60-second summary

Rising LGPS funding levels

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Over the last 12 months, LGPS funding levels have been increasing and reaching heights not seen for a very long time, if ever. How excited should we get and what does it mean for future funding plans?

What has been happening to LGPS funding levels?

Looking back on the last 12 months, it's amazing to think of the changes that have occurred in the economic environment. War in Ukraine impacting on global supplies of raw materials, foodstuffs and energy, inflation running at a level not seen since the early 1990s and constant revisions of economic growth and recession prospects.

Given all this, it's not surprising that funding levels have changed over this period. But it may be surprising that the direction of travel has been upwards (especially with a 10.1% benefit increase in April 2023).

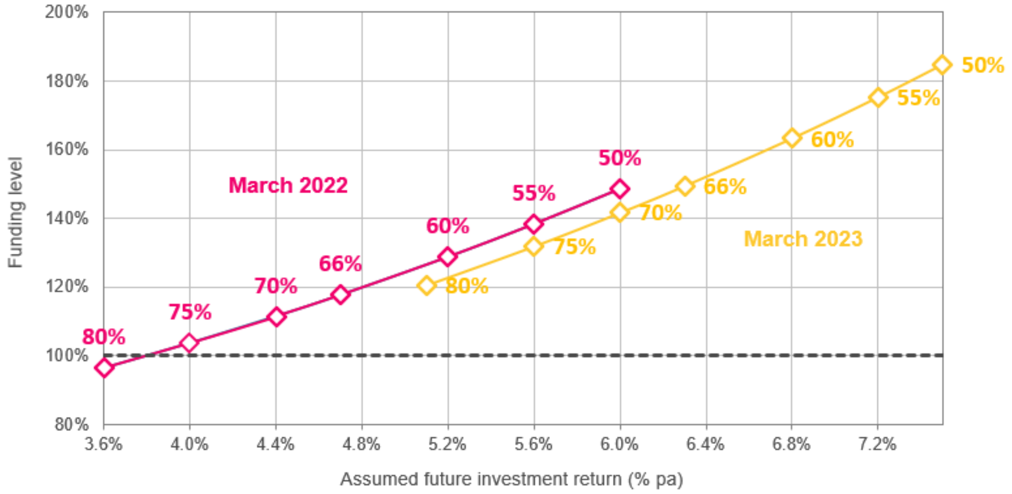
Sample LGPS fund funding level progression

Why are funding levels increasing?

In recent years, LGPS funding levels have been rising because of strong returns on assets. Some funds have generated a return in excess of 100% over the last decade. However, returns over the last 12 months have been relatively weak (around -4 to +2% for a typical LGPS fund). So, if it's not the usual culprit, what is it?

The answer is interest rates. Central Banks' response to increasing inflation has been to raise interest rates to levels not seen since the onset of the 2008 credit crunch. If investors can get a higher return on cash and other lower-risk assets, it follows that the return on riskier assets, such as equities, should also increase. And higher future expected investment returns lead to a lower value placed today on future LGPS benefits (a fund's liabilities).

So, LGPS funds are not suddenly holding more assets for each £ of future benefit payments (in fact, some are currently holding less than they were 12 months ago). Instead, funding levels have improved because of higher expected future returns (also known as the discount rate assumption) – see the below chart.



For this LGPS fund, if its assets generate a future return of 5.6% pa, the funding level at March 2023 (c130%) is lower than at March 2022 (c140%). This highlights the point above about some funds now holding less assets. However, if the fund measured its funding level with the same likelihood/prudence (denoted by the figures next to each diamond marker), then the reported funding level would be higher at March 2023 than at March 2022.

Do LGPS funds need to take any action?

Given that the recent funding level rise is a result of changes in future expectations, not because funds are holding more money to pay benefits, funds should act with caution before taking any action. Areas to think about with your actuary include cessation positions and surplus/exit credit management, updating employers and other fund stakeholders and managing employer queries, especially any requests to review contribution rates under the new flexibility regulations or implementation of a lower-risk investment strategy for those who are particularly balance-sheet sensitive.

For the Scottish LGPS 2023 valuations, this topic will be one that will be discussed in depth during the next few months. We've already set out some thoughts, including funding in a surplus environment, in this earlier paper.

If you have any questions about the content covered here, please do get in touch with your usual Hymans Robertson contact.