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# Managing risk in the LGPS - a spotlight on funding risk monitoring

# Regular monitoring of funding risk at Fund and employer level is a key part of robust risk management.

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The objective of the LGPS is clear: ensure the long-term sustainability for the scheme to keep providing pension benefits to members long into the future.

Meeting this objective means risk management is an essential part of the LGPS and the triennial valuation is just one of the essential risk management tools we all use. If ever we need a reminder of why managing risk, and funding risk in particular, is so important we only need to look at recent market volatility. Funds need to have the information, tools and decision making framework in place to allow them to review and adapt as the environment around them changes.

## Holistic risk management

So if you know what your objective is and you have a statutory need to look at funding risk every three years, is that enough? Or should you think about looking at your funding risks in-between valuations?

There are several types of risk that can affect LGPS funds, from funding, investment, longevity and covenant risks, to administrative and operational risks. Keeping your finger on the pulse can only be a good thing.

## Why is monitoring funding risk between valuations important?

### Three years is a long time

The triennial funding valuation is the key funding risk management exercise for LGPS funds.

However, with unpredictable and extreme events occurring with increasing frequency, we're in a **new era** where waiting until the next valuation might be too long.

Over the last three years alone, funds have been asked to navigate a global pandemic, the Ukraine invasion, record inflation, a cost of living and several banking crises.

Whilst we continue to advocate long-term funding plans and not knee-jerk reactions, it's important to identify emerging risks and their impact as quickly as possible.

This means you can make informed decisions and meet stakeholders' expectations in today's fast paced environment where everything is on-demand.

### The LGPS landscape continues to evolve

Economic and legislative changes continue to evolve the funding risk landscape within the LGPS, so it's important for funds to be able to adapt.

- **Funding levels across the LGPS have improved** at the 2022 valuation and with these improvements, funds are facing more regular questions on funding objectives and potential exits.
- **Market volatility and inflation remain high** making regular monitoring a critical risk management tool, but also providing valuable advice to stakeholders looking to understand the impact amid all the market noise.
- **New regulations** (September 2020 amendments) have given employers more flexibilities which funds need to manage throughout the inter-valuation period.
- **Other legislative changes** such as the recent reclassification of the higher education sector employers is another example of the importance to stay well-informed as changes to the funding environment emerge.

## What does funding risk monitoring best practice look like?

Many of the risks that face LGPS funds are macroeconomic events out of their control. However, while you cannot control inflation or asset prices, you can have monitoring frameworks in place that help you to understand and manage their impact.

In our view, best practice in the funding risk space includes:

- **Developing a holistic approach** which considers funding risk alongside covenant and investment risks. For example, a fall in asset values needs context against liabilities, or a deterioration in covenant may warrant a check on funding (or vice versa).
- **Applying a structured approach** to ongoing monitoring where an agreed set of funding risk metrics at both fund and employer level are collated and reported.

- **Regular tracking** of the metrics over time so you're alert to emerging risks and can identify any trends. The frequency may vary by employer, eg more regularity for higher risk employers with no guarantor, employers approaching exit and employers with post cessation funding plans.
- **Agreeing criteria** to flag outlying employers which would trigger additional engagement. LGPS funds are increasingly diverse with a wide range of employers, sectors, objectives, and funding plans. Having agreed criteria will help spot any employers which are bucking a general trend and may require further investigation, monitoring or engagement.
- **Taking responsibility** within your team for seeking an understanding of how emerging economic and demographic trends and events are affecting funding. For example, the impact of the mini-budget (and ensuing gilt market crises) was global news but the effect on LGPS funding was less understood by many.
- **Planning next steps** and using funding monitoring to inform meaningful and more regular discussions with key stakeholders.

## Engaging with stakeholders on funding risk

The best mitigation of funding risk is to understand the impact and to plan for the outcomes. Pension funding should be a continual dialogue. Having timely conversations with stakeholders allows more space to plan strategy beyond the short window of the valuation and ensures pension responsibility stays firmly on the radar.

Stakeholder engagement over the inter-valuation period could include:

- **Committees & local pension boards:** Providing elected members with regular updates on whole funding position or specific high risk employers allows them to carry out their role more effectively. Potential changes in funding or investment strategy can be identified and discussed earlier.
- **Employers:** Providing updated funding positions improves understanding and maintains engagement on their obligation to the scheme between valuations. Funding monitoring enables better planning for employers approaching exits or with specific funding arrangements (such as deferred debt or security).
- **Officers:** Understanding indicative funding and contribution trends between valuations allows officers to consider next steps and have earlier and well-informed discussions on funding strategy.
- **Other advisors:** Within an integrated risk management framework, funding analytics are a key component to provide insight to investment strategy and covenant reviews. Equally, changes in covenant or investments can be considered alongside the latest funding analytics to allay concern or plan for outcomes.

Regular engagement is key to successful risk management. However, it's critical for funds to have the information and tools needed to manage risk effectively.

## How can we help?

We have evolved our digital solutions to keep up with the pace of change in the LGPS. Funds can now access current funding and risk analytics on-demand through our funding risk monitoring (FRM) platform. Having this availability and reliability of information can facilitate a better understanding of inter-valuation funding risks and help to develop a robust risk management framework.

### Webinar on-demand

We recently hosted a webinar which focused on the importance of funding risk monitoring. This was the first in series of webinars on holistic risk management in the LGPS. Andrew McKerns was joined by Tom Hoare to discuss:

- Why monitoring funding risk between valuations is so important?
- What funding risk monitoring best practice looks like?
- Engaging with stakeholders on funding risk

Looking at funding risk is just one of the risk management processes funds need to do and so in the rest of our webinar series we will explore other key LGPS risks and how to look at the whole risk environment and use it to drive decision making and deliver benefits in your fund.

Watch on-demand here.

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