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A new funding era in the LGPS?

Since the last round of triennial valuations for the LGPS in England and Wales, there has been a significant change in the UK and global economic environment. Now, with around 12 months to go until the 2025 valuations, we consider whether this change in environment heralds a new era for funding in the LGPS. And, if so, what LGPS funds should be doing now to manage this change.

Reflecting on 2022

To start tackling such a topic, it's important to look back at where the LGPS in England and Wales stood at the last round of valuations. At the 2022 valuations, the overall outcome was positive; at scheme level, the funding level rose from 98% to 107% and average employer contribution rates came down from 22.9% of pay to 21.1% of pay[1].

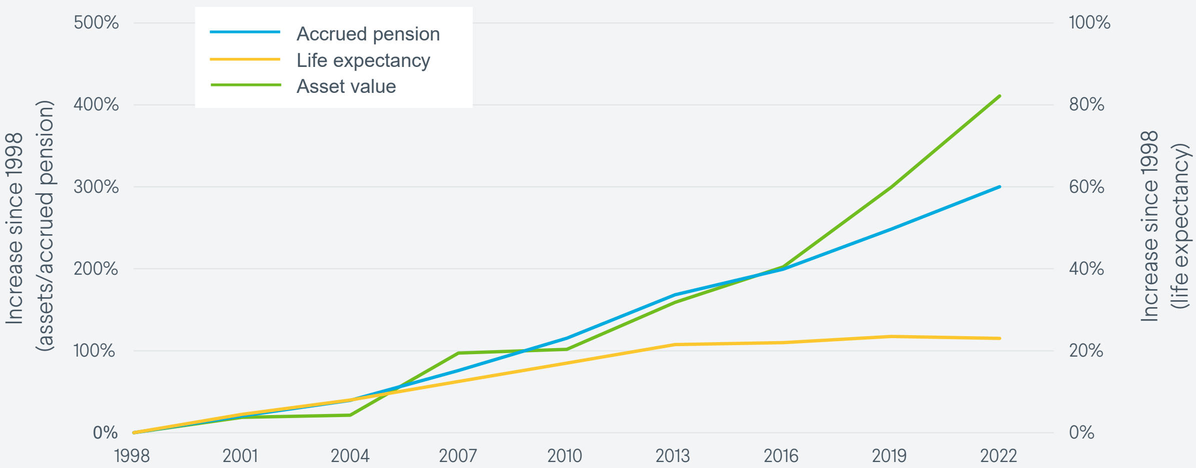
In fact, 2022 felt like the LGPS was in its strongest funding position in recent memory. To understand why that's the case, we've gone back to basics and looked at how some pension funding fundamentals have evolved since 1998 for a typical LGPS fund.

- **Accrued pension** - the total value of pension earned by all the members up to each triennial valuation date. This tells us how much pension a fund's going to have to pay out each year.
- **Life expectancy** - the average life expectancy for a member at each valuation. This tells us how long the pension is going to be paid for in retirement and, combined with the accrued pension, determines how much money a fund is going to have to pay out.
- **Asset value** - the amount of money a fund holds to pay all these pensions.

By looking at these simple objective measures we can avoid getting caught up in arguments around actuarial assumptions.

The chart below shows how each of these three funding fundamentals have evolved between 1998 and 2022.

Chart 1



[1] LGPS Scheme Advisory Board - 2022 Valuations - Report

The tough times

Looking at the first half of this period, we can see that the growth of a typical LGPS fund's accrued pension and assets broadly matched each other. This is good news given that you want the money you hold to pay the benefits to increase in line with the amount you have to pay.

However, life expectancy also rose over this period. So not only did LGPS funds have to pay out more pension, but they also had to pay it for longer. Because the rise in asset value only matched the increase in accrued pension, the observed increase in life expectancy meant that in 2010 LGPS funds had a weaker funding position. For the fund in this analysis, its funding level fell from 102% in 1998 to 80% in 2010.

LGPS funds weren't the only ones affected by this dynamic – it was being mirrored in private sector defined benefit pension schemes and was one of the contributing factors for the trend of closing these schemes.

The resurgence

However, the second half of the period, despite dealing with the lingering effects of the Credit Crunch, Brexit and the Covid-19 pandemic, saw an improvement in these fundamentals.

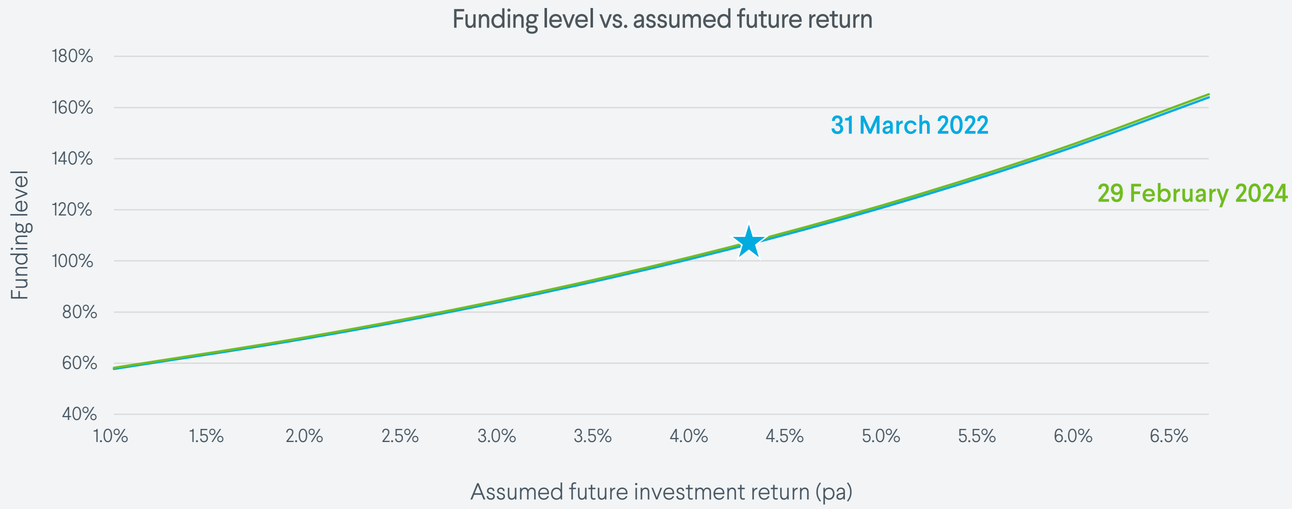
Whilst accrued pension continued its ever onward increase due to pension and salary increases, life expectancy broadly stayed flat (reflecting the general slowdown in life expectancy improvements in the 2010s). So whilst LGPS funds had to pay out more pension, the length of time over which payments are being made hasn't really changed since 2010.

However, asset growth has significantly exceeded the increases in accrued pension. Combining this greater level of growth and little change in life expectancy since 2010, we can quickly see that the funding fundamentals of the LGPS at 2022 were really strong – backing up the scheme-wide funding level of 107% quoted earlier.

Looking ahead to 2025

Since the 2022 valuations, there has been no material change in the LGPS's funding fundamentals. This is evidenced by the chart below. We've plotted how funding level varies with assumed future investment return (or the discount rate) and shown the change in position between 2022 (a blue line) and end of February 2024 (a green line). The star shows the scheme-wide reported funding level at 2022 of 107%. The two lines are practically on top of each other.

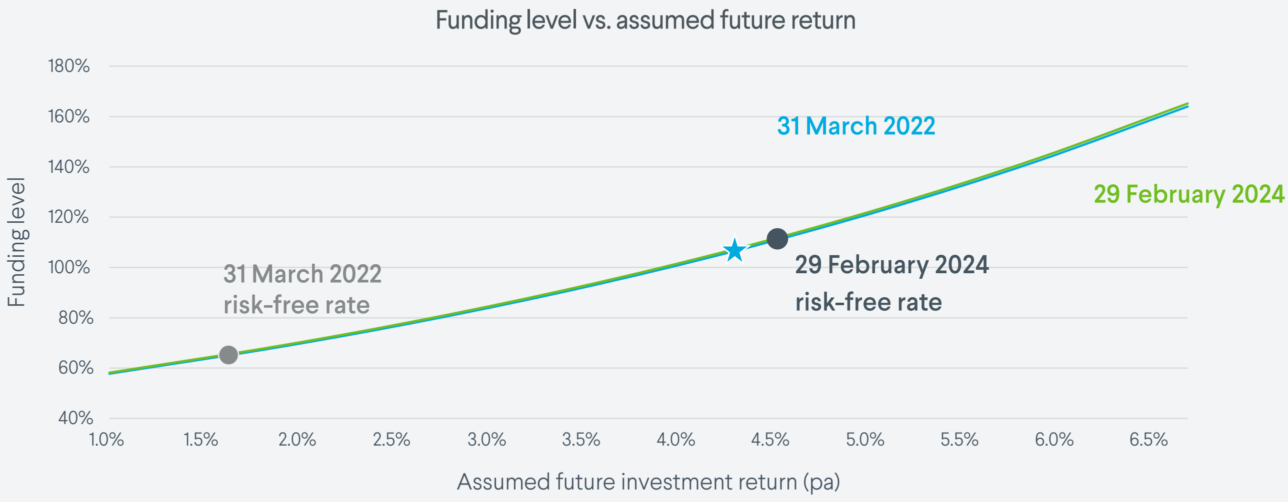
Chart 2



However, what has changed since 2022 is the economic environment that LGPS funds operate within.

There are all sorts of indicators that could summarise this change in environment. For example, we've seen it in insurer's pricing; changes in annuity rates mean that the amount of pension you can buy has increased by around 50% between 2022 and 2024. For the purpose of helping understand why the change in environment matters for LGPS funds, we've used a UK market-based long-term risk-free rate measure[2]. The values of this rate at 2022 and 2024 have been added to **Chart 2** above and shown in **Chart 3** below.

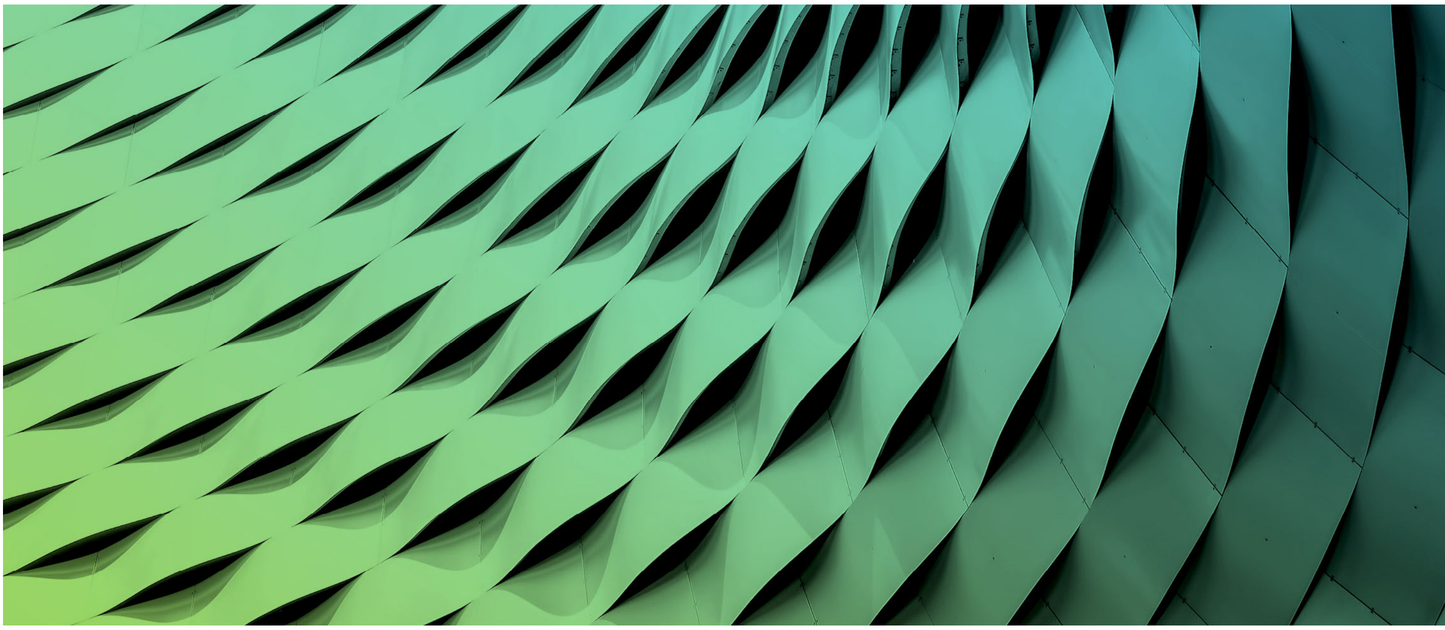
Chart 3



The risk-free rate has risen from around 1.7% pa in 2022 to 4.5% pa at end February 2024. The current risk-free rate is now higher than the average future investment return being assumed by the LGPS at 2022.

This change in environment matters when it comes to the 2025 valuation. It will require LGPS funds to take a step back and think about what it means for funding and investment strategies at 2025.

To bring this to life, we've considered two different scenarios, based on where a fund may consider its current funding position to sit, and worked through some possible implications.



[2] The measure is the yield on the FTSE Actuaries UK Conventional Gilts over 15 Years series

SCENARIO 1: funding level is broadly the same since 2022

In this scenario, the fund believes that funding levels have not materially changed since 2022. The fund will therefore be broadly where the blue star is on the above chart and have an assumed future return, or discount rate, lower than the market's current risk-free rate. The implications of this could be:

- **Investment strategy** - if you think your assets such as equities, property or infrastructure are not going to be able to achieve the market's current long-term risk-free rate of return, should you be taking all that investment risk? If not, do you do what has been happening in the retail savings market where there's been a move from equity-type investments to bonds returning 4-5% pa?
- **Contribution rates** - this scenario means rates should stay broadly where they were at 2022. Given most LGPS employer advisors are being vocal about funding level improvements and contribution rate reductions, you'll need to carefully manage expectations and be very clear on your reasoning and rationale with employers.
- **Prudence levels** - if you have an ongoing funding basis at this level, what do you set for your low-risk cessation exit basis? If you continue to use a market based risk-free rate, how do you explain to stakeholders that your low-risk basis is less prudent than your ongoing basis? Or, if you want to keep the prudence gap between ongoing and low-risk funding bases, how do you justify to employers that you're using a future return assumption which is much less than the current market's risk-free return?

SCENARIO 2: funding levels have significantly improved since 2022

In this scenario, you believe that you should get extra return for the investment risk you're taking so you have a higher future expected investment return, resulting in a much higher funding level than at 2022. The implications of this are:

- **Investment strategy** - do you need all that investment risk if that's the funding level? Or slightly more nuanced, do you need all that investment risk for every employer in the fund? Are there hotspots of opportunity to help reduce funding balance sheet volatility where it really matters in an affordable way?
- **Contribution rates** - high funding levels will likely see employers asking and/or expecting contribution rate reductions. How do you manage these expectations and effectively communicate that funding level is only a short-term measure, like a snapshot in time, and contribution rates need to be set with the long-term in mind?
- **Prudence levels** - could you put more prudence into the funding strategy and build up a rainy day fund to help smooth out the impact of any future adverse experience, eg if the economic environment shifts again?

What should LGPS funds do now?

The scenarios on the previous page show, no matter what your beliefs about the impact on funding, that the change in economic environment has brought in a new era for funding decisions in the LGPS.

This topic needs active consideration by LGPS funds and sufficient time to properly explore. The first place to start is to discuss and formulate beliefs. We've shown how the implications can vary depending on the beliefs a fund may have about its current funding position. So start to identify what your views are on the impact of environment change on funding; is it scenario 1 or scenario 2? Or something different?

As part of these considerations, don't limit yourself to just the economic environment. There's a lot of uncertainty in areas such as longevity and climate change.

Think about your views on those risks and uncertainties. Which ones worry you and how do you manage, monitor or mitigate the risks?

Once you've identified those beliefs, sit down with your actuary to discuss and work through what the implications could be under the broad categories of investment strategy, contribution rates and prudence levels.

In all of this, remember there is no right or wrong answer, what matters is what you as a fund believe and making sure your strategy and decisions reflect that.

In the next couple of months we'll be exploring how funds can navigate this new era by looking at belief setting and how to balance decision making between investment strategy, contribution rates and prudence.

Contact us

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