this process, and provides the context for the work with an update on the funding position of the Oxfordshire County Council Pension Fund as at 31 March 2024.
3. It also provides an update on changes to the funding environment since the 2022 valuation, the risks currently faced by the Fund and the actions to be taken to help manage these risks as part of the 2025 valuation. Finally, the report covers the latest position on the Fund's cash flow and sets out the inter-relationships between cash flow, and the decisions this Committee needs to make in respect of the 2025 Valuation and the next strategic asset allocation. More details of each issue are included in the two annexes to this report prepared by the Fund Actuary.

**Updated Funding Position**

4. The funding position of the Oxfordshire County Council Pension Fund as at 31 March 2024 is 146%. This represents an improvement in funding level from 111% at 31 March 2022.
5. Whilst this improved funding position is good news, there are limitations to the usefulness of the funding level metric because it is based on a single set of assumptions about the future and asset values at a single point in time. It also only

recognises benefits earned to date (“past service”) and not the cost of future benefits.

### **What has happened since the 2022 valuation?**

6. The Fund’s assets have remained relatively stable since the 2022 valuation, meaning that the Fund currently holds a similar amount of money to pay each pound of pension as they did at the 2022 valuation date.
7. Inflation has risen sharply since the valuation date. Benefits have increased by 10.1% in 2023 and 6.7% in 2024, increasing the value of the Fund’s liabilities (in isolation). This has also had an impact on the Fund’s cashflow profile as current benefit payments have also increased in line with the above pension increases.
8. However, despite these flat investment returns and inflationary pressures, the funding level has still improved. The improvement in funding level has largely been driven by an improved investment outlook due to a sharp rise in global interest rates (leading to higher expected future returns across all asset classes), which has more than offset the high inflationary pressures.
9. As at 31 March 2024, we now estimate that the Fund will achieve a much higher investment return of 6.6% pa (with a 70% likelihood of being achieved), compared to a return of 4.6% at 31 March 2022 (with the same likelihood).
10. Higher future investment returns lead to a lower value being placed on the Fund’s future benefit payments (liabilities). This means that the improved funding level is reliant on the Fund achieving higher investment returns in the future as opposed to holding more assets today (per pound of pension). The Fund therefore needs to carefully consider its options for managing this surplus.

### **Key Funding Risks**

11. There remains uncertainty in financial markets and material risks facing the Fund. There has been a significant shift in the economic environment since the 2022 valuation and the Fund is now facing new risks and opportunities. The key funding risks that the Fund continues manage are:
  - a. Investment risk
  - b. Inflation risk
  - c. Cashflow risk
  - d. Longevity risk
  - e. Climate risk
  - f. Employer covenant risk

### **Investment risk**

12. All assumptions (especially those on future investment performance) remain uncertain, especially during periods of increased market volatility. The funding position is based on future returns with a 70% assumed likelihood of being achieved. In other words, there is still a 30% chance that returns will be lower than

we assume. Fund officers will review prudence levels (ie the assumed likelihood of achieving returns) and the investment strategy at the 2025 valuation.

13. Currently all employer assets are invested in a single strategy with a mix of investments held across broadly three areas: growth (such as equities), protection (such as bonds) and income (such as property).
14. As part of an investment strategy review the Fund will consider the impact of investment income on cashflows and the current levels of risk in the portfolio. For example, some employers may now wish to reduce exposure to riskier assets (such as equities) given the strong funding positions. Fund officers plan to explore options for providing employers an alternative investment strategy at the 2025 valuation.

### **Inflation risk**

15. Inflation is a key risk for pension funds to manage. Higher inflation increases the cost of benefits, which increases longer term funding costs but also has an immediate impact on shorter term cashflow (pensions in payment).
16. Although the expectation is for inflation to fall, it remains uncertain. Persistently higher inflation is a risk for pension funds. For example, if pension increase are 1% pa higher than we assume over the long term, this will reduce the funding level by around 20%.
17. Fund officers will continue to monitor inflation trends and will include stress tests on funding strategy and cashflow modelling to help understand and manage this risk.

### **Cashflow risk**

18. As set out in the Fund's Funding Strategy Statement a main objective of the Fund is to *'take a prudent long-term view to secure the regulatory requirement for long-term solvency, with sufficient funds to pay benefits to members and their dependants'*. To meet this objective, it is necessary to understand how the Fund's cashflow position is likely to evolve over the longer term.
19. Historically the Fund has been cashflow positive on the balance of pension contributions received and pension benefits paid. As the scheme matures the cashflow position can be expected to reverse leaving a cashflow deficit that needs to be covered as is the case for several other LGPS funds already.
20. High inflation over recent years has also led to a large increase in benefits paid over and above the increase in contributions seen from the level of pay rises bringing forward the point the Fund is likely to reach a cashflow negative position.

### **Cashflow Projections**

21. Attached at Annex 1 is a report produced by the Fund's actuary Hymans Robertson considering the Fund's cashflow position over the coming years under several different scenarios.
22. Under the baseline scenario the Fund is expected to become consistently cashflow negative from 2028. Under this scenario the Fund would have an income requirement of approximately 0.6% per annum to remain cashflow neutral over the 20-year assessment period.
23. The report considers the impact of different scenarios for inflation, employer contribution rates, and a reduction in membership on the Fund's cashflow position as well as a 'worst case' scenario combining negative cashflow impacts from all three areas.

### **Next Steps on Cash Flow**

24. There are broadly two options for meeting a cashflow shortfall for the Fund; generating and utilizing investment income, and/or periodic sales of investment assets.
25. Using investment income has the advantage of avoiding transaction costs but has limited scope for control to adjust to situations where the cashflow position is different to the forecast and may lead to the need for rebalancing due to the income being taken only from certain portfolios.
26. Sales of investments allows greater control over the amount and timing of cash receipts to the Fund as well as over asset allocation against target but incurs costs in the sale process.
27. The Fund currently has several portfolios that can distribute income as detailed in the table below:

<b>Portfolio</b>	<b>Approximate Income Yield</b>
Secured Income	6%
UK Property	3%
International Property	3%
Private Debt	8%
Listed Private Equity	3%

28. At the whole fund level opting to receive income on all these portfolios would generate a yield of approximately 1%. This level of income would be sufficient to meet the cashflow requirements under the majority of the scenarios modelled with the exception of the high inflation scenario and 'worst case' scenario.
29. The Fund will need to consider cashflow impacts when undertaking the 2025 triennial valuation and when reviewing its strategic asset allocation in the review due to take place at the beginning of 2026. As part of the strategic asset allocation review the Fund should consider the development of a cashflow management policy.

### **Longevity risk**

30. Recent longevity trends have seen increased deaths in recent years. In 2020 and 2021, these deaths were a result of the Covid-19 pandemic, however the cause of these excess deaths in 2022 and 2023 is less clear cut.
31. Understanding these demographic trends and setting appropriate mortality assumptions is key to managing longevity risk. The Fund's longevity assumptions will be reviewed as part of the 2025 valuation and the Fund should consider its beliefs around future longevity improvements.
32. With increased levels of uncertainty on the lasting impact of the pandemic and future longevity, the Fund may consider maintaining a funding cushion to help manage these uncertain outcomes.

### **Climate risk**

33. Climate risk is now widely regarded as one of the main sources of risk for pension schemes, with potential implications for future inflation, investment returns and longevity.
34. At the 2022 valuation, the Fund carried out scenario analysis representing a broad range of possibilities for how the world might respond to climate change. Despite imposing significant stresses and big increases in volatility, the impact on risk metrics of these scenarios was quite modest.
35. However, climate change has the potential make extreme outcomes more likely, therefore it is important to consider catastrophic outcomes when assessing the impact of climate risk. As part of the 2025 valuation, we will therefore consider new, 'extreme', scenarios (complementing the existing scenarios) allowing the Fund to assess the impact of catastrophic outcomes on funding strategies.
36. Ahead of the 2025 valuation, the Fund will review its approach to managing climate risk, including setting objectives, capturing views and beliefs and carrying out scenario modelling.

### **Employer covenant**

37. Although the recent improvement in funding is good news, employers continue to face a wide variety of challenges from the evolving economic, demographic and regulatory environment. Higher inflation, interest rates and pay awards are all putting pressure on organisations.
38. As part of the 2025 valuation, the Fund will assess employer covenant risk to ensure early engagement with employers and appropriate risk categorisation. The

Fund will also consider how this risk categorisation impacts on its holistic approach to setting employer funding strategies.

## **2025 valuation planning**

39. As part of the preparatory work to help inform the Fund's funding and investment strategy in this new economic environment., the Fund is reviewing the following areas:

- Employer contributions
- Investment strategy
- Prudence levels
- Treatment of surplus
- Risk management for other sources of uncertainty and volatility.

40. Given the current cost pressures facing employers, there may be a desire for contribution rate reductions at the 2025 valuations. However, the Fund will need to consider how to manage any contribution rate reductions against the potential need to increase contribution rates in the future. The impact of any contribution reductions on the Fund's cashflow needs will also be considered.

41. Given the improvement in funding, many employers may now want an opportunity to manage volatility in their funding position by reducing their exposure to investment risk. Fund officers are considering providing an appropriate alternative investment strategy (in addition to the main strategy) which aims to reduce volatility for employers and stabilise long-term contribution rates.

42. The Fund should review the prudence levels in the funding strategy to help explore if the current market conditions and increased levels of volatility and uncertainty around certain risks warrant management by increasing levels of prudence. An alternative approach is to deliberately target a given level of surplus by targeting a funding level of above 100% before considering any reductions in employer contribution rates.

43. Ahead of the 2025 valuation, the Fund will therefore:

- Engage early with employers and other stakeholders to plan the valuation effectively;
- Monitor employer funding and covenant risks, including early engagement with high risk employers;
- Engage with all employers ahead of the valuation to build up appropriate messaging around the current economic environment;
- Consider options for funding and investment to help manage the current surplus including a review of current prudence levels; and
- Carry out contribution rate modelling for the long-term, secure employers to inform budget setting, including consideration of an alternative long-term investment strategy aiming to reduce investment volatility.

- Develop a cashflow management policy that considers the impact of potential outcomes at the 2025 valuation such as changes in investment strategy and contribution reductions.

Lorna Baxter Executive Director Resources and Section 151 Officer

May 2024