HYMANS ROBERTSON

What do the 2023 valuations have in store?

As the new year fireworks returned to Edinburgh castle for the first time since 2020 to celebrate the arrival of Scottish valuation year (we know it's only us LGPS actuaries that were thinking this!), there's something comfortingly familiar about another triennial valuation in the LGPS – data, assumptions, liabilities and contribution rates, plus a discussion on risk!

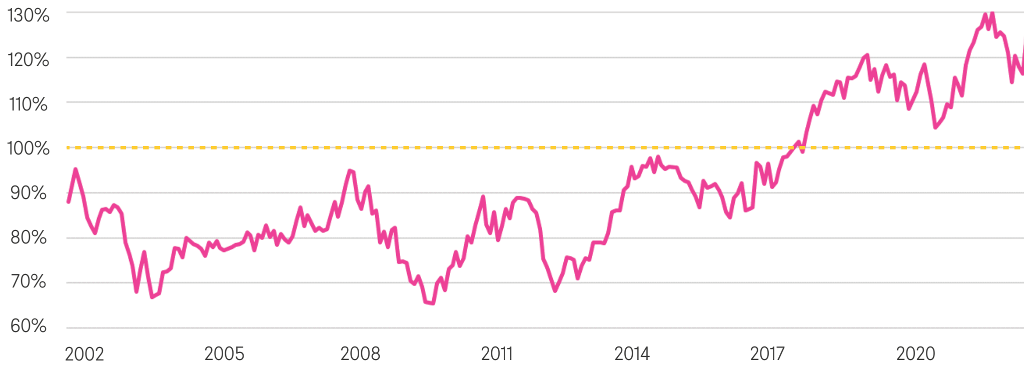
While some things have remained the same (like the home of the Calcutta Cup), the three years since 2020 in between have been anything but familiar having witnessed; a pandemic, the death of the Queen, three prime ministers, four chancellors and Russia's invasion of Ukraine. These have all brought periods of significant uncertainty in all aspects of life – politics, financial markets and demographics. Since the last valuation:

1. Assets have grown significantly (well in excess of long-term assumed returns).
2. Interest rates have risen sharply in recent months (as anyone with a mortgage due for renewal this year will be aware of).
3. Inflation has taken off (with an expected 10.1% increase in benefits in April), and now there are worries it may come back to earth with too much of a bump.
4. Excess deaths have sadly continued to occur despite the retreat of Covid-19.

Robert Bilton
Head of LGPS Valuations
robert.bilton@hymans.co.uk
0141 566 7936

So, what does all of this mean for the 2023 valuation?

Amidst these challenges, there's some good news (not only the recent Scottish rugby team's performance!). Perhaps counter-intuitively, funds are likely to see a **significant improvement** in funding level.



Despite inflation pressures, a combination of strong asset returns and a higher cost of borrowing (meaning an increase in expected future asset returns) have seen higher asset values and lower liabilities.

This is a very different position for funds - a lot of people can still remember the days of deficits and managing contribution rate increases. Now, we're in the recently unchartered territory of determining the use of a surplus, and potentially substantial surpluses at that.

Is it time to start cutting contribution rates?

It's the usual and not unsurprising reaction to good news like this, and the answer may well be yes. But, of course as actuaries, we have to consider all of the risks of doing so, and before making this decision, you need to consider the full range of options available.

Firstly, funding level is a blunt measure. It considers only the benefits earned to date with no reference to the cost of future benefits – particularly important when considering that most (more than 90%) of an employer's contribution rate is likely to be in respect of future benefits. Funding level also says nothing about the level of volatility and risk in the current environment. For example:

Inflation: the big unknown at the moment. Some think it has peaked and will come down back to 'normal' levels very quickly, others are worried about it staying higher for longer due to high pay increases in the private sector. All we can be certain of is that it's highly uncertain and is a big risk for LGPS funding since benefits are inflation-linked.

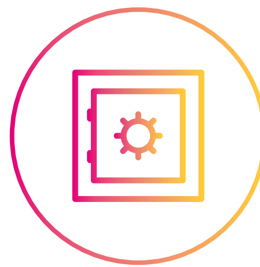
Market volatility: which countries will go into recession? Where's the next big price shock? What impact will higher interest rates have on governments and companies? What will Putin do next? Whilst long-term return expectations are higher, there's much more volatility around them. Funding plans should be robust to the volatility to avoid having to chop and change plans. This is even more of a risk for short-term employers who may exit the fund in the next few years.

Life expectancy: the pandemic has shone a spotlight on life expectancy, and the long-term impact of the last couple of years is yet to be fully understood. Whilst challenges currently faced by the NHS may ultimately reduce life expectancy for some, there's also a school of thought that lifestyle changes such as working from home and increased hygiene efforts may result in longer-term improvements.

Moving on to the options and there are a few to choose from:

Contributions

Prudence



Retaining the Surplus

Investment Risk

Choices, choices, choices

Contributions

Taking the obvious one first – contributions. Given the current cost pressures facing employers, this is an appealing one. But before immediately jumping to this, consider:

- It's easy to reduce contributions, but a lot harder to increase them. Even if a reduction is only for some short-term relief, it can quickly become the cost that finance directors will then anchor on. Ways to mitigate this are having low rates in years 1 and 2, and then increasing back to a 'normal rate' in year 3 of the Rates & Adjustment Certificate.
- What's a long-term stable cost of the LGPS and are current rates higher or lower than this? Agreeing the long-term cost can be done via asset-liability modelling at the valuation and using this to put current rates in context will be helpful. This can also help with employer engagement. If they're already paying less than this cost, is it realistic to reduce further? And equally vice versa, if they're paying more then it gives you more comfort that you aren't storing up problems for the future by reducing rates.
- Which generation will benefit by reducing contributions, bearing in mind the requirement to consider intergenerational fairness? The current generation have implicitly supported rate increases over the last 20 years. It should be considered whether a reduction places too much risk of future increases on future generations.

Prudence

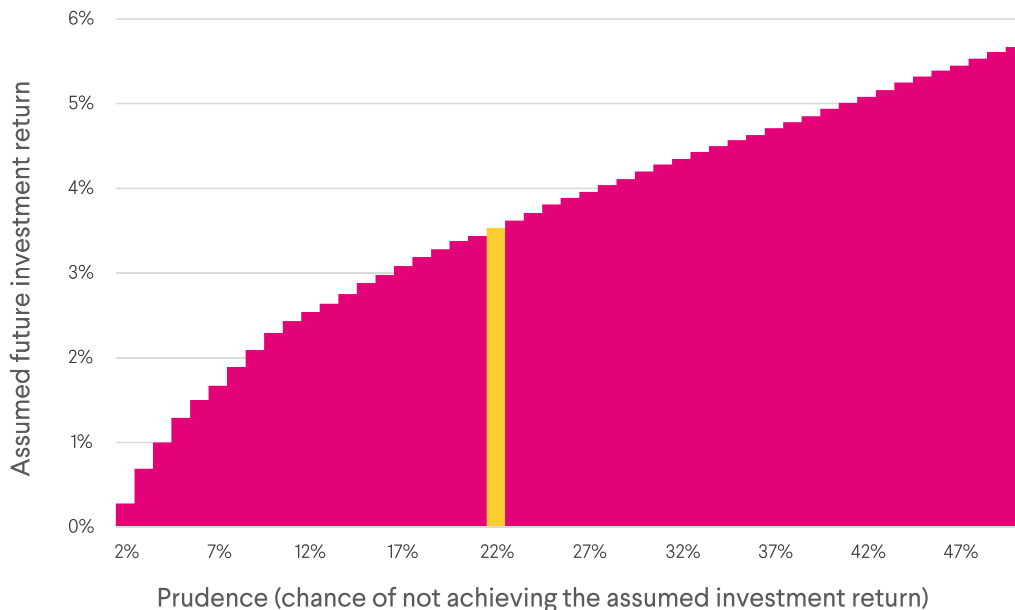
There's risk inherent with funding for a guaranteed pension amount, you can never have 100% certainty and so there will always be some element of risk in the funding strategy. The question is how much, ie how prudent are you going to be?

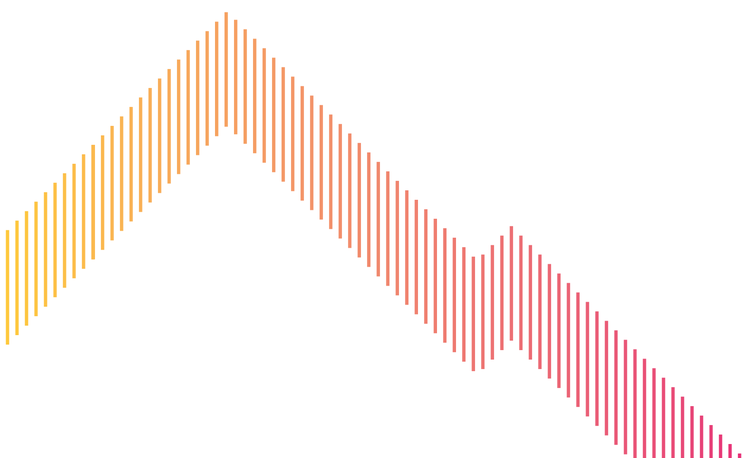
All LGPS funds invest differently but, in general, they all have the same objectives. This leads to some consistency in investment strategies when you look at them from a very high level. Most funds will currently have best estimate returns (ie a 50/50 likelihood of future returns being higher or lower than this level) between 7% pa and 8% pa.

But different funds will have different views on how prudent they want to be, and this can change over time. For example, some funds may think that the current improvement in funding position has largely arisen due to higher expected returns, not due to the actual investment performance. Given the higher level of volatility, there may be concerns that the funding level increase will not be realised in the event that those higher returns are not achieved.

To reflect this concern, additional prudence may be factored into funding plans via the level of assumed future investment returns. The chart below shows for a typical fund how the prudence (chance of not achieving the assumed future investment return) varies by the assumed return.

In this example, the fund had a tolerance at the last valuation of about a 1 in 4 chance of not being able to achieve the assumed return. However, at this valuation, due to concerns around the higher levels of volatility and uncertainty they've increased the prudence and are now only willing to accept a 1 in 5 chance. This results in a lower assumed future return, lower funding level (all other things being equal) and the fund ultimately wishing to hold more assets today per £ of future benefit payment.

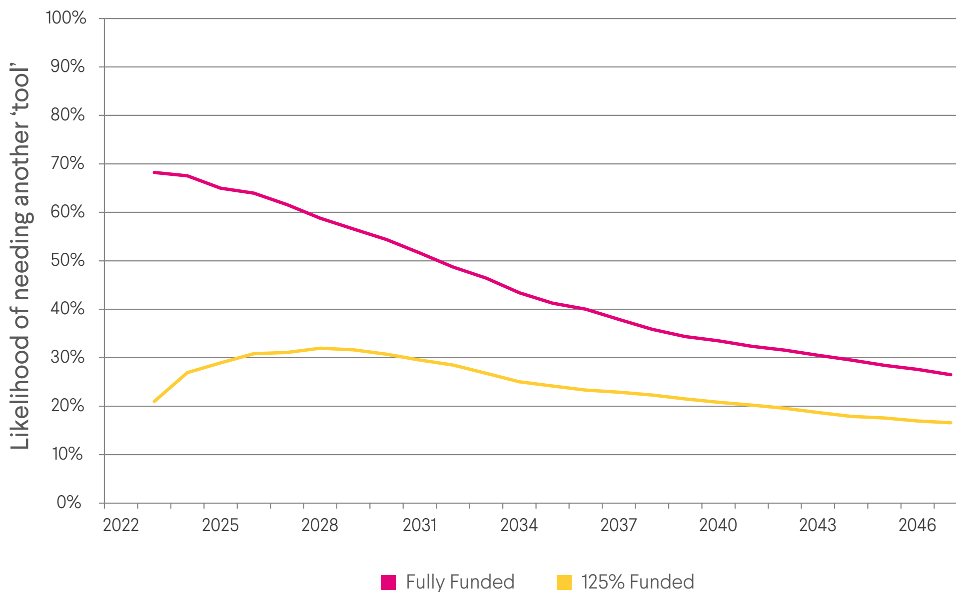




Explicit surplus retention

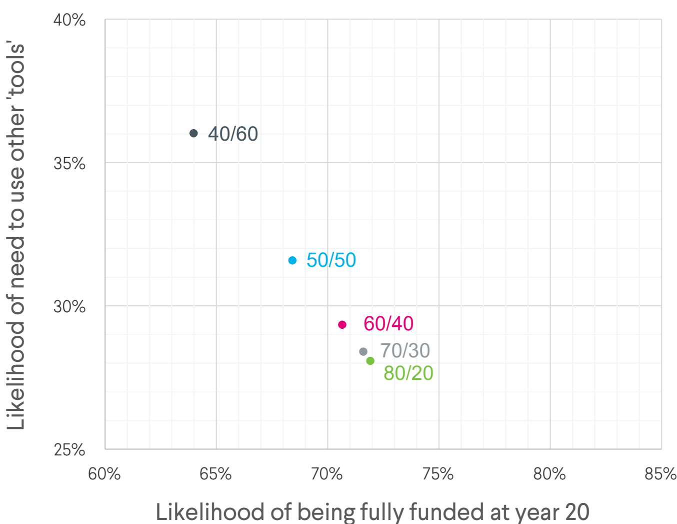
An alternative approach to increasing prudence is explicitly retaining some of the surplus before changes to the funding plan are granted (ie contribution rate reductions). For example, you may only permit rate reductions if an employer is, say, at least 110% funded.

To justify such an approach, analysis can help to demonstrate how surplus retention provides the fund and employer with some assurance about future contribution rate changes. For example, the chart below shows that at even at 100% funded, there's still a high chance – around 70% - that contribution rates are susceptible to change. However, a 25% surplus reduces this chance to around 1 in 5, providing longer-term comfort around rates.



Reducing investment risk

One of the first things commonly heard when it's apparent that the funding position is good is 'time to de-risk'. This mindset is born out of private sector pension funding where the schemes are pre-dominantly towards the latter stages of a pension fund lifecycle. The LGPS is very different as it remains open to new benefit accrual and new joiners. So, this automatic instinct may not be appropriate.



Typical LGPS funds are currently holding around 60-80% in growth-like assets and around 20-40% in diversifying and protection assets. De-risking is useful for reducing future funding and contribution rate volatility, but we can't forget that we're here for the long-term.

Taking too much investment risk out means the fund risks not getting the level of future investment returns needed to keep contribution rates affordable. So, the magic question is how do we get the right balance?

The answer is to explore different combinations of investment strategy and understand what they mean for the likelihood of requiring additional future contributions. A sample of such analysis is shown on the left.

This shows that the 40% growth/60% diversifying investment strategy would not give enough returns to support the contribution rate. Equally, the little difference between the 60/40, 70/30 and 80/20 investment strategies show that there's an element of unrewarded investment risk with the higher growth options.

Bringing it all together

Whilst the immediate headlines of a good funding position may give hope that the 2023 valuations will be simple and straight-forward, there are still some important decisions to make. Specifically, which of the four options do you take for managing the strong funding position? In reality, we would expect the eventual choice to be a mixture of between one to all four of the possible options and reflect each Fund's own outlook on the world and attitude to risk.

The most important thing for funds to do now is to make sure you have the time set aside to explore the options, engage with affected stakeholders and decide what you're going to do. As actuaries to a lot of funds in Scotland, we're looking forward to working with you over the next 12 months.

And finally…

In addition to the above, there are a few other areas that we expect LGPS funds to be considering in 2023:

- Streamlining your Funding Strategy Statement to make it more accessible, easy to navigate and fully compliant with the new requirements as a result of the June 2022 amendment regulations.
- Managing the diversity of employers within the fund. The messages within this paper will likely to apply to the majority of the employers within your fund, but not all. At a time when budgets are under increasing strain for all employers, understanding the impact of your funding decisions on all employers, not just the majority, will be very important.
- Improved funding positions have seen many smaller employers reconsider their ongoing participation within the LGPS. In the extreme, this could result in funds paying out large exit credits. The potential impact of this should be explored and consideration given to the approach used to undertake cessation valuations.

If you wish to discuss any of the topics raised in this note, please contact your usual Hymans Robertson consultant, or get in touch with one of us below.

Contact us

Robert Bilton
Head of LGPS Valuations
0141 566 7936
robert.bilton@hymans.co.uk

Julie West
Senior Actuarial Consultant
0141 566 77990
julie.west@hymans.co.uk

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