

Surrey Pension Fund

Actuarial valuation at 31 March 2022

Advice on assumptions

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For and on behalf of Hymans Robertson LLP



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A glossary of technical terms used in this report can be found in Appendix 5

Summary of recommendations

Assumption	Recommended approach	Comments
Future investment return assumption	Based on Hymans Robertson ESS model updated to latest market calibration	Asset class return expectations are generally higher than in 2019. This is due, in part, to an increase in inflation expectations since the 2019 valuation and reflects the natural inflation hedge included in the asset portfolio.
Discount rate	Can be increased from 1.8% to 2.2% above the risk-free rate at the same level of prudence.	No significant change in environment to suggest an increase or decrease in prudence levels, so an increase in the future margin above the risk free rate is justified and this would apply downward pressure on contribution rates.
CPI inflation (benefit increases / CARE revaluation)	Based on Hymans Robertson ESS model	Inflation expectations are slightly higher (c.0.2-0.3% p.a.) than 2019 due to current economic outlook
Salary increases	1% above CPI inflation (was 0.9% at 2019)	2022 proposed assumption in line with 2019 long-term salary increase expectations. However, at 2019, allowance was made for short-term expected pay restraint. Given recent increases in National Living Wage and reduced impact on pension liabilities from short-term pay expectations, recommend that no allowance is made for any short-term pay restraint.
Baseline longevity	Based on Club Vita analysis updated to reflect non-Covid related experience	Longevity assumptions are tailored to the Fund's experience and membership
Future improvements in longevity	Updated to CMI 2021 model with no weight on 2020/21 data with long term improvement of 1.5%	Latest version of CMI model is best practice but avoid projections being affected by short-term Covid-19 experience
Demographic assumptions (excluding longevity)	Adopt Hymans standard demographic assumptions	Based on LGPS wide experience – full information will be provide in the final valuation report



The valuation process



The valuation process



Assumptions advice
Now

Contribution rate modelling
Q2 2022

Funding Strategy Statement
Summer 2022

Employer results
November 2022

Valuation sign off
March 2023



Employer risk management
Q2 2022

Data provision
Summer 2022

Whole Fund results
Q4 2022

Employer discussions
Q4 2022 / Q1 2023



Assumptions advice

It's now time to set assumptions for the 2022 formal valuation, after taking advice from us as your Fund Actuary. As part of this process you need to make three main decisions:

1

Agree the prudence level
in the assumptions

2

Confirm approach and
choice of financial
assumptions (salary and
pension increases)

3

Agree the life expectancy
assumption, including
how much weight is
placed on recent years
affected by COVID-19

4

Agree all other
demographic assumptions

Why and how we set assumptions



Assumptions matter – projecting future benefit payments and assets

To determine the level of employer contributions we carry out two projections.

The **benefit projection** estimates the future payments that will be made to members, allowing for future pension increases, death and other events.

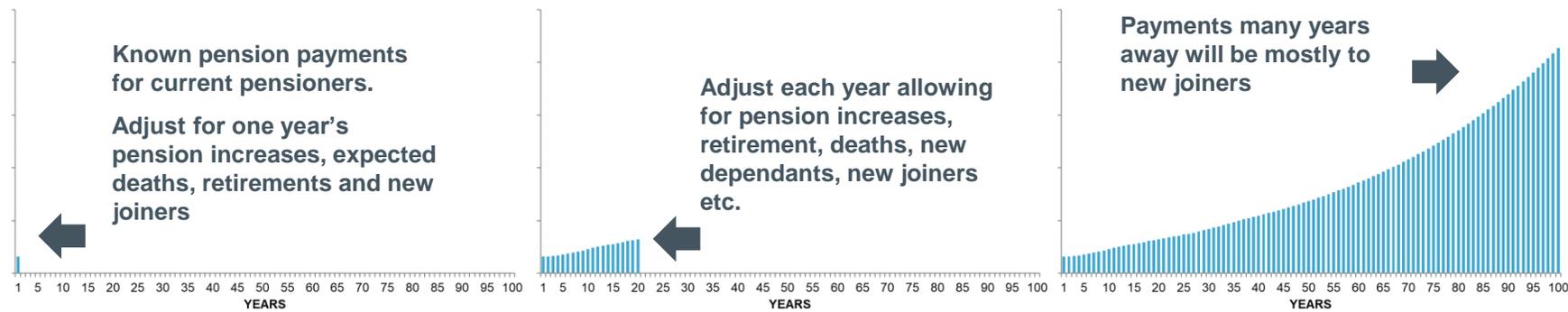
The **asset projection** takes into account future investment returns, contributions and benefits paid to members.

The contribution rates are set so at the funding time horizon, there are enough assets to meet future benefit payments in a sufficiently high number of future economic scenarios – the funding objective.

Because we can't see into the future, the projections mean working with uncertainty and require assumptions.

We review assumptions regularly to make sure they're relevant to the financial, demographic and regulatory environment.

Illustration: how we project benefit payments



Two types of assumptions:

1

Financial assumptions (like inflation) affect the amount of payments and asset values.

2

Demographic assumptions (like how long members live) affect the timing of payments.

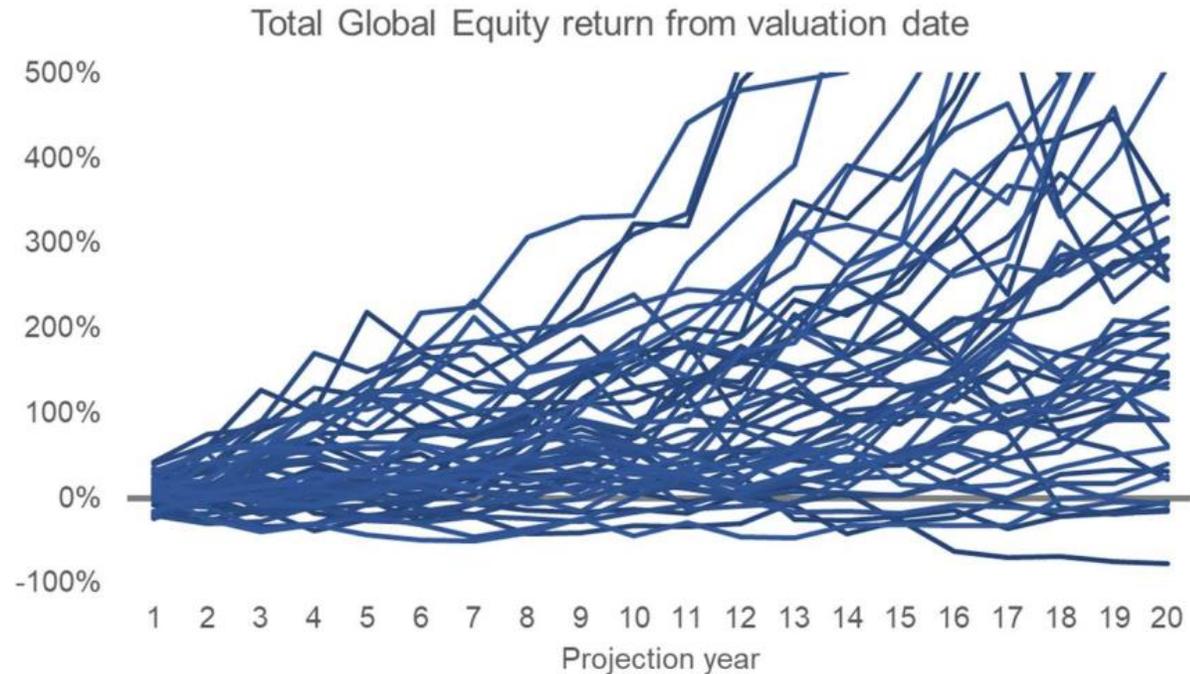
Assumptions and our valuation approach

We use a “risk-based” approach to calculating the benefit and asset projections.

Under this approach, we use an economic scenario generator (Hymans Robertson’s proprietary generator is called the Economic Scenario Service – ESS) to produce 5,000 different simulations of future economic conditions and associated assumptions.

The assumptions in each scenario vary by year i.e. they are not ‘flat’, so they are a better representation of reality than a single, linear assumption.

The chart shows a sample of the 5,000 simulations for future cumulative total returns on global equities over the next 20 years.



This approach allows the generation of a distribution of future benefit and asset projections so all stakeholders in the Fund can better understand risk.

What assumptions are needed

Assumption	Description	Required for
Financial assumptions		
Future investment return	Projected annual returns and volatility on asset classes invested by the Fund e.g. UK equities, property etc.	Asset projection – to project employers’ asset shares to the end of the funding time horizon
Discount rate	Annual rate of future investment return that will be earned on the Fund’s assets after the end of the funding time horizon	Funding objective – to place a present value at the end of the funding time horizon of the future benefit payments
CPI inflation (benefit increases / CARE revaluation)	Future Consumer Price Index inflation	Benefit projection – to determine the size of future benefit payments (LGPS benefits are index-linked to CPI inflation)
Salary increases	Future inflationary salary awards	Benefit projection – to determine the size of future benefit payments (the pre-2014 final salary benefits are linked to salary) Asset projections – to determine future payroll values (and hence contribution income)
Demographic assumptions		
Baseline longevity	How long we expect members to live based on current observed death rates	Benefit projection – to determine how long each member’s benefits are paid for
Future improvements in longevity	How death rates are expected to change in the future (historically life expectancy has improved over time)	Benefit projection – to determine how long each member’s benefits are paid for
Other demographic events	Events such as retirement age, rate of ill health retirement, level of commutation and 50:50 take up	Benefit projection – to determine the size and timing of future benefit payments



How we review and set assumptions

Our approach

1. **Look at the assumptions from the last valuation**
2. **Review evidence and consider the landscape:**
 - Changes in financial/economic conditions
 - Regulation and guidance
 - Population and general pension scheme statistics
 - Fund specific data and experience, especially members' demographic characteristics
 - Future trends
 - Assessment of employers' financial strength
 - Investment strategy
 - Fund views – and employer views in some cases (e.g. salary increases)
3. **Propose, discuss and agree changes to set new assumptions**

Acknowledging uncertainty

There is no certainty about how the future may evolve and it is important to acknowledge this uncertainty during the valuation. Understanding the impact of the future deviating from the assumptions on funding levels and contribution rates is an important aspect of how the Fund manages risk.

Ways of understanding the impact:

- **Stress testing** – measures immediate changes in assumptions by testing alternatives at valuation date. We will stress test the longevity assumptions as part of the valuation.
- **Risk-based modelling** – risk-based approach involves projecting a wide range of possible future outcomes. There is no single figure for an assumption – instead, we work with a future range. We use a “risk-based” approach to calculate the benefit and asset projections and set the underlying financial assumptions.
- **Scenario projection** – considers future projections across different scenarios, bringing together relevant factors for a better understanding of overall impact. We will use different climate change scenarios at the valuation to help you understand this risk.

Most assumptions are a best estimate, set objectively without margins for adverse experience. A prudent discount rate assumption meets the requirement (from LGPS guidance) for a ‘prudent’ valuation.



Other factors affecting assumptions at the 2022 valuation

Climate change

Climate change will affect many aspects of the Fund's assets and liabilities, for example the return on its assets, the inflation used to revalue benefits and the longevity of its members. The uncertainty around future climate pathways and their impact means that it is impossible to factor climate change considerations meaningfully into every assumption described in this paper.

We will however consider climate change scenarios when setting the long-term longevity improvements assumption, and the Fund will consider climate risk in its funding strategy by testing the resilience of the strategy in three climate scenarios.

Possible benefit changes

McCloud

Benefits accrued by certain members between 2014 and 2022 may be increased in future following the outcome of the McCloud case, which ruled that transitional protections introduced in 2014 to older members were discriminatory. We will make an allowance for the cost of these potential improvements in the 2022 valuation, based on the assumptions agreed here (in particular the salary increase and withdrawal assumptions). The impact is expected to be minimal for the majority of employers.

Cost sharing mechanism

Benefits could also change as a result of the 2016 and 2020 "cost cap" valuations, neither of whose outcome has been completely confirmed. If new assumptions are necessary to value any potential changes we will agree these separately.

Guaranteed Minimum Pension equalisation and revaluation

As per our approach for the 2019 valuation, we will assume that the Fund will fund all increases on GMP for members with a State Pension retirement date after 5 April 2016.

Other legal cases

Benefits could change as a result of other legal challenges (e.g. the "Goodwin" case affecting partner pensions), but at present we do not believe any additional assumptions are needed to value these.

Financial assumptions



Financial assumptions

Approach to setting financial assumptions

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1. Hymans' proprietary economic model, the Economic Scenario Service (ESS), is used to generate 5,000 different simulations of the future
2. ESS generates a range of future benefit and asset projections so stakeholders can better understand risk (hence "risk-based" approach)
3. Projections allow for different levels of inflation and returns across all asset classes
4. No single assumption for future investment returns or inflation

Comparison with 2019

Here are how some of the main ESS assumptions have changed since 2019. Full details are in Appendix 1

Assumption	31 March 2019	31 March 2022
CPI inflation	2.2%	2.7%
Global equity returns	5.8%	6.2%
Index-linked gilt returns	0.3%	0.1%
Corporate bond returns	1.9%	1.5%

Figures are median annualised values over years 0-20. ILGs and Corporate Bonds are medium duration, the latter is A rated.

The outlook for inflation is worse compared to 2019, however the outlook for return seeking assets has improved

Key decision

A discount rate is needed to place a prudent value on the benefit payments due after the funding time horizon. This value determines each employer's funding objective. The level of prudence is a key funding decision.

The discount rate is set relative to risk-free rates so that it varies according to the economic conditions in each of the 5,000 projections.

Investment return and future discount rate assumptions

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<p>2019 approach</p>	<ul style="list-style-type: none"> • Investment return assumptions: Risk-based approach to generate future investment returns, based on Fund’s investment strategy • Future discount rate assumption: Assumed future investment returns are generated for each asset class from the ESS and combined into an overall portfolio return • At the 2019 valuation, the future discount rate was set equal to 1.8% above the risk free rate.
<p>Considerations</p>	<p>Maintaining the same discount rate assumption</p> <ul style="list-style-type: none"> • The prudence level is the likelihood of the Fund’s investment strategy achieving the desired excess return over years 20-40 • At 2019, there was a 70% prudence level associated with a future discount rate based on the risk free rate plus 1.8 p.a. • As at 31 March 2022, the same future discount rate assumption (risk free rate plus 1.8% p.a.) is now associated with a higher prudence level of 75% • As the prudence level has increased it would be acceptable to retain this future discount rate assumption, however maintaining the same level of prudence (70%) would lead to a higher future discount rate assumption. <p>Maintaining the same prudence level</p> <ul style="list-style-type: none"> • To maintain the same level of prudence, we have tested the level of return above gilts that has a 70% prudence level • The resulting discount rate would be 2.2% above the risk-free rate. • It would therefore also be acceptable to increase the future discount rate assumption to this level. This would be a consistent application of prudence at the 2022 valuation (relative to that as at the 2019 valuation).

RECOMMENDATION:

Continue to use the ESS to generate future investment returns

Increase the future discount rate assumption to 2.2% p.a. above the risk-free rate.

IMPACTS:

The money you are aiming to hold to meet benefit payments and the target for investment return

SIGNIFICANCE:

Increasing the assumed future discount rate by 0.4% p.a. will reduce assets you are aiming to hold by around 8%



The investment strategy used in our analysis is set out in Appendix 2

Benefit revaluation and pension increases

2019 approach	Benefit projections were assumed to be in line with CPI projections from the ESS model
What's changed since the previous valuation?	Increased inflation expectations, perhaps due to a combination of government actions during Covid-19 pandemic, Brexit-related supply pressures and/or energy & food related supply pressures arising from the conflict in Ukraine.
Proposed approach for the 2022 valuation	No change in approach, but use updated ESS calibration reflecting current market outlook in the short-medium term

RECOMMENDATION:
CPI inflation will be derived from the updated calibration of the ESS model

IMPACTS:

The increase applied to benefits each year

SIGNIFICANCE:

Increase in assumed future inflation will increase inflation linked liabilities

Salary increases

2019 assumption	CPI + 0.9% pa, plus a promotional salary scale We will only consider the inflationary element here
2019 approach	At the 2019 valuation, the assumption for 'inflationary' increases was based on an underlying assumption of short-term pay restraint (3.0% to 2023) followed by long-term increases in line with CPI inflation + 1.0%. After allowing for the expected run-off of the Fund's final salary (pre-2014) linked benefits, this gave an assumption of CPI + 0.9%.
Things to consider	<p>Run off of final salary liabilities: it is expected that this will be more gradual than at previous valuations and therefore the impact of any short-term pay restraint is negated</p> <p>McCloud remedy: many members' benefits earned between 2014 and 2022 will retain a link to final salary, further negating the impact of any short-term pay restraint</p> <p>Impact of Covid-19 on budgets: the impact of the pandemic on public and private sector finances may mean lower future salary increases</p> <p>National living wage increases: recent years have seen an above inflation rise in the National Living Wage (NLW) and an increasing number of employers adopting this as their minimum wage. Although the NLW is aimed at the lowest paid, these recent increases will put pressure on salary rates across the whole workforce as employers may feel the need to keep the increments between staff consistent to adequately reward those with more responsibility or experience.</p>

RECOMMENDATION:
No allowance made for short-term restraint with no change from 2019 long-term assumption
CPI + 1.0% pa (plus a promotional salary scale)

IMPACTS:

- The benefits paid to members with service earned prior to 31 March 2014
- Payroll projections used for contribution modelling
- The estimated cost of the McCloud remedy

SIGNIFICANCE:
Less significant than in previous valuations

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Reporting the funding level

As well as setting contributions, a key output of the valuation is a measurement of past service liabilities at the valuation date itself to determine the funding level.

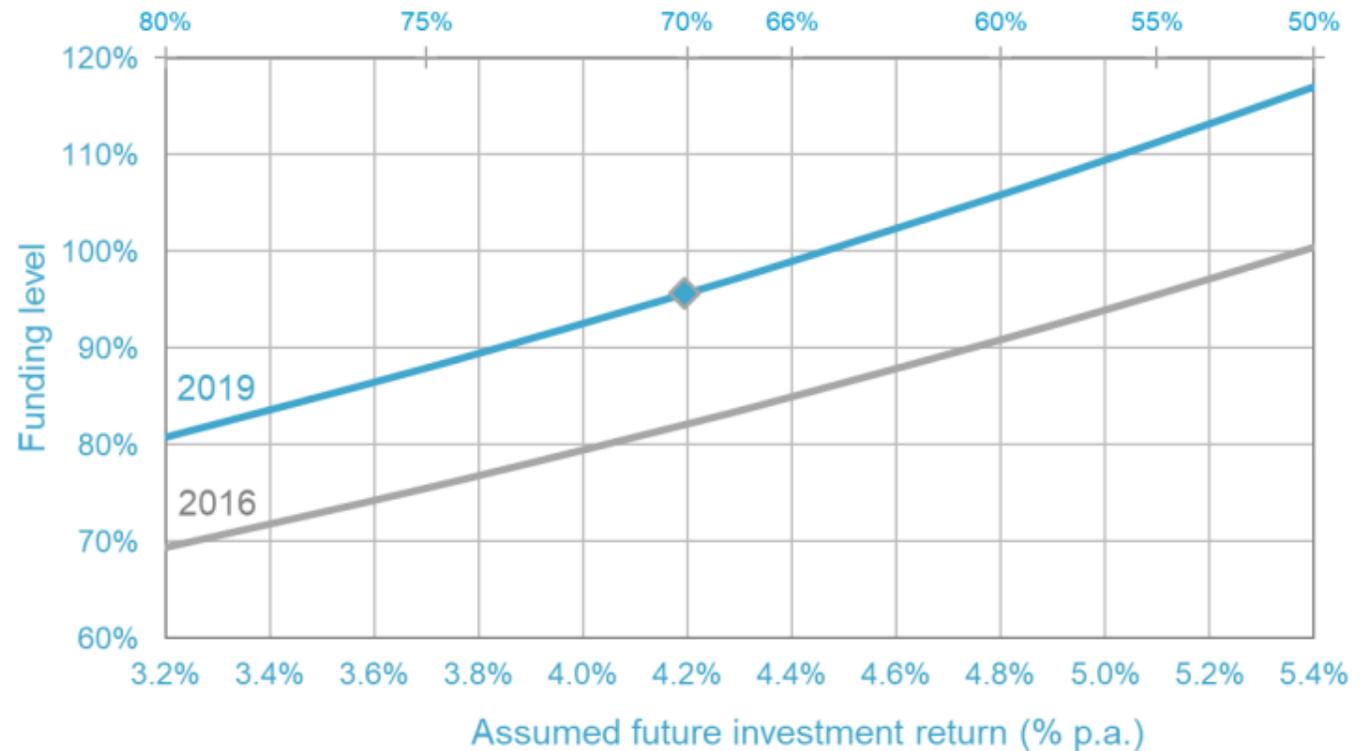
To report a funding level, we need to use a single value for each assumption (compared to the risk-based approach used for contribution rate setting).

To ensure consistency between the reported funding level and employer contribution rates, we still use the ESS to derive the assumptions used to report the funding level. These assumptions are summary statistics of the 5,000 individual simulations used to project forward assets and benefit payments when setting contributions.

At the 2019 valuation, we showed how the funding level at the valuation date varied with the choice of future investment return and the likelihood of the Fund’s assets yielding at least a given investment return (based on the ESS simulations).

This was all detailed in this chart. A similar chart will be shown in your 2022 valuation preliminary results report.

Likelihood of achieving the assumed future investment return over 20 years (from the 2019 valuation date)



Assumptions for reporting the funding level

2019 approach

Funding level was reported using an assumed investment return assumption of 4.2%, which had an associated prudence level of 70%
 Pension increases were based on market-implied RPI inflation minus 1% p.a.

Proposed approach for the 2022 valuation

In general the approach is the same as already discussed, except that instead of 5,000 projections we choose a single value from those projections as follows:

Assumed investment return

Use the same approach as in 2019 with the same prudence level as used for the discount rate, i.e. 70%. This gives an assumed investment return of 4.4%

For information, the likelihood of achieving returns of at least 4.2% pa over the next 20 years is 73%.

Pension increases

Use the median projected CPI inflation from the ESS over the next 20 years (equivalent to 2.7% p.a. as at 31 March 2022). This is an increase from 2019 (and is due to the factors outlined on page 16).

Salary increases

Assume salary increases of 1.0% p.a. above median projected CPI as mentioned above

RECOMMENDATION:

Use prudence level of 70% for the assumed investment return, and assume pension increases in line with the median projected CPI inflation from the ESS

IMPACTS:

Reported funding level.
 Does not affect contributions.

SIGNIFICANCE:

For reporting and tracking the funding level only





Longevity assumptions

Breaking it down

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Your longevity assumptions

How long you expect to pay a pension to each member and their dependants.



Baseline

- A snapshot of how long people currently live
- Measured **objectively** based on recent mortality data
- Use Club Vita analytics for a **tailored best estimate** based on members' characteristics
- Reflects that people with certain characteristics tend to live longer (women, non-ill-health retirees, higher affluence, non-manual workers)



Future improvements

- How life expectancy increases over time
- Shorter-term expectations reflecting recent trends
- Longer-term expectations reflecting historical trends **plus** evidence that improvements may be higher or lower than historical trend
- **Subjective** – wide range of possible outcomes

Evidence based baseline + informed future judgement

Baseline

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2019 approach	Club Vita tables tailored to fit each individual member of the Fund
What's changed since the previous valuation?	Current assumptions capture the unique mix of people in your scheme using experience across the Club Vita database of similar individuals to identify a baseline longevity assumption for each member. But new evidence on longevity emerges yearly. Since your last valuation more data has been gathered and VitaCurves have been updated.
Proposed approach for the 2022 valuation	Adopt the latest member-specific Club Vita base tables – a consistent approach that captures a more up-to-date experience. We will make an appropriate adjustment to recent data to avoid the assumption being skewed by excess deaths due to Covid-19 in 2020 and 2021
Other comments...	The Covid-19 pandemic has unfortunately resulted in increased morbidity and death since 2020. It is likely that we will see higher than expected death experience since the 2019 valuation. This will result in a decrease in liabilities as the Fund will be paying out less pension than expected. However, our initial estimates for a typical LGPS fund suggest that the reduction in liabilities due to the higher number of deaths will only be a decrease of 0.1-0.2%

RECOMMENDATION:
Latest member-specific Club Vita mortality base tables, adjusted to avoid being skewed by Covid-19.

IMPACTS:

How long you expect to pay a pension to each member and their dependants.

SIGNIFICANCE:

Small change in base table to reflect up-to-date experience

