“Is my 100% funded the same as my neighbour’s 100% funded?”

Looking ahead to the LGPS English & Welsh 2022 valuations, we set ourselves the task of answering some of the questions that will be most commonly asked in the lead up:

1. **“Will I be 100% funded at the next valuation?”**
2. **“Now I’m 100% funded, will I stay that way?”**
3. **“Is my 100% funded the same as my neighbour’s 100% funded?”**

Our discussion of the first two questions identified that the LGPS is in a stronger funding position than it has been for many years, and the 2022 valuation offers a real opportunity to reduce the risk of future “funding booms and busts”. After a brief hiatus, we move onto the final question which looks at something that all humans are guilty of – comparing ourselves to others and secretly hoping we’re doing just a little bit better.

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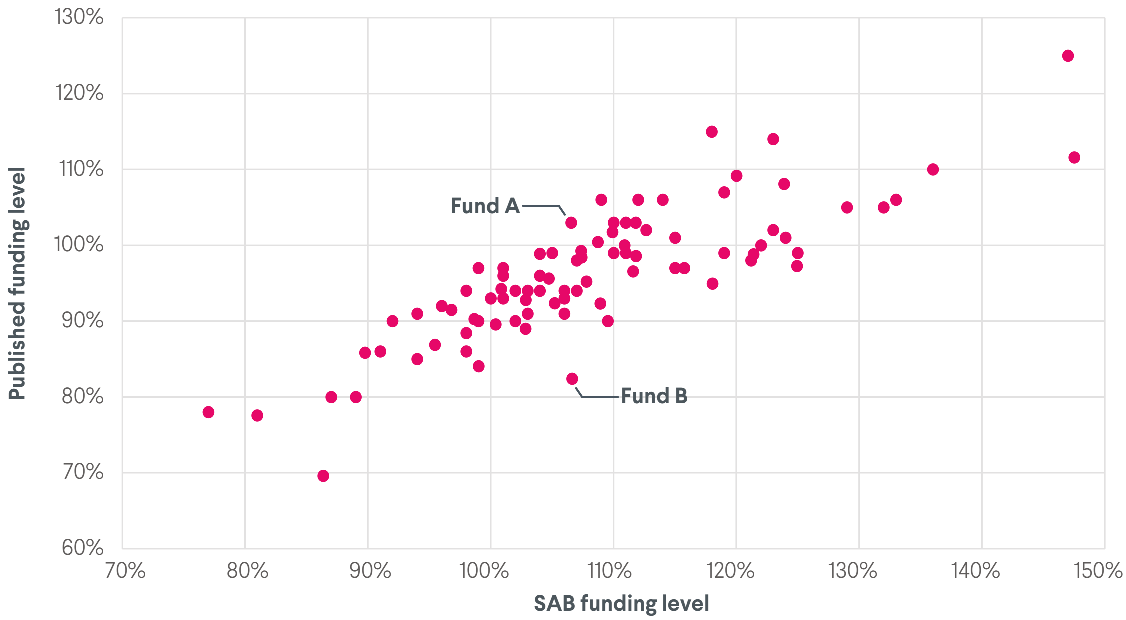
So am I better funded?

The triennial formal valuation is one of a LGPS fund's key risk management exercises, with one of its purposes to take stock and review the health of the fund. The funding level (ratio of assets to liabilities) is the most commonly used measure to summarise the health of a fund, because it's simple and easily allows a very quick comparison between Fund A and Fund B – *"A is healthier than B because it's funding level is 12% higher"*.

Is it as simple as that?

The funding level measure can flatter some neighbours relative to others because each fund will use different assumptions in the assessment. In an effort to allow a more robust comparison, the Scheme Advisory Board now requires every fund to calculate a funding level on the same assumptions for the purpose of allowing people to compare and contrast.

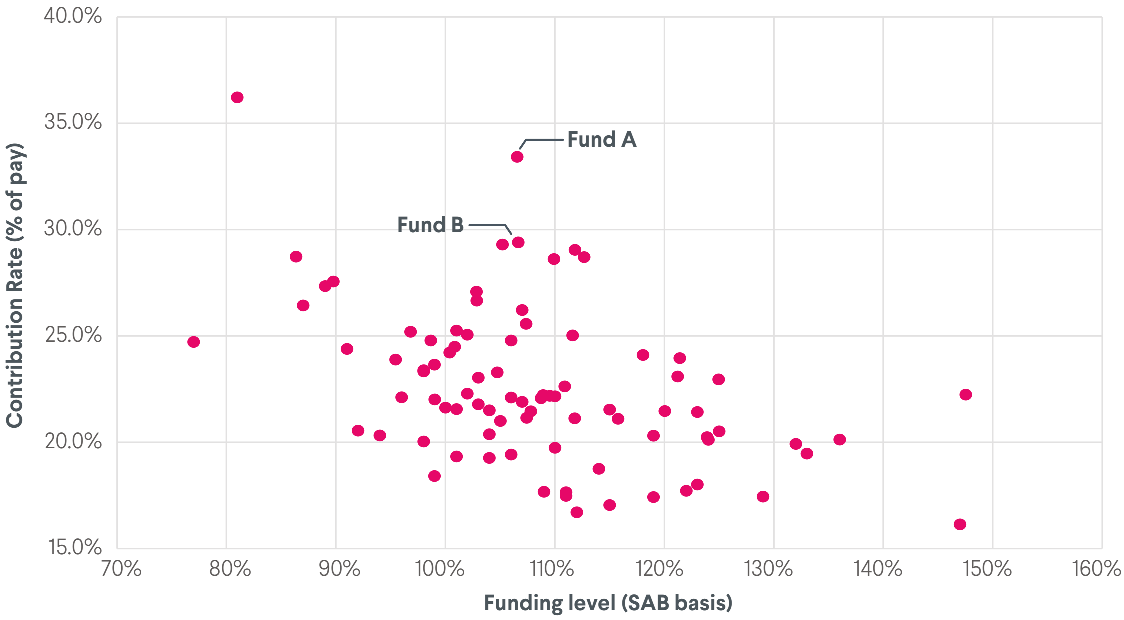
2019 valuation funding level - Published vs. SAB comparison basis



In the above benchmarking chart, you can quickly see that Fund A and Fund B have very similar funding levels. So the answer to the question, "Is my 100% funded the same as my neighbour's 100% funded?", the answer could be "yes". However, that's still not the whole story if you are wanting to really compare the funding health of LGPS funds.

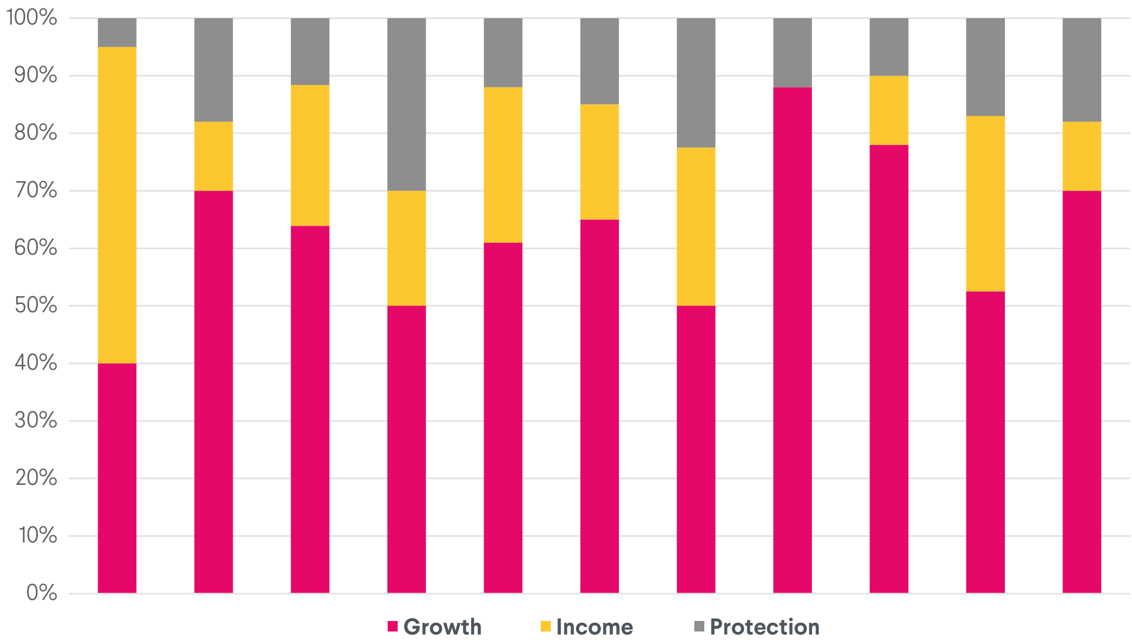
What else do you need to consider?

Funding level (SAB basis) vs. Contribution rate



Looking at this chart, we can see that Fund A is paying a higher contribution rate than Fund B. Now, given that both funds have the same funding level, it seems that Fund A has a funding plan that is more likely to result in having sufficient money to pay its members' benefits in the future. But that conclusion only holds if both funds have the same investment strategy. In the LGPS, there is a variety of investment strategies as can be seen even in a small sample of funds.

High-level investment strategy allocations



So, Fund A's higher contribution rate may be a result of a lower growth-orientated strategy (implemented for the purpose of reduced future contribution rate volatility) which, in the long-term, will be expected to yield a lower future investment return. When the investment strategy is factored in, it may be the case that Fund A and B are back to being comparable in terms of funding health, or even Fund B exceeding Fund A.

So when comparing funding health and to answer our initial question, you need to look past the funding level and incorporate the rate being paid by employers and the investment strategy.

How do you compare and contrast?

Having three variables to think about does make it more difficult to form an opinion of funding health. However, all of these factors can be combined into one summary metric – the likelihood of being fully funded in the long-term ("Likelihood of Success"). This risk-based metric allows for both past and future service benefit accrual and reflects the contribution rate being paid and the investment strategy.

This metric can be used to understand the level of prudence incorporated into a fund's funding strategy. The higher the Likelihood of Success, the more secure the funding plan and, therefore, more prudent (and vice versa). Comparing this likelihood metric allows an objective comparison of funding health between funds or even between different strategy options within a fund.

What's the right level of prudence?

Although there is a requirement on LGPS funds to fund prudently, there is no such thing as the correct level or definition of prudence.

This is both a blessing and a curse of a LGPS fund. It gives the fund leeway to set a strategy that allows them to reflect their own individual attitude to risk, but it also means they have to defend that approach to employers if they think the balance is overly prudent (resulting in higher contribution rates).

Whilst the decision around the level of prudence in the funding strategy is one of the key decisions revisited at each valuation, it will take on even more significance at the 2022 valuation because of Covid-19.

On the one hand, employers may be struggling to balance budgets and having to cut prudence margins in all areas of their financial planning. It would be reasonable to assume that some employers will expect this approach to also be taken to the level of prudence in their pension funding strategy.

On the other hand, nearly all employers will be highly certain that they can meet their payroll costs. As a pension is part of the renumeration package, albeit deferred, then the level of certainty should be similar to that of being able to pay the other aspects of remuneration.

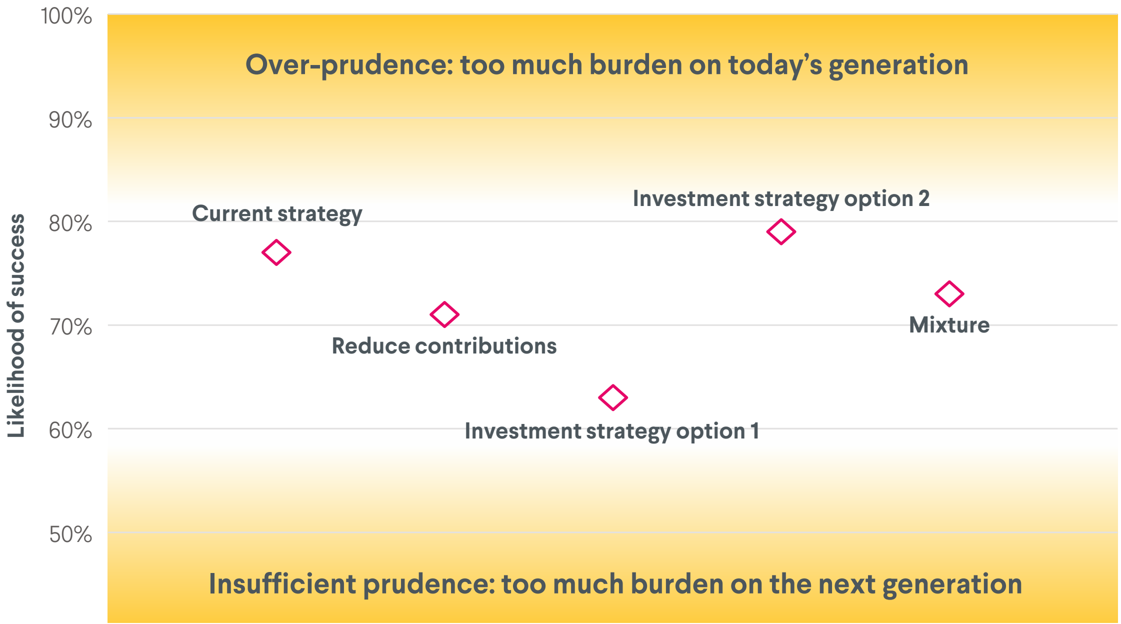
How can inter-generational fairness help determine prudence levels?

It is tempting to think about the level of prudence as something just for the valuation. However, pension funding is a very long-term game, so the prudence decision turns into a consideration of fairness between generations.

The concept of inter-generational fairness is a hot topic, especially given events since the pandemic and discussions over how and when the societal and economic costs of managing the impact should be recovered. Even before the pandemic, this issue was high on the agenda. So much so that the setting of intergenerationally fair funding plans is one of the four criteria that are measured under Section 13 ('Long-Term Cost Efficiency').

A less prudent strategy may store up problems for the next generation as there is an increased risk of having insufficient monies in the future to pay the benefits earned by today's members. Whilst a more prudent strategy may place more pressure on today's generation by requiring employers to pay higher contribution rates. This may mean too much burden on today's taxpayers and potentially affecting the ability of employers to provide jobs for staff.

The Likelihood of Success measure can be used by funds to explore prudence levels and factor in inter-generational fairness.



The above chart shows how a fund may explore different investment and contribution strategies to compare the funding risk inherent with each strategy. By ensuring that a chosen strategy falls within the 'goldilocks band' (not too prudent and not too imprudent), funds can set a strategy which has an appropriate level of prudence and is also inter-generationally fair.

Back to the original question

Hopefully by this point it won't be a shock to hear that yes, one fund's 100% can be very different from another fund's 100%. However, the Likelihood of Success measure does allow a better comparison and, if available, can be used to compare and contrast between funds. Perhaps where it is more useful is within a fund itself. This metric can be used to help funds select an investment and funding strategy by transparently reporting prudence and aligning it with the fund's risk appetite and funding objectives.

Contact us

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Outlook for the 2022 valuations

Over the 2010s, LGPS funds were consistently having to increase contribution rates in light of increasing life expectancy and reducing outlook for future investment returns. However, as our series of papers has discussed, 2022 will be different. The strong position the LGPS now finds itself in (see our first paper) is a direct result of the hard work done in the previous decade (and longer). This means the LGPS will avoid the significant increases in contribution rates recently seen in the other unfunded public sector pension schemes. However, the strong position does not mean the 2022 valuations will be easy – with an improved funding position funds will now have more options:

- Review the investment strategy (see our second paper)
- Reduce employer contribution rates
- Increase the prudence in the funding plan

The challenge at 2022 will be for funds to explore these options and decide which choice, or combination of choices, best aligns with their funding objectives and risk appetite. The decision will vary between funds depending on local circumstances, but if you can't resist a peek at your neighbour then make sure you look at the whole picture, including the Likelihood of Success...!

Whilst this paper concludes our series looking ahead to the 2022 valuation, we will be starting our regular series of webinars that run throughout the valuation year to help keep you up to speed with the valuation's key themes and hot topics as they emerge. Keep an eye out in your inbox for the invites!