CYNGOR Sir y Fflint Flintshire COUNTY COUNCIL

CLWYD PENSION FUND COMMITTEE

Date of Meeting	Wednesday, 23rd November 2022
Report Subject	Draft Funding Strategy Statement
Report Author	Head of Clwyd Pension Fund

EXECUTIVE 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 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 which will determine the **minimum** contributions required. Employers have a responsibility to consider the appropriate level of contributions in the context of their own circumstances and reference to this is included in the draft 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 will take place over December and the final FSS will be brought back to the February 2023 Committee for final approval. On the basis of the proposed assumptions, the provisional total Fund results show a funding level of 105% and a future service contribution rate of 18.7% of pay. The Actuary will present the main matters and decisions needed for approval of the FSS at the meeting along with the provisional total Fund results.

RECOMMENDATIONS	
1	The Committee approve the proposed key actuarial assumptions and funding parameters, in paragraphs 1.05 to 1.10 of the report, which will be incorporated into the Funding Strategy Statement.
2	The Committee approve the draft Funding Strategy Statement for consultation with employers (noting some information can only be included when the actuarial valuation is complete) and note the provisional results in paragraph 1.16.
3	The Committee delegates the refinement and finalisation of the draft FSS to the Head of Clwyd Pension Fund, before formal consultation with employers, having regard to the advice of the Fund Actuary.

REPORT DETAILS

1.00	Draft Funding Strategy Statement and the Valuation
1.01	**Draft Funding Strategy Statement** The 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. In doing this, they must have regard to FSS guidance issued by the Chartered Institute of Public Finance and Accountancy (CIPFA). The Fund Actuary must have regard to the FSS as part of the actuarial valuation process.
1.02	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. The draft includes reference to the current investment strategy objectives. These will be updated to reflect the agreed strategy and objectives emerging from the investment strategy review currently being undertaken. This review will take into account the actuarial assumptions and how they have changed since the valuation date so it is not expected there will be any changes to invalidate the proposed assumptions in the draft FSS.
1.03	As a matter of good governance, the FSS will also be reviewed on an annual basis to ensure it remains up to date with changing legislation or other requirements. Any material change would be brought to Committee for approval and employers would be consulted on the changes as necessary.
1.04	The draft FSS attached as Appendix 1 is based on preliminary valuation information. It can only be finalised once the valuation, consultation processes and associated analysis have been completed. The draft FSS has been streamlined for 2022 to make it easier for all parties to navigate. It will be formatted and translated in due course also. It incorporates the following key updates:
1.05	<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 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.
1.06	<u>Discount Rate (average expected return) basis for past service liabilities (funding target)</u> 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). 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. The Actuary has proposed to reduce 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 the discount rate). This results in a gross discount rate of 4.6% p.a. (3.1% + 1.5%) at the valuation date.
1.07	<u>Discount Rate (average expected return) basis for future service liabilities</u> 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. 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. 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. (3.1% + 2.0%) at the valuation date.
1.08	Pay Growth assumption (including increments) 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+1.25% 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 either 3% p.a. or 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 1.16 of this report we have used a 4% p.a. assumption for all employers.
1.09	Demographic Assumptions 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. 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: 21.5 years (22.4 years) Male active member currently age 45: 23.3 years (24.0 years) Female pensioner currently age 65: 23.9 years (24.8 years) Female active member currently age 45: 26.0 years (26.8 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. Both of these changes have marginally increased the liabilities and future service rate but not significantly compared to life expectancy and other factors.
1.10	Recovery periods (surplus and deficit) 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. 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 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 1.19.
1.11	<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, 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.
1.12	<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 the Actuary has yet to complete the analysis.
1.13	<u>Other Fund policies</u> 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. The existing policies have all been reviewed and streamlined to enable stakeholders to read and understand the information in a clearer and more concise way. However, the majority of the content remains unchanged (except to reflect the 2022 valuation updates such as assumption and date changes etc). We will also be reviewing the termination policy in light of the current gilt market volatility as referenced in the draft FSS.

1.14	There are some areas which need refinement due to information not yet being available e.g. the analysis in relation to the funding effect of climate change. It is recommended that the Head of Clwyd Pension Fund is given delegated powers to finalise the draft FSS having regard to advice from the Actuary, should there need to be any changes as a result of further development on these or similar matters. The Committee will be updated on the progress of these issues at the next Committee meeting.
1.15	Once the draft FSS has been approved by the Committee, the draft will be refined for any comments by the Head of Clwyd Pension Fund in conjunction with the Fund Actuary. The consultation with the Fund employers will then commence. Subject to the finalisation of the Regulations/guidance and the outcome of the employer consultation, the proposed final FSS incorporating the final assumptions and policies (including any changes post consultation) will be brought to the Committee for final approval at the February 2023 Committee.
1.16	**Provisional Valuation results** The final actuarial outcome will be reported to Committee at February 2023 meeting, however preliminary whole Fund results (based on the proposed assumptions in the draft FSS) are set out below:

	£m
Assets	2,490
Liabilities	2,365
Surplus	125
Average Funding Level	105%
Average Employer future service (Primary) contribution rate (% of pay)	18.7% p.a.

These results will be subject to change as the valuation is completed for each employer – in particular any changes in the assumption for short term pay award (the results above assume an average pay award of 4% p.a. for the next 3 years).

The equivalent 2019 valuation results were a funding level of 91% and a deficit of £177m. The equivalent average future service rate was 17.3% 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.

1.17	Initial employer contribution results will be distributed to employers along with the draft FSS (once approved) and the consultation process will begin. Preliminary discussions have already taken place with the Steering Group of the three local authorities and with larger education employers as they represent the biggest proportion of the Fund's liabilities. Other employers will be offered 1:1 sessions with the Actuary after the AJCM.

1.18	The Fund's FSS, taking into account actuarial advice, aims to provide a framework to determine the **minimum** contribution requirements for employers. The assumptions/parameters have been set to, as far as possible, achieve sustainable contributions taking into account economic factors at and beyond the valuation date as well as adopting other parameters to restricting the pace at which surplus can be run off through reduced contribution rates e.g. the recovery period.
1.19	However, the employers also have a responsibility to manage the sustainability of contributions in the context of their own budgets. The draft FSS now includes explicit reference to this responsibility. As part of the consultation employers will be asked to consider the level of affordability versus the sustainability of future contribution rates if experience turns out worse than assumed e.g. a more prolonged period of low growth/returns (affecting the assets) and higher inflation (which affects the liabilities). This could result in employers choosing to pay more than the minimum contributions required by retaining more of the surplus identified at the valuation date or paying off any deficit over a shorter period. The parameters set out in the draft FSS include the flexibility for employers to do this if they wish.

2.00	**RESOURCE IMPLICATIONS**
2.01	Mercer and officers will need to spend a significant amount of time as part of the consultation with employers. This will involve meetings with employers as well as written correspondence.

3.00	**CONSULTATIONS REQUIRED / CARRIED OUT**
3.01	The Administering Authority is required to consult with employing bodies over the development of the Funding Strategy Statement. The consultation will commence once the Committee has agreed the draft FSS and also delegated the responsibility of the refinement and finalisation of the draft FSS to the Head of Clwyd Pension Fund.

4.00	**RISK MANAGEMENT**
4.01	This report addresses some of the risks identified in the Fund's Risk Register. Specifically, this covers the following (either in whole or in part): • Governance risk: G2 • Funding and Investment risks: F1 - F6
4.02	The actuarial valuation is a vital governance tool and is meant to control the risks relating to the CPF's funding position and employer contributions requirements which have a material impact on budgets and local services. The funding strategy (along with the investment strategy) which comes from the actuarial valuation is a key determinant of the overall financial risk levels in the CPF. 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.

5.00	APPENDICES
5.01	Appendix 1 – Draft Funding Strategy Statement

6.00	LIST OF ACCESSIBLE BACKGROUND DOCUMENTS
6.01	1. Current FSS and 2019 Actuarial Valuation report. 2. Committee report on the actuarial valuation from June 2022 **Contact Officer:** Philip Latham, Head of Clwyd Pension Fund **Telephone:** 01352 702264 **E-mail:** philip.latham@flintshire.gov.uk

7.00	GLOSSARY OF TERMS
7.01	(a) **CPF – Clwyd Pension Fund** – The Pension Fund managed by Flintshire County Council for local authority employees in the region and employees of other employers with links to local government in the region (b) **Administering authority or scheme manager** – Flintshire County Council is the administering authority and scheme manager for the Clwyd Pension Fund, which means it is responsible for the management and stewardship of the Fund. (c) **PFC – Clwyd Pension Fund Committee** - the Flintshire County Council committee responsible for the majority of decisions relating to the management of the Clwyd Pension Fund (d) **LPB or PB – Local Pension Board or Pension Board** – each LGPS Fund has an LPB. Their purpose is to assist the administering authority in ensuring compliance with the scheme regulations, TPR requirements and efficient and effective governance and administration of the Fund. (e) **LGPS – Local Government Pension Scheme** – the national scheme, which Clwyd Pension Fund is part of (f) **FSS – Funding Strategy Statement** – the main document that outlines how we will manage employers contributions to the Fund (g) **Actuarial Valuation** - The formal valuation assessment of the Fund detailing the solvency position and determine the contribution rates payable by the employers to fund the cost of benefits and make good any existing shortfalls as set out in the separate Funding Strategy

	Statement. (h) **Actuary -** A professional advisor, specialising in financial risk, who is appointed by pension Funds to provide advice on financial related matters. In the LGPS, one of the Actuary’s primary responsibilities is the setting of contribution rates payable by all participating employers as part of the actuarial valuation exercise. (i) **GAD – Government Actuary’s Department -** The Government Actuary's Department is responsible for providing actuarial advice to public sector clients. GAD is a non-ministerial department of HM Treasury.