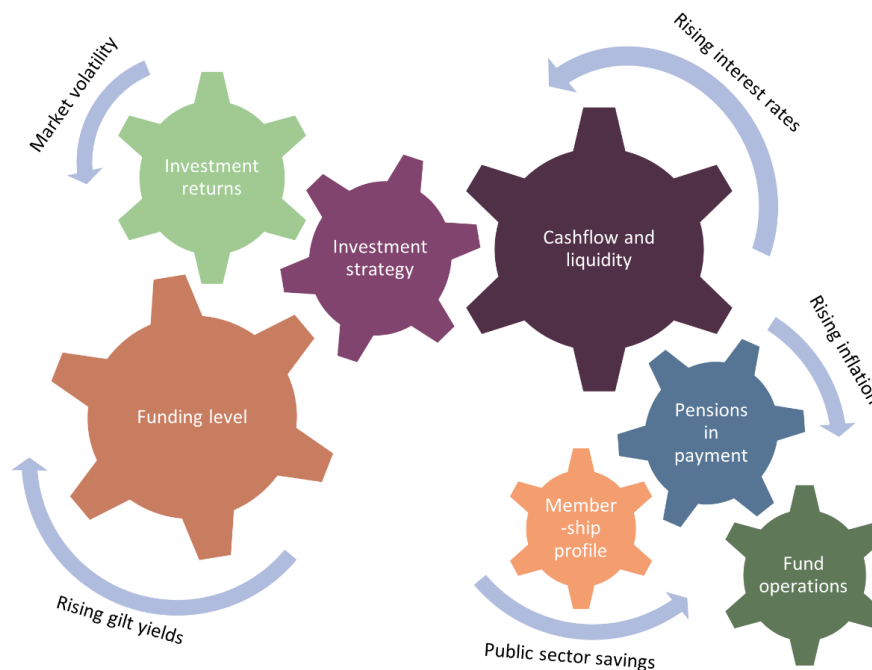


The cost-of-living crisis, and the impact on WPF



Introduction

2022 has seen some extreme market conditions. Inflation has been rising, mainly driven by increases in the price of food and energy. Reasons for this have been pent up post-pandemic demand, further compounded by the invasion of Ukraine, which has meant that supply of energy from Russia has been restricted, as well as reductions in the amount of grain exported from Ukraine. This has led to rising interest rates as the Bank of England attempted to control inflation back to its long-term target of 2%.

The UK mini-budget in September 2022 announced large unfunded tax cuts, leading to a complete loss of confidence by investors. Sterling fell, and gilt yields rose dramatically. The International Monetary Fund took the unprecedented step of writing to the chancellor expressing concern, and the Bank of England stepped in with temporary quantitative easing measures to stabilise the situation. Pension funds were making the headlines due to the impact that this situation was having on them. Many of these measures were reversed in the Autumn Statement, but the environment remains challenging. Local authorities and most public sector services will need to make significant cuts to balance their budgets.

The cost-of-living crisis affects Wiltshire Pension Fund across the entire fund. Perhaps the area of biggest concern is the influence that the differing pressures in this situation will have on cashflow, and the consequent demand for liquidity. This paper examines the impact of the cost-of-living crisis on the following areas:

- Investment performance and strategy
- The funding level
- Administration issues and the fund's membership profile
- Cashflow
- Communications with stakeholders
- Operations and resourcing

Why look into this topic?

The Fund's vision is to deliver an outstanding service to our scheme employers and members. The current situation could affect multiple stakeholder groups, so we need to attempt to identify where the largest impacts will be seen, and consider what we can do to mitigate against them. The following strategic vision goals are particularly relevant:



For public sector employers during a period of recession and facing spending cuts and rising costs, maintaining stable and affordable contributions is essential to manage budget costs and plan for the future.



Employers need to be aware of the 50:50 option and levels of uptake, as well as levels of opt-outs, to allow employees to manage the cost of contributions. It is important for employers to be aware of the secure inflation-linked benefits available for their employees, as a significant part of their remuneration package at a time when it may be challenging to provide pay increases in line with inflation.



Members in receipt of a pension can be assured that their benefits are linked to inflation, meaning their pension will increase in line with prices, and this inflation link is also provided for active and deferred members who may not realise their accrued benefits are increasing in this way, protecting their future benefits. The impact on annual and lifetime allowances needs to be understood.

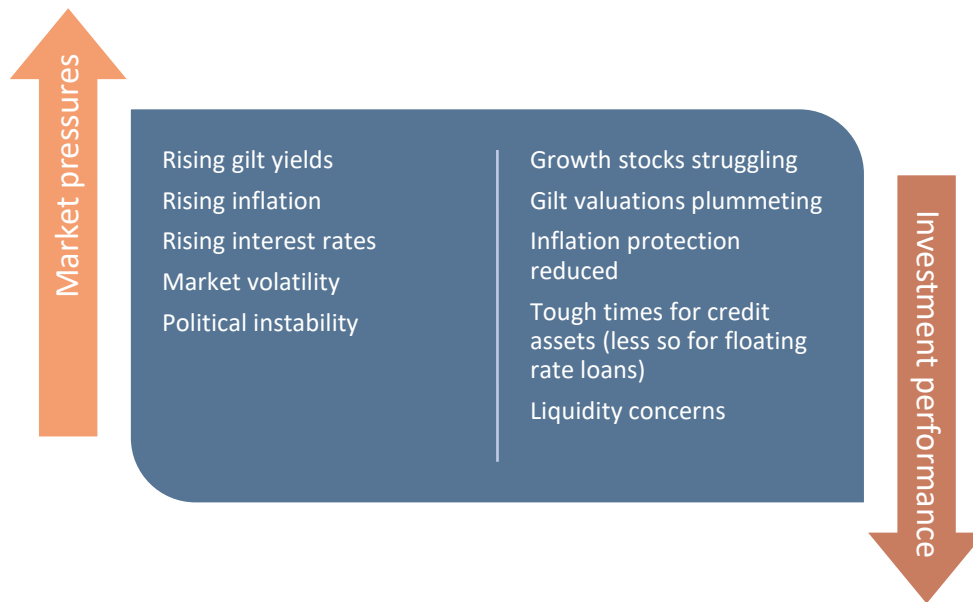


Maintaining a well-diversified investment portfolio and assets with inflation linkage to ensure investment returns are maintained. Monitoring the markets and ensuring managers are working well to maintain and protect investment returns.



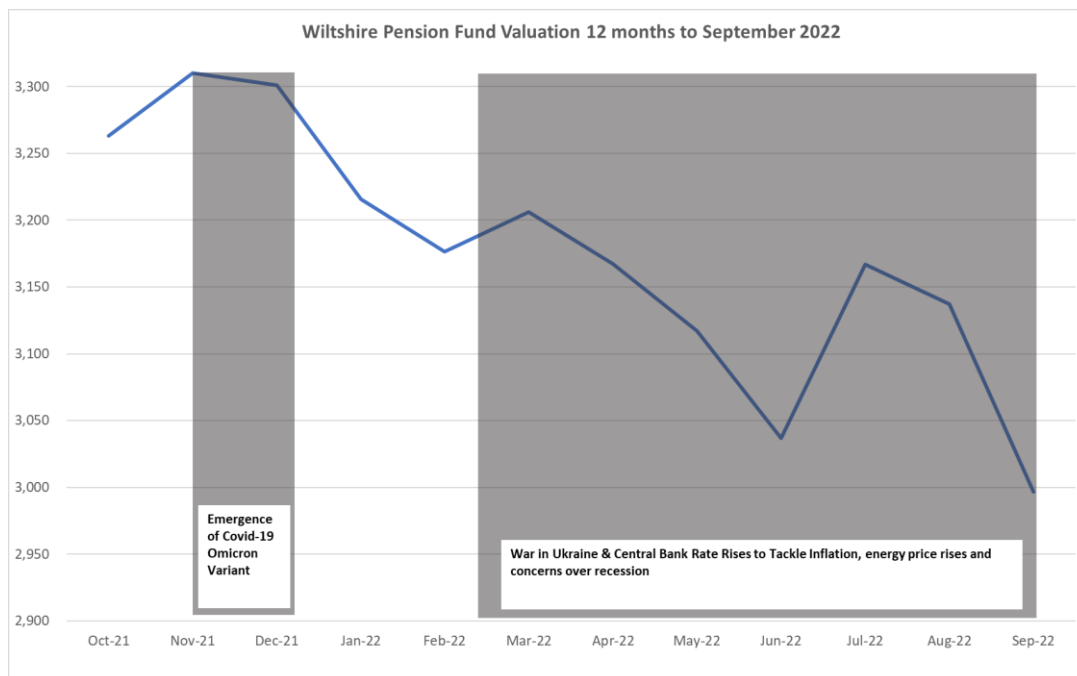
The Fund's value of **long term thinking** conveys our approach to assessing risks and planning ahead. As a signatory of the Stewardship Code 2020, the Fund needs to assess how effective we have been in serving the best interests of our beneficiaries (principle 1), and take account of beneficiary needs and communicate activities and outcomes to them (principle 6). This paper addresses both these points.

Investment Impact



Investment Returns

In the 12 months to the end of September 2022 (Q3) the fund achieved an investment return of -6.1%, this has been -6.3% behind the fund's consolidated benchmark performance. This has seen the fund total value decline from a peak of £3.3bn to just under £3.0bn. Rapidly rising inflation, global economic uncertainty, and central banks raising interest rates in an attempt to bring inflation back under control have been key components determining this investment performance.

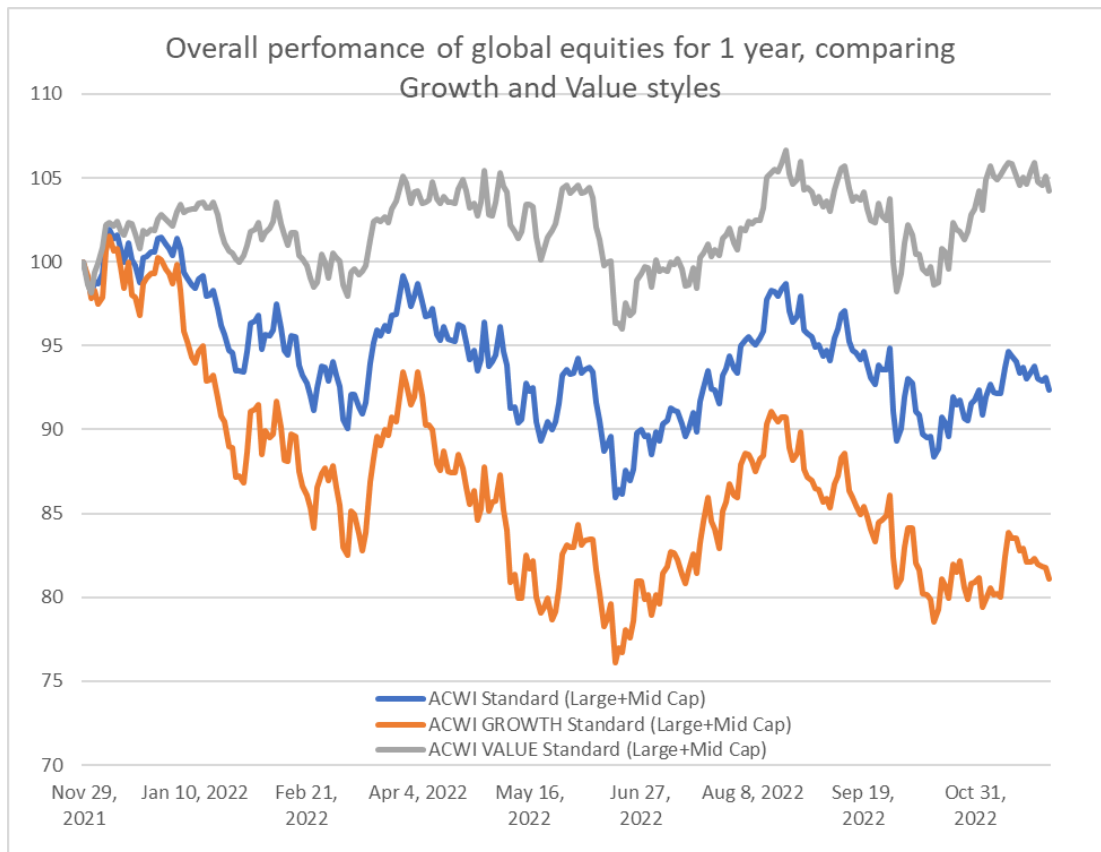


Equities

A key reason for the underperformance versus the benchmark has been the relative performance of the Fund's equity holdings. The Fund's active equity portfolios generally have a growth style bias, favouring companies who have strong growth prospects and whose value is derived from

discounting potential future earnings. The valuation of these companies is sensitive to changes in interest rates, and as interest rates have risen to combat inflation the valuation of growth stocks has declined over the past year.

Over the same period value style stocks have performed much better, being less sensitive to interest rates and containing many fossil fuel producers who have benefited from high oil and gas prices. The following table shows the relative performance of growth and value stocks for this period, with value outperforming growth by 12%.

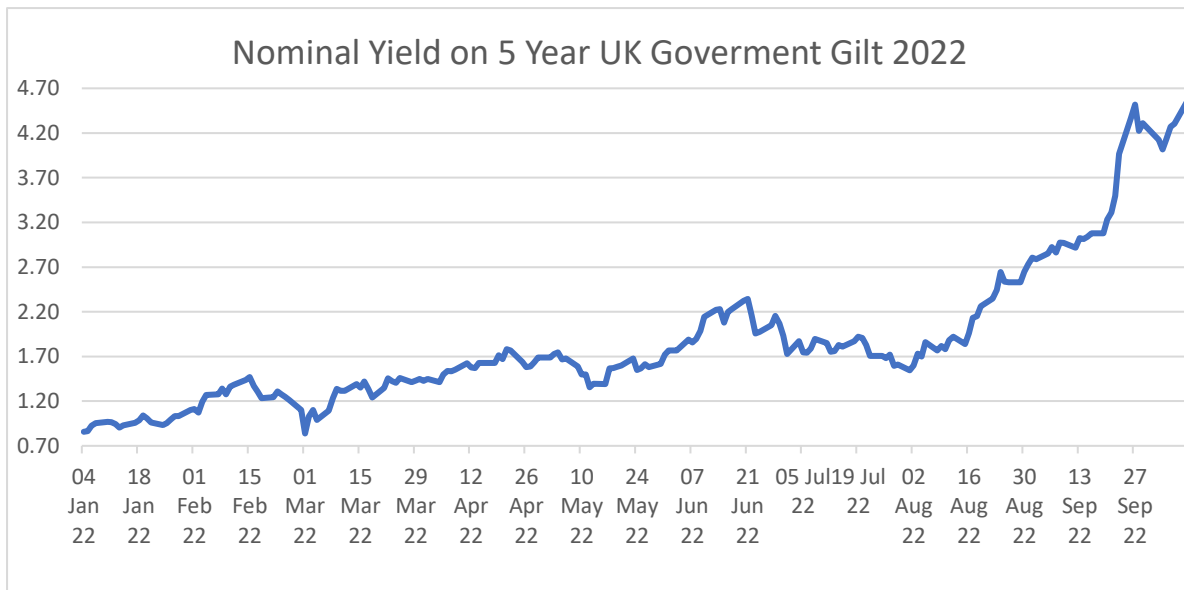


The fund is a long-term investor and has benefited from the relative outperformance of growth stocks over an extended length of time preceding this period, we remain committed to our investment strategy, employing managers with a long-term focus for investment returns. The shift to higher inflation and the revaluation which has been incurred for growth stocks means in the future there may become less of a distinction between the two styles and more of a focus on company fundamentals and quality style stocks.

Gilts

The fund holds investments in >5-year duration index linked gilts, the long-term allocation to this asset class is 7% of the fund. These assets are chosen for their characteristics which broadly match the fund liabilities, being inflation linked and held in sterling. With the rapid changes in interest rates and market volatility in the UK partly caused by changing government fiscal policy, these assets have undergone a significant reduction in value over the past 12 months. The WPF Gilts portfolio has returned -29.4% over the 12-month period to the end of September 2022.

The nominal yield on 5 years gilts (which is inversely related to value) has risen by almost 4% from the start of the year. The following graph shows how quickly this has risen in August and September 2022.

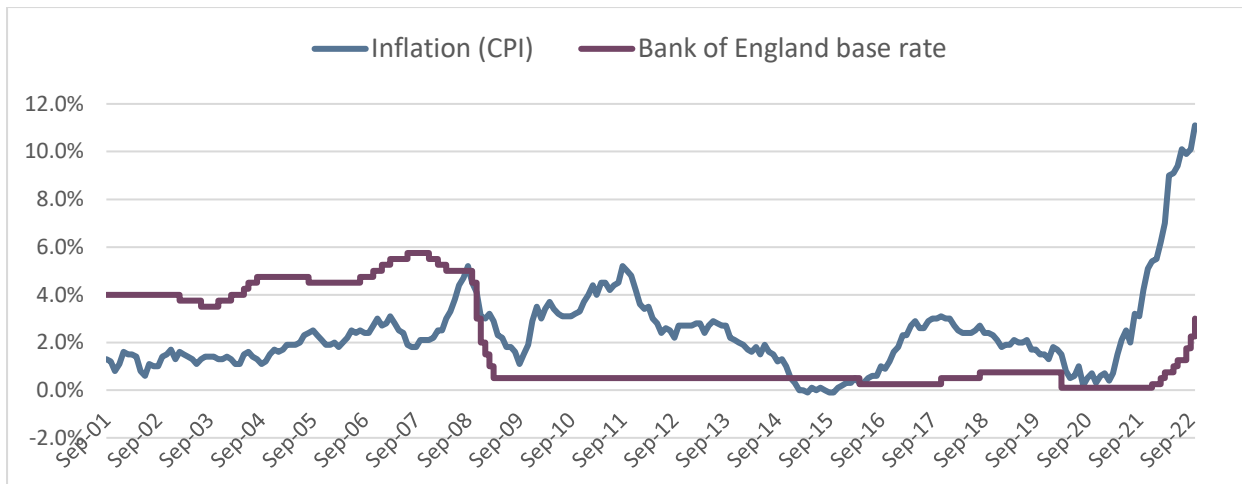


The fund has been diversifying away from holding a large proportion of the fund in this asset class. In March 2020 the long-term allocation to Gilts was 25%, this reduced to 15% with a new allocation to Secured Income made in June 2020. This further reduced to 7% in December 2021 with new portfolios for Affordable Housing and Renewable Infrastructure / Climate Solutions being added. These new portfolios will provide many of the beneficial properties of Gilts, delivering sterling, index linked returns whilst also providing further diversification.

The fund is further diversified through its allocation to global leveraged loans, these assets have performed better than most other credit asset classes throughout the past year. The floating interest rate returns provide protection against rising interest rates making these assets appealing as central banks raise rates. The outlook for this asset class is tempered by a potential for rising defaults in a recessionary environment, but the fund has selected a defensive manager whose skill in loan selection and strong risk management framework should allow it to provide enhanced returns.

Inflation

The inflation measure in September is a key statistic for the LGPS as it determines revaluation of accruing pension liabilities (for active and deferred members) and increases to pensions in payment (for pensioners) the following April. This is designed to ensure benefits keep pace with prices and the cost of living. As can be seen in the chart below, most years inflation figures have been unremarkable.

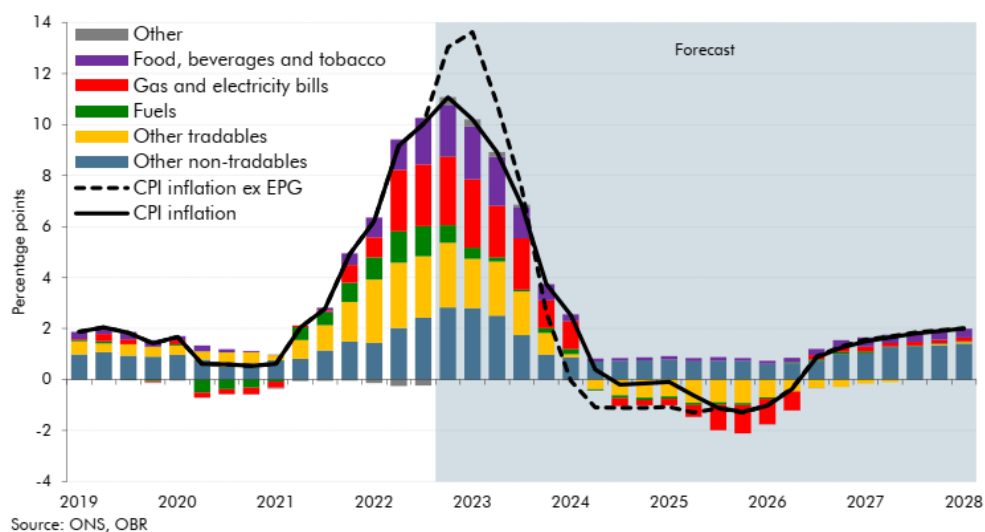


The *rate of change* of inflation has been particularly alarming in 2022. Over the past decade, interest rates have been low. A combination of factors; fiscal and economic policies, the war in Ukraine, energy price crisis and in turn, the cost rises for food, has resulted in a significant spike. Longer term forecasts are for inflation to revert to lower levels, but in the meantime there significant risks that the Fund will need to monitor and manage.

What this could mean for the Fund is an increase of 10.1% to pension outgoings. Without an increase to active membership, and with active members on lower rates of pay in real terms, the cashflow (excluding investment income) of the Fund may become negative.

The following chart shows the exceptional recent rise in inflation and the key components of the increase, gas and electricity costs have been a significant factor and have fed through into all other components. This forecast from the OBR shows the latest expectation that inflation will have peaked at the end of 2022, then as a result of fiscal policy inflation will decline throughout 2023.

Chart 4: Contributions to CPI inflation



Note – EPG = energy price guarantee

Affordable Housing – a case study into affordability in the current climate



The impact affordable housing portfolio objective is to provide measurable social impact in addition to competitive market returns. Returns will be primarily driven by rental income, with inflation-linked uplifts, with a smaller component of capital appreciation.

However, there is a fine line between continuing to collect inflation-linked rents, and pricing tenants out of the market. This has both a social impact (i.e. the goal of the portfolio is to provide affordable housing, so this needs to be maintained), and a purely financial impact (i.e. if tenants are unable to meet payments and are defaulting, this damages returns). This was discussed with the managers at the time they were appointed, and we were reassured by their approach to assessing long-term affordability for tenants. However, in an environment with rising inflation, this does mean that in the short term, the inflation protection of this portfolio is reduced.

The [Autumn Statement](#) contained a cap in rent rises of a maximum of 7% in 2023-24. The cap is intended as a temporary measure to provide stability as inflation rises and aims to strike a balance between protecting tenants and ensuring that income is available for repair and maintenance of existing stock and for new developments.

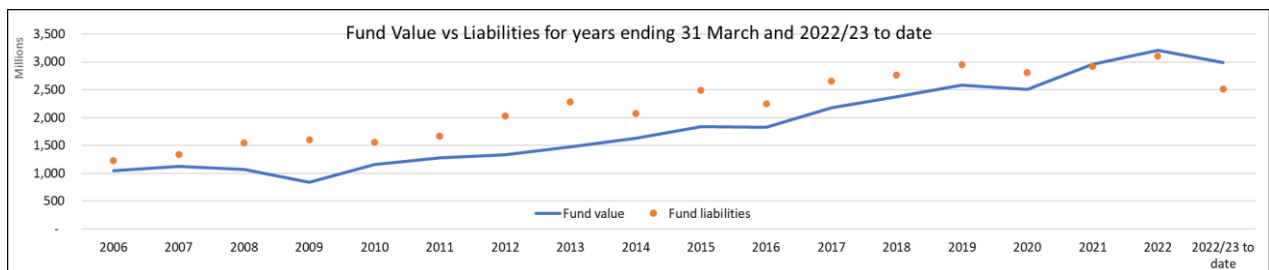
From our discussions with the individual managers, circumstances vary, but we are reassured that the **managers are taking a balanced view of affordability for tenants vs achieving returns**, and are focussed on long-term financial sustainability for both parties.

Funding and Actuarial Impact

Since the start of 2022, global economic volatility, rising inflation, the war in Ukraine and subsequent rising interest rates have led to a decline in the value of assets for Wiltshire Pension Fund. Valued at just over £3.3bn at the start of 2022, the investments have fallen to just over £3bn at the end of October 2022.

Whilst suffering a decline in asset values the rise in gilt yields has been the dominant factor in the movement in the funding level (i.e. what proportion of discounted future liabilities are covered by the Fund's assets). This is because the rate used to discount the liabilities to an equivalent value in today's money is based on gilt yields.

The charts below show the significant impact this has had on reducing the present value of the future liabilities. The rising yield on gilts has the effect of reducing the current value (the amount of money needed today) of the future liabilities (the pension obligations the fund must pay in the future).



What's changed since the last valuation?

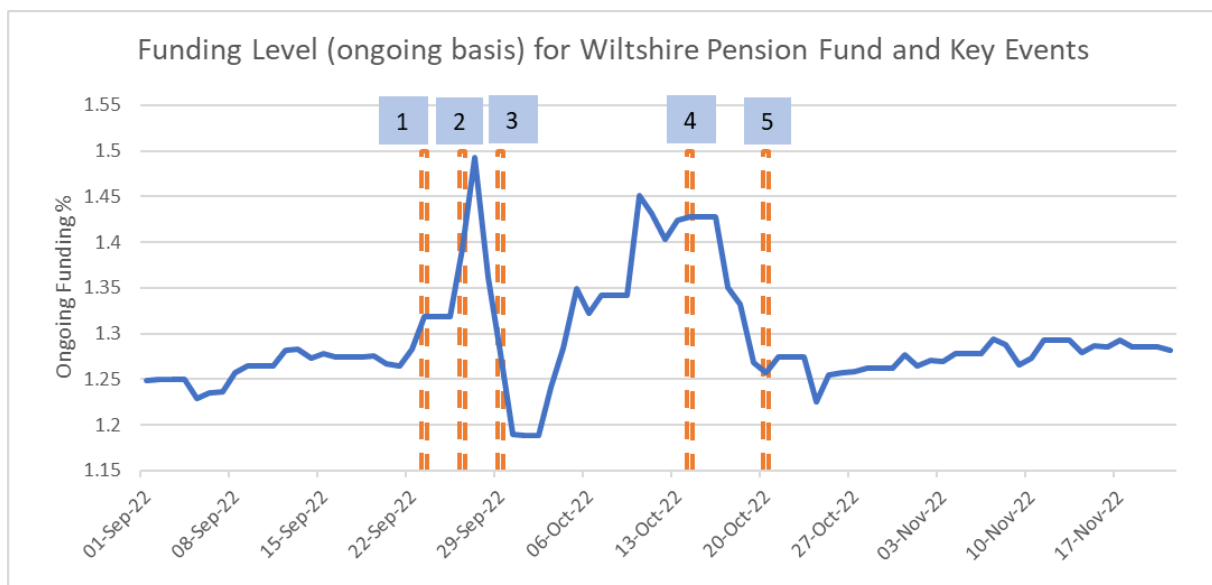
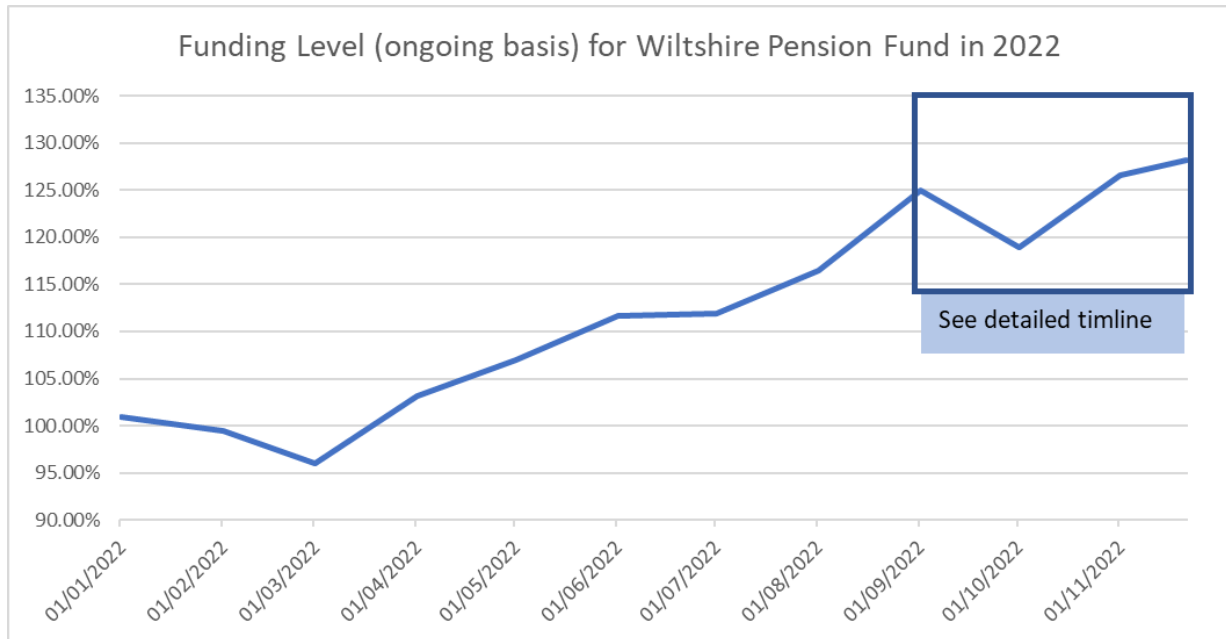
From: To:

Liabilities	£m	Assets	£m
Liability value as at 31 December 2021	3,270.5	Asset value as at 31 December 2021	3,301.3
Cost of benefits accruing	84.9	Contributions paid in	83.8
Benefit payments	(84.1)	Benefit payments	(84.1)
Interest on liabilities	107.1	Expected return on liability-matching assets	118.2
Impact of change in yields & inflation	(968.5)	Excess return on assets	(341.2)
Liability value as at 31 October 2022	2,409.9	Asset value as at 31 October 2022	3,078.1

Surplus/(deficit)	£m
Surplus/(deficit) as at 31 December 2021	30.8
Contributions (less benefits accruing)	(1.1)
Interest on surplus/(deficit)	11.1
Excess return on assets	(341.2)
Impact of change in yields & inflation	968.5
Surplus/(deficit) as at 31 October 2022	668.1

(Data provided by Hymans-Robertson)

Since the start of 2022 the overall funding level has continued to improve due to rising interest rates and associated gilt yields. The 2-month period from the start of September was exceptionally volatile due to political events in the UK. The following graphs show the key events which effected the funding level.



1. 23rd September 2022 - Mini Budget Delivered
2. 26th September 2022 - BoE announced it wouldn't hesitate to increase rates and the chancellor said a medium-term plan would be published in 2 months' time.
3. 29th September 2022 - BoE implement support for Gilts through purchasing
4. 14th October 2022 - Kwasi Kwarteng resignation
5. 20th October 2022 - Liz Truss resignation

Employer Contribution Rates



With affordability and budget challenges in mind, contribution rates for our two largest employers, Wiltshire Council and Swindon Borough Council, have been temporarily reduced over the next 3 years as follows:

23/24: reduction of 1%

24/25: reduction of 1%

25/26: increase of 1% and then to move to stabilisation policy reviews (a part of the funding strategy which permits the possibility of future rate rises/decreases of 1% maximum per annum).

This has been possible on the back of strong investment returns over the last valuation period and an improved funding position, and due to the stabilisation policy, the Fund's overall likelihood of success for long-term funding has been maintained. This helps to support affordability for these employers at a time of financial pressure on public services.

Employer Cessations

An important point regarding the extreme movement in gilt yields over the year, is how this impacts on employer cessations. Two employers in the Fund (one large, with liabilities of around £100m, and one much smaller) ceased at the end of September 2022. These cessations have been discussed for a long period of time, with the employers concerned about how to manage the cessation debt due, and lengthy negotiations around payment plans and security over assets. However, as shown above, during 2022 the funding level of the Fund (and these two employers within it) has improved materially, and the cessation debt for both employers has reduced by a very material amount. Final calculations are currently being performed by the Fund's actuary.

For employers with no guarantor (such as the two mentioned above), cessation valuations are currently calculated on a "low-risk basis", i.e. assuming that the entirety of the employer's assets is invested in gilts. Going forward, the Fund will be moving to a basis which, like the triennial valuation, looks at 5,000 modelled outcomes, with a high prudence level (i.e. funding success will need to be achieved in a high percentage of modelled outcomes).

Rather than setting a specific likelihood of success, a corridor will be introduced with cessation deficits/surpluses only being due if the final cessation funding position sits outside of that corridor (and it will only be necessary to make or receive payments to reach the boundary of the corridor rather than the centre). The corridor will provide a bit more certainty and reduce down the volatility of these exit positions, and it will reduce down the size of deficits/surpluses, as they would only need to reach the edge of the corridor.

Cashflow Impact

The higher rate of inflation leads the fund to increase the value of pension payments to members in receipt of benefits. The high one-off increase of 10.1% leads to a significant increase in the amount being paid out each year in benefits, c£11m p/a.

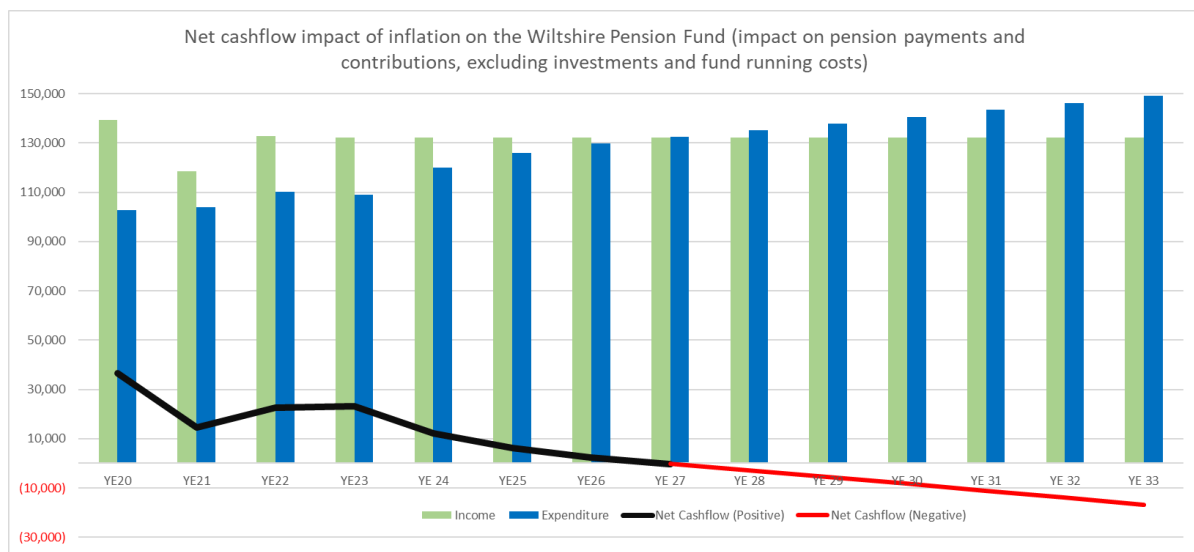
Given the financial pressures on the employers in the fund, we have forecast they will award below inflation pay rises and be under financial pressure to constrain costs, such as implementing recruitment freezes. This may lead to no increase in member and employer contributions to offset the increase in pension payments.

Assuming a 10.1% known inflationary increase for 2023, 5% in 2024, 3% in 2025 and 2% onwards we have modelled the growth in pension payments against static contribution payments.

This moves the pension fund from cashflow positive based on pension payments and contributions to cashflow negative by the financial year ending 31 March 2027.

This will require the fund to reconsider the investment strategy to ensure sufficient cash-generating assets are available to provide suitable liquidity. Such a review would next be completed during 2025. In the meantime, the situation will continue to be kept under regular review.

Further work has been commissioned from Hymans Robertson to provide more granular modelling and scenario testing.



At the most recent triennial valuation and investment strategy review (November 2022) the fund has agreed a new Strategic Asset Allocation (SAA). Ensuring sufficient liquidity was a key consideration in the design process, **the percentage of the fund allocated to liquid asset classes has risen from 44% to 53%**. This has been achieved by making a permanent allocation to liquid loans and a new strategic allocation to liquid asset matching investments (SALAMI) for managing short term cash requirements.

Administration impact

Employee Opt out

Employee opt outs occur when active members of the scheme decide that they wish to leave the pension fund. Employers administer the opt out process, but Wiltshire Pension Fund can see where employees have been members of the scheme for more than three months. 'Opt out' status is reportable from the pension administration system. Consequently, there can be uneven periods of opt outs as larger scheme employers run re-enrolment processes (every three years).

Year	Count of Opt outs	Active membership	% active membership
2017/18	92	21,781	0.42%
2018/19	175	22,541	0.78%
2019/20	254	23,487	1.08%
2020/21	117	23,131	0.51%
2021/22	97	23,324	0.42%

2022/23 is expected to be at similar level as 2019

Source: Pension administration system (Heywoods)

The rate of opt outs for Wiltshire Pension Fund has not shown in increase as a result of the recent cost-of-living crisis. In October 2022, the [PLSA reported Pensions seeing the first signs of the Cost of Living crisis](#) beginning to emerge, but that more positively, only around one in ten schemes surveyed said that they have seen members wanting to opt out (12%), which is only a little above the long-term trend of 9%.

The LGPS has a very low level of opt outs compared with occupational schemes, and this is expected to continue. The [Opt out forms for Wiltshire Pension Fund](#) provide comprehensive information on benefits that are being given up in line with guidance and best practice.

50/50

The LGPS offers flexibility to pay half the normal contribution rate and build up half the normal pension (the 50/50 section of the LGPS). Full life and ill-health cover is kept while in the 50/50 section.

Year	Count of 50/50	Active membership	% active membership
2017/18	55	21,781	0.25%
2018/19	67	22,541	0.30%
2019/20	96	23,487	0.41%
2020/21	111	23,131	0.48%
2021/22	120	23,324	0.51%

Source: Pension administration system (Heywoods)

The percentage of fund members making use of the 50:50 option has been gradually increasing since it was introduced, however it still remains a very small proportion of the fund at 0.51%.

The degree of accuracy on 50/50 is higher as *Wiltshire Pension Fund* administers the process. Analysis of age/salary profile does not reveal any strong trends, but the population size is quite small. As the number of employers using iConnect (the contribution payments portal) increases, it may be possible to observe changes more frequently. But currently, reporting across all employers is only available at year end.

Membership profile

The change in membership profile for the Fund (as described in the cashflow section above) may result in a gradual administrative shift from active membership to the deferred and pensioner membership.

Active membership over recent years:

Year	Active membership	% change
2017/18	21,781	
2018/19	22,541	3.5%
2019/20	23,487	4.2%
2020/21	23,131	-1.5%
2021/22	23,324	0.8%

Annual Allowance

The Annual Allowance is the amount pension savings can increase by in a year without incurring a tax liability. The standard annual allowance is currently £40,000, and for defined contribution savers, the assessment against this is straightforward.

For the LGPS, the calculation in simple terms involves valuing the increase in benefits over the year by taking the starting amount at the 'pension input period' and increasing that amount by inflation. For defined benefit pensions the £40,000 value is of the pension (per annum) amount, and it therefore catches members with relatively modest salaries if they have long service or moderate promotional pay rises. Historically, the number of members affected by the AA has been relatively low and overseen by the Technical and Compliance Manager.

For Wiltshire Pension Fund, additional operations include producing pension savings statements (for those members that might expect to be affected by the AA) and the associated tax charge where the AA is exceeded. Based on experience, **it is estimated that the number of statements could increase by 70-80% and the number of tax charges increased by 80-90% (roughly 160 statements and 60 members with a tax charge in 2022/23)**. Where members typically exceed the £40,000 limit each year, the amount by which they are likely to exceed will be higher.

The team are beginning to consider resourcing required for this exercise (which will be carried out in summer 2023). Requests for projections have already been received from members concerned about the potential increase in their tax liability.

Other operational issues

Other operational issues that may arise during periods of high inflation/a cost of living crisis include:

- Increased member queries
- Potential need to send out more communications
- Increased number of opt outs / 50/50 elections (associated administration)
- Increased number of early retirement quotes
- [Cost of living making pension savings more vulnerable to scams \(FCA research\)](#) (e.g. transferring out to release cash)
- Lifetime Allowance (LTA) tax liability – whilst the impact of this will be lower than annual allowance, CARE accounts and deferred pensions would be being increased by 10.1% but the LTA limit has been fixed at £1,073,100 from 2020/21 to 2025/26.

Comms Response

Following on from the extreme market response to the “mini-budget” in September 2022, pension funds were all over the news. In order to reassure members about the security of their pensions, we published a news article on the Fund’s website:

<https://www.wiltshirepensionfund.org.uk/article/6662/Fund-update-on-current-market-conditions>



Pension Awareness Week (PAW) 2022 focussed on supporting members during the cost-of-living crisis. Topics covered included:

- Educating members on how much they need to retire, looking at retirement living standards, and directing members to log in to our online portal, My Wiltshire Pension, to see their own financial position.
- Informing members about options open to them, such as 50:50, and highlighting how benefits increase in line with inflation.
- Providing links to quick tips for saving energy at home, as a preference to opting out.
- Explaining the unseen benefits of the pension fund, such as tax relief, flexible retirement, and the contributions made by the investment returns.
- Putting members more in touch with their pension by explaining jargon, and linking to helpful resources and guides to learn more.

The campaign was **sent to 23k members** directly, but also provided to the employers (including Wiltshire Council) to achieve a wider reach. We saw high **open rates of 50%**, with just under **60k emails opened** across the week, and **4.6k members clicking through** to find more information.

Over the week we saw an **additional 108 members registering with My Wiltshire Pension**, and more than **double the usual activity** on the portal, as more members engaged with their pension.

Our website also saw additional traffic, with over **2k more views and 0.9k more users** compared to the prior week, representing around **2.5x more website interaction**.

In terms of further information, this cost-of-living paper will be summarised and shared with the membership via the news pages.

Workforce Considerations

The cost-of-living crisis is impacting on WPF staff. We promote flexible and remote working practices, with most staff working from home the majority of the time. With energy bills skyrocketing, the team may feel additional pressure to come into the office instead, rather than paying to heat their homes. However, staff have become accustomed to working from home during the pandemic, and many have commented that they now find the office environment distracting, and the commute, even if short, is time-consuming. There is a risk that this conflicting situation may adversely affect staff wellbeing.

Inflation is eroding wages, and public sector finances are under continuous strain. Recruitment is already difficult for local authorities, and LPGS funds are no exception. Resourcing may become increasingly tough in the short term. We are responding to this challenge by focussing on the things we can control. A specific webpage has been produced to showcase the benefits of working for the Fund: <https://www.wiltshirepensionfund.org.uk/Working-at-WPF>. We have launched team newsletters to promote a friendly and collaborative culture, and a recent restructure has introduced more career progression opportunities, which will hopefully boost retention of staff.

Conclusions

These are challenging times, with competing pressures in the form of high inflation (applied to pension increases), low wage growth, a tough financial situation for both our scheme members and the public sector bodies who make up our employer base, as well as being a difficult year for investment returns. As an open pension scheme with a long-term time horizon, WPF is able to weather many of these challenges.

Perhaps the area of most concern in the short term is cashflow, caused by a potential shift in the membership profile, and rising pension payments alongside static contribution receipts. Our rough estimates indicate that we should be positioned to deal with the expected magnitude of changes to our cashflow demands, however due to the importance of this area, more analysis is needed, and we have commissioned further modelling work from the Fund's actuary.

<p>Working together as One Fund</p> <p>1</p> <p>We work together as One Fund, demonstrating the values of transparency, accountability, ownership, critical thinking, respect, and agility</p>	<p>High performing team</p>  <p>We aspire to be role models and leaders, through our commitment to develop knowledge and training</p>	<p>Data driven decisions</p>  <p>We use data to inform and evidence our decision making, and to measure our progress and successes</p>	<p>Efficiency through technology</p>  <p>We collaborate, and challenge our systems and processes, to create innovative solutions and drive continuous improvement</p>
<p>Long term thinking</p>  <p>We always act with the long term in mind, whether we are setting our investment strategy, planning improvements, or working towards our net zero by 2050 goal</p>	<p>Clear communications</p>  <p>We communicate with all our stakeholders in a clear, concise, relevant and effective way</p>	<p>Smarter working</p>  <p>We maintain focus on our core objectives, and work in a proactive and disciplined way, to promote simplicity and efficiency in everything we do</p>	

There are also concerns around resourcing, which we are working to mitigate to the best of our ability. Our investment strategy has recently been reviewed, and the modelling shows that in spite of the recent turmoil, we should be well positioned to deliver the investment returns needed over the long term. We have established processes for monitoring the investment performance, funding level, contribution receipts, cashflow position and administration

performance, and we will continue to keep the situation under review and proactively address any emerging concerns.