London Borough of Enfield

Report Title	Funding Position and Risk Update, Cashflow Forecast & 2025 Valuation Planning.
Report to	Pension, Policy & Investment Committee (PPIC)
Date of Meeting	31 July 2024
Cabinet Member	Cllr Tim Leaver
Executive Director / Director	Fay Hammond
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Key Decision Number	Non Key
Classification	Part 1 Public

Purpose of Report

1. This report provides an update on changes to the funding environment since the 2022 valuation, the risks currently faced by the London Borough of Enfield Pension Fund ("Fund") and the actions to be taken to help manage these risks as part of the 2025 valuation.

2. The report also 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 future strategic asset allocations. More details of each issue are included in the annexe to this report prepared by the Fund Actuary.

Recommendations

I. To note the contents of this report

Updated Funding position

3. The funding position of the London Borough of Enfield Pension Fund at 30 June 2024 is around **122%.** This represents an improvement in funding level from 104% at 31 March 2022.

4. 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?

5. 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.

6. 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.

7. 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.

8. At 30 June 2024, we now estimate that the Fund will achieve a future investment return of 5.5% pa (with a 80% likelihood of being achieved by the Fund's current investments). This is much higher than the assumed investment return of 4.4% pa at the 2022 valuation.

9. 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

10. 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:

- Investment risk
- Inflation risk
- Longevity risk

- Climate risk
- Cashflow risk

Investment risk

11. All assumptions (especially those on future investment performance) remain uncertain, especially during periods of increased market volatility. The funding position at 30 June 2024 is based on future returns with a 80% assumed likelihood of being achieved. In other words, there is still a 20% chance that returns will be lower than we assume. Fund officers will review prudence levels (i.e. the assumed likelihood of achieving returns) and the investment strategy at the 2025 valuation.

12. 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).

13. The Fund will review this strategy at the 2025 valuation, and as part of this review the Fund will consider the current levels of risk in the portfolio and the level of investment income needed for cashflows management.

Inflation risk

14. 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).

15. Although headline inflation has fallen recently, longer-term forecasts remain uncertain. Persistently higher inflation is a risk for pension funds. For example, if pension increases are 1% p.a. higher than we assume over the long term, this will reduce the funding level by around 20%.

16. 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.

Longevity risk

17. 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.

18. 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 if it holds any strong beliefs around future longevity improvements.

19. 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

20. 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.

21. Climate change scenario testing carried out at 2022 valuation within the LGPS typically showed quite modest impacts on future funding under most of the stresses applied.

22. 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. More 'extreme' narrative-based scenarios will be tested at the 2025 valuation to allow the Fund to understand the impact of catastrophic outcomes on funding strategies.

23. Ahead of the 2025 valuation, the Fund will review its approach to managing climate risk, including setting objectives, capturing views and believes and carrying out scenario modelling.

Cashflow risk

24. As set out in the Fund's Funding Strategy Statement, a main aim of the Fund is to *'ensure that sufficient funds are available to meet all benefits as they fall due for payment'*. To meet this aim, it is necessary to understand how the Fund's cashflow position is likely to evolve in the future.

25. Historically the Fund has been cashflow positive, with pension contributions received exceeding pension benefits paid. As the scheme matures the cashflow position can be expected to reverse leaving a day-to-day cashflow deficit that needs to be covered - as is the case for several other LGPS funds already.

26. 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.

27. Cashflow negativity should not be a concern for the Fund (as the assets held are ultimately there for paying benefits), however it does require more careful management.

Cashflow Projections

28. Attached at Appendix 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.

29. Under the baseline scenario the Fund is expected to become cashflow negative in the near future. Under this scenario the Fund would have an income requirement of approximately 0.6% per annum to remain cashflow neutral over the short to medium term (10-year assessment period).

30. The report also considers the impact of different scenarios for inflation and the impact of a reduction in employer contribution rates which shows that a higher level of investment income would be needed if inflation was higher or contributions were reduced.

Next Steps on Cash Flow

31. There are broadly two options for meeting a cashflow shortfall for the Fund; generating and utilising investment income, and/or periodic sales of investment assets.

32. 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 investment funds.

33. 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. In addition, the Fund would not want to be in a position where it is a forced seller of assets at inopportune times.

34. At the whole fund level, the current portfolio of assets generates an income yield of approximately 1% pa. This level of income would be sufficient to meet the cashflow requirements under the majority of the scenarios modelled. However, the impact of possible reductions in contributions and/or higher inflation in the future need to be monitored.

35. Given the recent changes to the strategic asset allocation agreed by the committee and new commitments made to these asset classes, the proportion of income generating assets that the Fund, has increased substantially. For example, infrastructure assets that yield income and private debt funds. As a result, the future income yield is likely to be significantly in excess of the current 1%. This would be sufficient to meet the cashflow requirements even in a high inflation scenario.

36. 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.

2025 valuation planning

37. 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.

38. 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.

39. The Fund will consider its views on the recent change in the funding environment when undertaking a review its investment strategy, including consideration of the appropriate level risk within the portfolio and future cashflow needs.

40. The Fund should consider how best to manage any employer surpluses within it’s funding strategy. Given the level of uncertainty within the key funding risks, the Fund may consider adopting a higher level of prudence. Alternatively a funding cushion could be used to protect against future volatility for example, targeting a funding position above 100% could help to manage longer-term affordability and stability of contributions.

41. 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.
- Carry out contribution rate modelling for long-term secure employers to inform budget setting, including consideration of alternative long-term investment strategies.
- 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.

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Appendices

Appendix 1: Cashflow projections

Background Papers

None