Update on funding position as at 31 March 2021

Purpose and scope

This paper has been commissioned by and is addressed to London Borough of Barnet as Administering Authority of the London Borough of Barnet Pension Fund ("the Fund").

Its purpose is to provide the Fund's Pension Committee ("the Committee") an update on the overall fund level funding position as at 31 March 2021 and how it compares to the position at the last formal valuation of the Fund (31 March 2019).

Background

The Committee have previously been presented with an updated whole fund funding level figure. The funding level is derived as the ratio of the value of the Fund's assets to the value of its accrued liabilities. Whilst presenting this figure as a single number aids simplicity, it does hide a level of detail which we believe would help the Committee to better understand and monitor the long-term funding position of the Fund. This paper seeks to set out this detail.

Information regarding the data, assumptions, methodology and funding risks associated with the results in this paper is contained in the Appendix.

In particular it should be noted that the financial assumptions have been derived as per the Funding Strategy Statement in force as at the 31 March 2019 formal valuation of the Fund. As such, no allowance has been made for RPI reform whereby it is expected that RPI will align with CPIH from 2030 onwards. As part of the 2022 valuation, the Fund will need to consider how this announcement is reflected in the assumption made for long term inflation expectations.

Liabilities

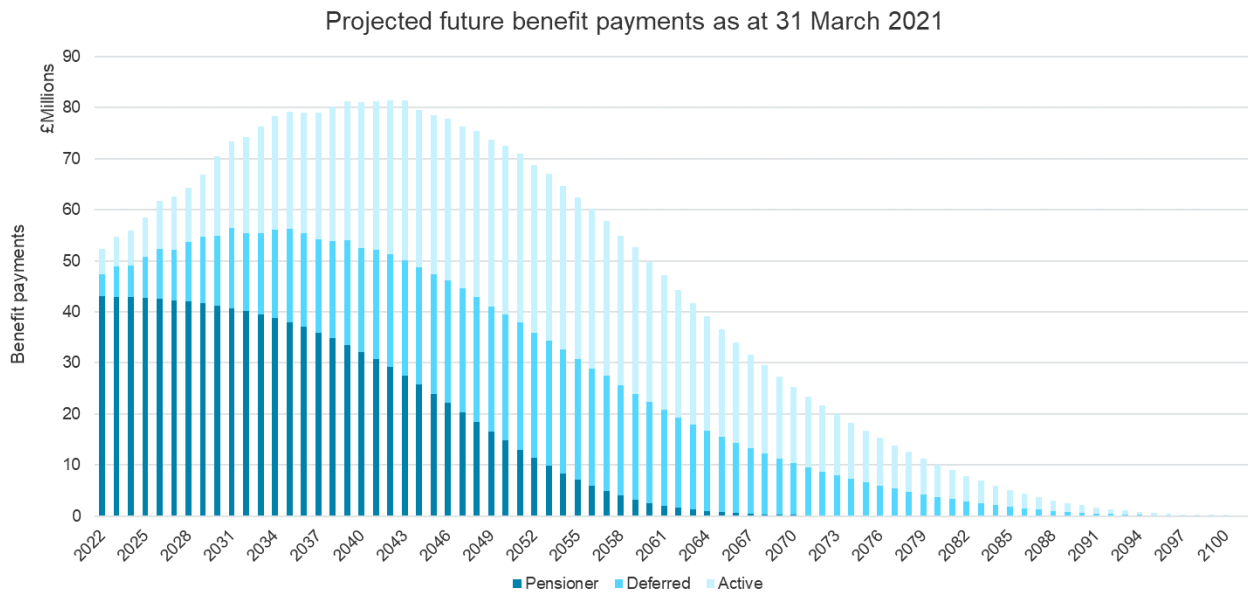
The Fund's liabilities are the future benefit payments due to members in respect of their service accrued in the Fund. Future benefit payments will be in respect of both service accrued up to today ("past service") and service that will be accrued in the future ("future service"). The funding level traditionally presented is only in respect of past service benefits.

To better understand the Fund's past service liabilities, we have detailed below in Chart 1 the projected annual future benefit payments due to all members in respect of service earned up to 31 March 2021:

- Pensioners: those members currently in receipt of their benefits
- Deferreds: those members who have left the Fund but are yet to retire
- Actives: those members who are still participating in the Fund and accruing service

The member group classification is based on each individual member's status as at the last formal valuation (31 March 2019) and the figures are in nominal terms.

Chart 1



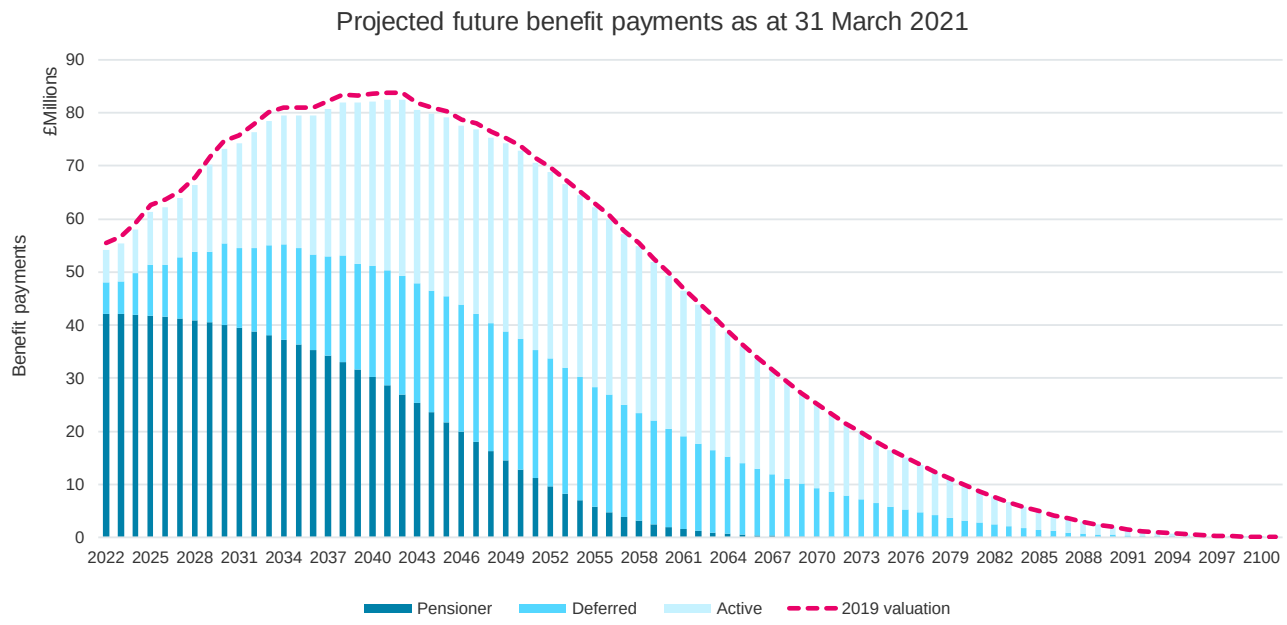
Important points to note from the chart are:

- Currently, the majority of benefit payments are in respect of pensioner members. However, some benefits are expected to also be paid to members who were deferred and active at the last formal valuation and have either since retired or some other benefit crystallisation event has taken place e.g. death-in-service.
- Over time, the benefit payments will transition from being mostly in respect of pensioners to deferred and active members (i.e. the pensioners of the future). This is expected as pensioners are older than deferred and active members and payment of benefits ceases upon death.
- The timeframe for benefits payable in respect of service accrued up to 31 March 2021 is 80+ years. This emphasises the long-term nature of the Fund.

Change since 2019 valuation

The projected benefit payments are based on the membership data and the financial and demographic assumptions used for the 2019 formal valuation and in line with the Funding Strategy Statement (FSS) dated March 2020. However, they have been updated to reflect actual pension increases since the valuation and changes in future long-term inflation expectations derived consistently with the approach in the current FSS. Actual pension increases at April 2020 and April 2021 were less than expected (1.7% vs. 2.3% and 0.5% vs 2.3% respectively) and market based long-term inflation expectations have stayed the same since 31 March 2019 **(noting that no allowance has been made for any changes resulting from RPI reform).** The pink line on Chart 2 below shows the total projected annual future benefit payments as at 31 March 2019 (in line with Chart 1 above). The impact of lower than expected pension increases has resulted in a reduction in the projected benefit payments as at 31 March 2021.

Chart 2



Assets

As at 31 March 2021, it was estimated by the Fund that the Fund's asset value was £1,370m. The Fund's assets are there to pay all the member benefits accrued to date. We can understand if the current value of assets is sufficient to pay the past service benefits by projecting these values forward over time and allowing for future investment returns and benefit payments. The benefit payments are assumed to match those shown in Chart 2. At 31 March 2021, we estimate that the Fund's asset allocation has a 75% likelihood of achieving an annual return of at least 4.3% p.a. (at 31 March 2019, the equivalent return was 4.4% p.a.).

Chart 3 below details the projected Fund asset value over the next 100 years. Again, the figures are in nominal terms.

Chart 3

Important points to note from the chart are:

- It is estimated that the Fund's assets will be insufficient in paying all future benefit payments due.
- In order to meet all future benefit payments due, the Fund currently:
  - requires an additional £32m of assets as at 31 March 2021; or
  - can rely on future investment returns of at least 4.4% p.a. (which we estimate that there is a 74% likelihood of achieving based on the current allocation).

Chart 4 below details the projected Fund asset value under both of these scenarios (along with the base scenario). Please note that the yellow line broadly tracks the blue line from around 2055.

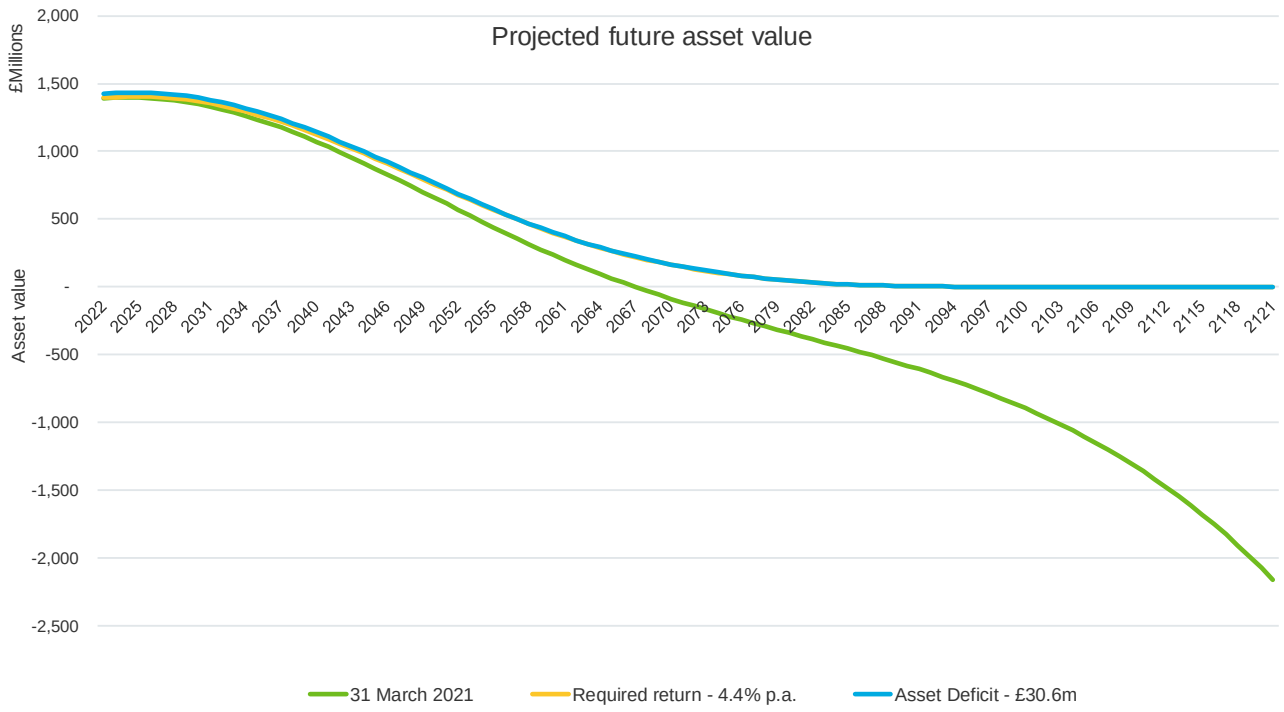


Chart 4

Change since 2019 valuation

It is difficult to make a direct comparison of the actual asset value projections at different dates as there are many factors which will affect the projection. Instead, it is more helpful for comparison purposes to consider and compare the level of cash injection or required return between dates.

At the 31 March 2019 valuation, the Fund's assets were not sufficient to pay all future benefit payments based on an assumed investment return of 4.4% p.a.. To have sufficient monies, it was estimated that the Fund would need either:

- an additional £187m of assets as at 31 March 2019; or
- future investment returns of at least 5.4% p.a. (which were estimated to be achievable in c.60% of future outcomes).

Comparing both of these figures to the equivalent as at 31 March 2021, we note that:

- the past service funding shortfall has decreased from £187m to £32m; and

- the required investment return has fallen from 5.4% p.a. to 4.4% p.a. as well as the likelihood of the Fund's assets achieving the required level of return increasing from 60% to 74%.

Future service considerations

So far, this paper has only considered past service benefits. Similar analysis and projections in respect of future benefit accrual could also be prepared, however, because the LGPS continues to be open to accrual and new joiners, there would be no end date for the projections. Therefore, such projections would be limited in their usefulness.

Instead, it is helpful to consider the long-term cost of future benefit accrual and how that compares to both the long-term cost as at the last formal valuation and the Primary Rate in payment by employers.

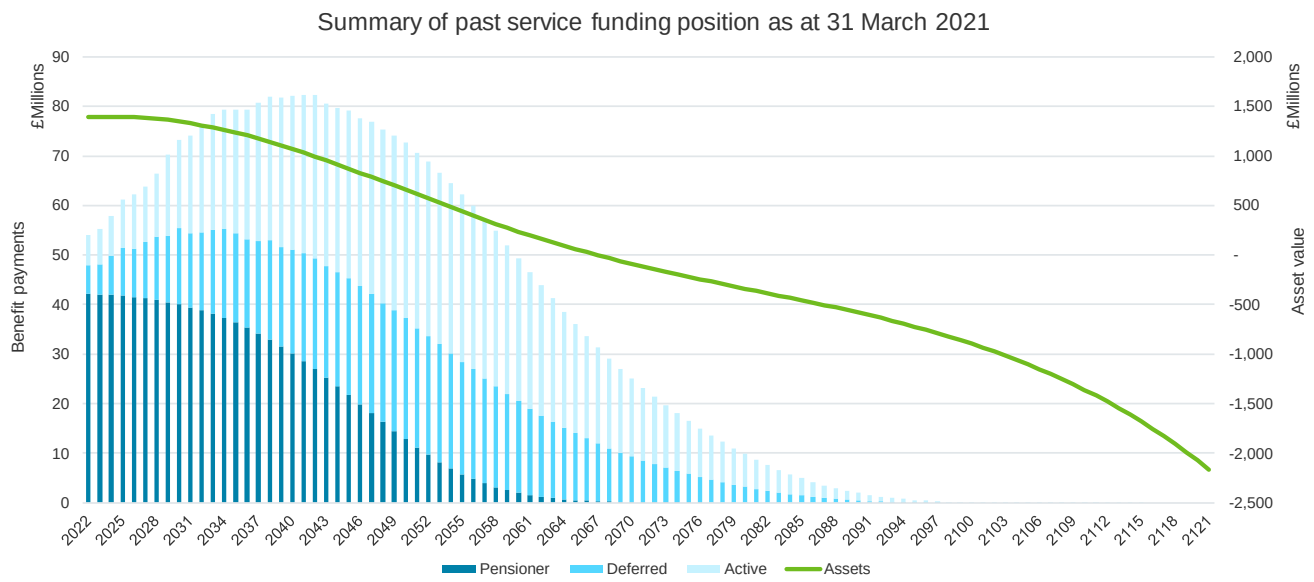
Currently, the Fund level Primary Rate in payment is 20.6% of pay (including expenses of 1.0% of pay). At the 2019 valuation, there was a 70% likelihood that this rate would be sufficient to fund the long-term cost of accrual.

As at 31 March 2021, we estimate that there is 66% likelihood that 20.6% of pay will be sufficient to fund the long-term cost of accrual i.e. the cost of future benefit accrual has increased.

Summary

Chart 5 below combines the liability and asset sides of the funding balance sheet to provide an overall view of the past service funding position.

Chart 5



As at 31 March 2021, the past service funding position has improved. Despite the worsening in long term future investment return prospects, this is primarily due to the investment outperformance since 31 March 2019.

Additionally, the future service position has deteriorated. This is primarily due to the reduction in long-term investment return expectations.

Combining both these factors together, if the Fund's funding strategy and investment strategy remained static, we may expect funding plans to be unchanged at the next formal valuation (31 March 2022), this does mean that if an employer was anticipating an increase in rate following the outcomes of the previous valuation this may still be required.

However, there are many moving parts and as such the following caveats apply:

- the funding position and cost of future benefit accrual may change when an allowance is made for RPI reform and the resulting impact on future inflation expectations;
- the impact on the rates of different employers will vary depending on their membership profile;
- the various judgements relating to McCloud and Goodwin will impact employers differently (the above analysis doesn't make any allowance for these matters) and
- any change to market conditions and the outlook for future returns will impact contributions requirements.

Next steps

The paper has been provided for information purposes only to help understand how the funding position has changed since the last formal valuation when the current funding strategy was agreed.

The Fund may use the results of this paper to act as an insight for considering whether any sources of risk need to be discussed or further investigated, or to trigger a review of the current and future long-term funding and investment strategy.

However, it must be noted that this paper has been provided for information purposes and does not seek to propose any changes to the Fund's funding or investment strategy. Furthermore, the contribution rate figures quoted should not be taken as suggestions for rates that will payable at the next formal valuation or advice that contribution rates need to be amended before the next valuation.

Reliances and limitations

This paper has been prepared for London Borough of Barnet as Administering Authority of the London Borough of Barnet Pension Fund for the purpose described above. It has not been prepared for use for any other purpose and should not be so used. The paper should not be disclosed to any third party except as required by law or regulatory obligation or with our prior written consent. We accept no liability where the paper is used by or disclosed to a third party unless we have expressly accepted such liability in writing. Where this is permitted, the paper may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

The following Technical Actuarial Standards are applicable in relation to this advice, and have been complied with where material and to a proportionate degree:

- TAS100

This report together with the formal valuation report for the Fund (issued March 2020) and the Fund's Funding Strategy Statement set out the aggregate of my advice.

Prepared by:-

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April 2021

For and on behalf of Hymans Robertson LLP

Appendix

Data

The benefit projections are based on membership data supplied for the 31 March 2019 formal valuation of the Fund. Further details about the data can be found in the 2019 valuation formal valuation report dated March 2020.

Assumptions and methodology

Liabilities

All demographic and financial assumptions underlying the benefit projections are as per the 31 March 2019 formal valuation with the exception of the future inflation assumption (which affects the rate of future pension increases, CARE revaluation and salary increases).

Further details about the assumptions can be found in the 2019 valuation formal valuation report dated March 2020.

The future long-term inflation assumption used in the benefit projections as at 31 March 2021 is 2.3% p.a.. Therefore, as at 31 March 2021 we have assumed that:

- Future pension increases are 2.3% p.a.
- Future CARE pot revaluation is 2.3% p.a.
- Future salary increases are 3.1% p.a.

The benefit projections assume that membership experience since 31 March 2019 has been in line with the assumptions made. At a whole fund level, this assumption is reasonable to make and, for the purpose of this paper, we do not expect this to result in a material inaccuracy.

We have also allowed for additional benefit accrual between 1 April 2019 to 31 March 2021. This allows comparison with the Fund's asset value as at 31 March 2021.

To calculate the updated future service cost, we have used our proprietary Economic Service Scenario ("ESS") model, and the same methodology used to set employer contribution rates at the last formal valuation. Further details about the ESS model, and the calibration of the model as at 31 March 2019, can be found in the 2019 valuation formal report dated March 2020. The contribution rate setting methodology is discussed in Appendix D of the Fund's current Funding Strategy Statement (available on the Fund's website).

The calibration of the model as at 31 March 2021 is detailed below. The following figures have been calculated using 5,000 simulations of the ESS, calibrated using market data as at 31 March 2021. All returns are shown net of fees. Percentiles refer to percentiles of the 5,000 simulations and are the annualised total returns over 5, 10 and 20 years, except for the yields which refer to the simulated yields for at that time horizon. Only the overall Fund portfolio returns are shown, however similar information for separate asset classes is available on request.

		Annualised total returns									
		Cash	Index Linked Gilts (medium)	Fixed Interest Gilts (medium)	UK Equity	Overseas Equity	Property	CorpMedium A	Inflation	17 year real yield	17 year yield
5 years	16th %'ile	-0.3%	-2.7%	-2.5%	-3.9%	-3.6%	-3.5%	-2.9%	1.8%	-2.6%	0.8%
	50th %'ile	0.4%	0.2%	0.1%	4.3%	4.3%	2.5%	0.1%	3.4%	-1.7%	1.9%
	84th %'ile	1.2%	3.2%	2.6%	12.3%	12.3%	8.8%	2.8%	4.9%	-0.8%	3.1%
10 years	16th %'ile	0.0%	-1.9%	-1.1%	-0.9%	-1.0%	-1.3%	-1.1%	1.8%	-2.2%	1.1%
	50th %'ile	1.0%	0.1%	0.3%	4.8%	5.0%	3.2%	0.6%	3.5%	-1.0%	2.4%
	84th %'ile	2.2%	2.3%	1.6%	10.7%	10.8%	8.0%	2.1%	5.1%	0.3%	4.1%
20 years	16th %'ile	0.6%	-1.2%	0.2%	1.3%	1.4%	0.8%	0.5%	1.7%	-1.6%	1.3%
	50th %'ile	2.0%	0.5%	1.0%	5.8%	5.8%	4.2%	1.6%	3.2%	0.1%	3.3%
	84th %'ile	3.6%	2.2%	1.7%	10.3%	10.3%	8.0%	2.5%	4.9%	1.9%	5.7%
	Volatility (Disp) (1 yr)	0%	7%	7%	17%	17%	14%	8%	1%		

The current calibration of the model indicates that a period of outward yield movement is expected. For example, over the next 20 years our model expects the 17 year maturity annualised real (nominal) interest rate to rise from -2.3% (1.3%) to 1.0% (3.2%).Assets

The asset value as at 31 March 2021 has been rolled forward from the 2019 valuation with actual and estimated index returns and includes allowance for estimated contributions and benefits payable. These data inputs are summarised below:

Investment returns	
Actual return: 1 Apr 2019 to 31 Mar 2021	19.0
Cashflows	**1 April 2019 to 31 March 2021**
Estimated contributions received	£114.5m
Estimated benefits paid	£112.4m

This asset value will be different from the Fund's actual asset value as at 31 March 2021. However, this approach means that the assets are consistent with the liabilities which allows for the two to be compared for the purpose of this paper.

To derive the level of likelihood associated with certain level of expected future returns, we have used the ESS model as described above and the Fund's current strategic asset allocation:

% allocation	
UK equities	1.10%
Overseas equities	36.8%
Private Equity	5.0%
Emerging market equity	7.1%
Infrastructure Equity	5.0%
Infrastructure Debt	7.0%
Medium Corporate Bonds	10.0%
Commercial Property	10.0%

Asset Back Securities	7.0%
Private Lending	11.0%

Model limitations

The models used to calculate the results in the paper make some necessary simplifying assumptions. I do not consider these simplifications to be material and I am satisfied that they are appropriate for the purposes described in this report.

Sensitivity of results

The results in this report are dependent on a number of factors including the membership details, current financial conditions, the outlook for future financial conditions and demographic trends such as longevity. Changes in each of these factors can have a material impact on the results. I have not sought to quantify the impact of differences in the above because of the complex interactions between them. If further information about the sensitivity of the results to different data or assumptions is required, this can be provided on request.

Funding Risks

Please see the FSS for details of the funding risks that apply to the future ability of the Fund to pay all members' benefits. These include, but are not limited to:

- Market risks – these include investment returns being less than anticipated or liabilities increasing more than expected due to changes in market conditions underlying the financial assumptions (e.g. inflation or pay increases above that assumed etc.).
- Demographic risks – these include anything that affects the timing or type of benefits (e.g. members living longer than anticipated, fewer members opting into the 50/50 option, etc.).
- Regulatory risks – the LGPS is a statutory scheme. There is a risk that central Government legislation could significantly change the cost of the scheme in future.

  In particular, the benefit structure of the LGPS is currently under review as a result of the consultation on the McCloud and Sargeant judgement, HM Treasury's and Scheme Advisory Board's cost-sharing valuations as well as the recent outcome of the Goodwin tribunal. Benefit changes as a result of these issues may materially affect the value of benefits earned by members both in the past and future. I have made no direct allowance for these changes and may need to review my calculations once the outcomes are known.
- Administration and Governance risks – failures in administration processes can lead to incorrect actuarial calculations. For example, where membership data is not up to date (e.g. leaver forms not being submitted in a timely matter) material inaccuracies in respect of the level of deficit and contributions may occur at future valuations.
- Resource and Environmental risks – i.e. risks relating to potential resource constraints and environmental changes, and their impact on Fund employers and investments: such risks exist and may prove to be material. Given the lack of relevant quantitative information available specifically relevant to the Fund, I have not explicitly incorporated such risks in this advice. The Administering Authority may wish to seek direct advice on these risks.