100 HYMANS # ROBERTSON

“Now I’m 100% funded, will I stay that way?”

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?”**

The first question was discussed in this paper, with analysis showing that the LGPS is in a stronger funding position than it has been for many years. Most LGPS funds will have more assets per £ of future benefit payment than they have had in at least the last 15 years. And, as discussed in our last paper, most funds will likely be able to say they are 100% funded with a reasonably prudent level of required future investment returns.

Whilst this is a fantastic position to be in, and envied by many other pension schemes in the UK, those long in the tooth will remember that the LGPS has been here before. These people, along with those who remember the hard work that has been done during the last decade to restore the past service funding position, are now wondering whether it will stay this way.

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

Refining the question

'Staying 100% funded' will mean different things to different people. For this paper, we don't view the question as asking if the fund will always be 100% funded. We expect volatility in the funding level on a daily basis as the value of the fund's investment assets fluctuates in line with the financial markets. The LGPS, as an open, long-term pension scheme can 'look through' the short-term market fluctuations.

Instead, the concern driving the question is whether the fund can remain in a strong funding position, and avoid increasing employer contributions, if there is a substantial shift in the economic or market regime which has a persistent impact on funding over the long term. This is what we have considered in our paper.

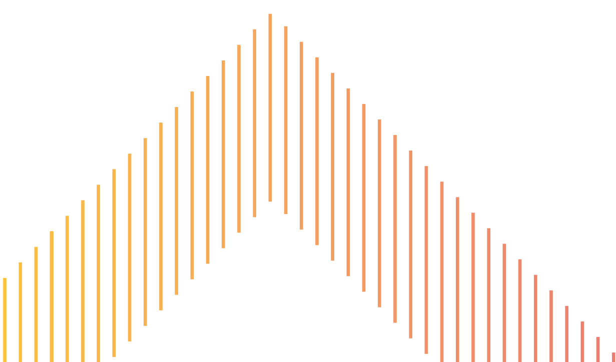
Answers please

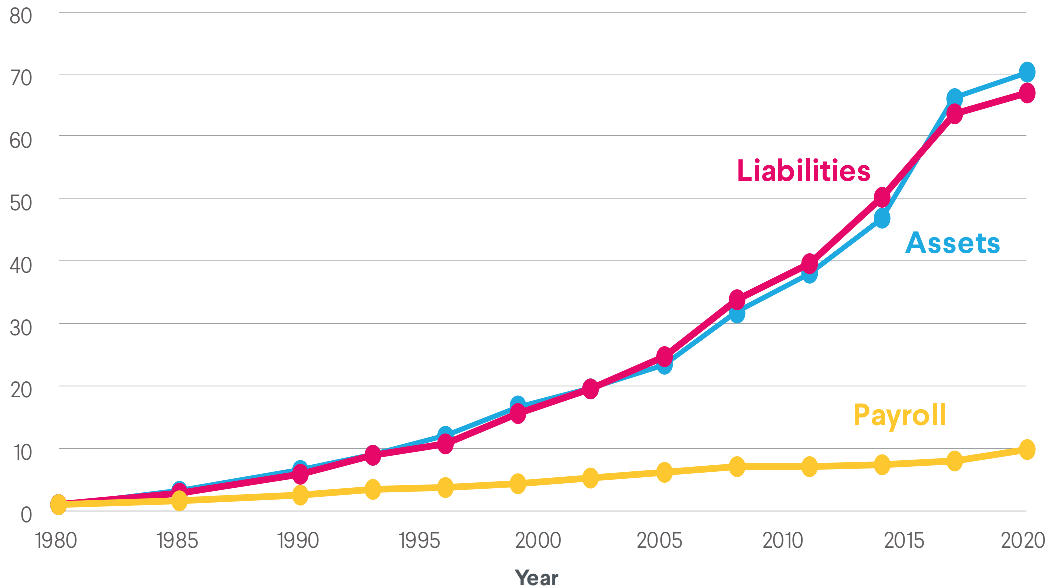
If LGPS funds continue to keep their significant allocations to equities and other risk assets, it's very unlikely that they will be able to avoid previous cyclical "funding booms and busts". However, we do believe that the LGPS has a very good opportunity at the 2022 valuations to take action that will reduce the risk of giving ground in the future on the current strong funding position.

Why is 2022 different from previous times?

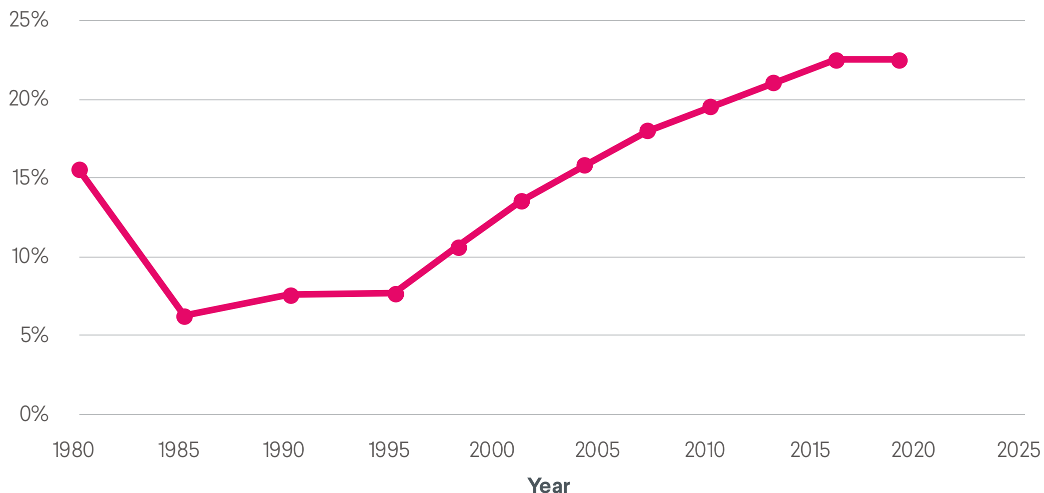
At 2022, there are a few factors working in favour of the LGPS protecting the current strong funding position.

1. **The ratio of funds' accrued liabilities and assets compared to participating employers' payroll is the highest in the history of the LGPS. This means that there is a lower tolerance for a change in the assets or liabilities before it feeds through to employer contribution rates. Furthermore, the current pressure on employers' finances has resulted in a much lower ability to afford contribution rate increases. Therefore, there is a lower appetite for funding volatility at 2022 than at previous valuations.**



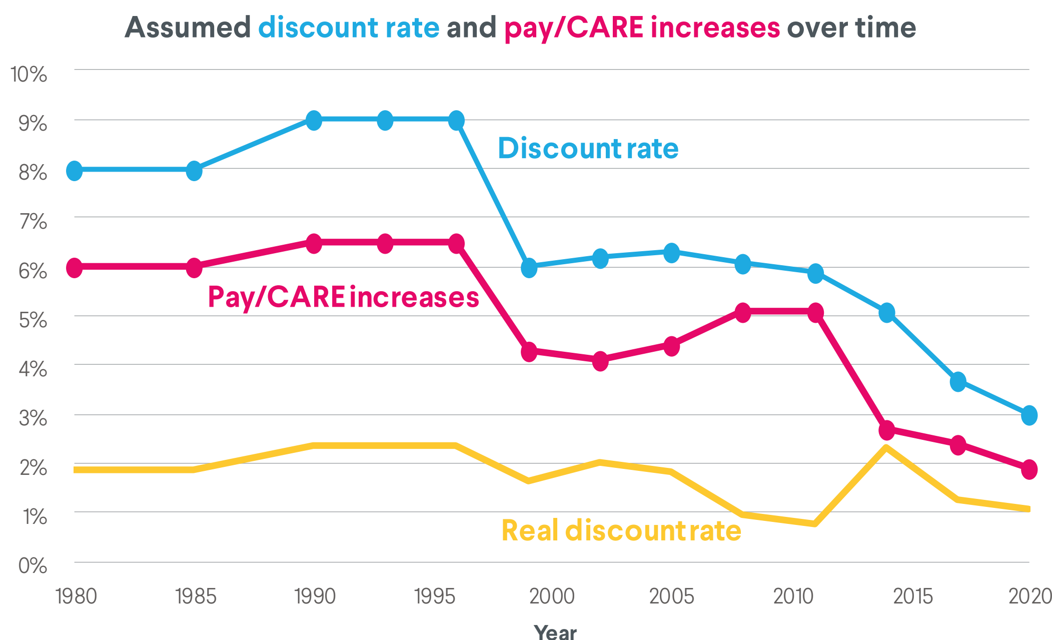


2 Over the past 35-40 years, employer contribution rates have gradually risen from around 5% of pay in the 1980's to the current average rate of around 20-25% of pay (of which around 80% is in respect of future benefit accrual). Whilst all employers would probably want to pay as little as possible for the LGPS, there has been a growing realisation over recent years that the benefits offered by the LGPS are generous and as such there is a relatively high cost attached to them. Most employers are now accepting of a Primary Rate between 15-20% of pay which is much higher than the last time the LGPS found itself in this strong funding position. This gives funds more scope in being able to reduce investment risk without unduly affecting the affordability of the scheme for employers.



3

Surprisingly, the main cause of the rise in employer contribution rates over the last 20-30 years is not due to investment performance or lower expected future returns. In fact, expected future real returns have remained broadly steady over the last 40 years.



THE CULPRIT HAS BEEN INCREASES IN LIFE EXPECTANCY.

The average assumed life expectancy for a 65-year-old LGPS retiree has increased from around 15 years in 1980 to more than 23 years today.

This matters when thinking about how to protect today's strong funding position. Over the last decade, there has been significant advances in analysis and monitoring of pension fund longevity. Club Vita analysis allows pension funds to set mortality assumptions more closely matched to their individual membership profile, whilst the Actuarial Profession's Continuous Mortality Investigation provide well-researched and robust models for considering how life expectancy will change in the future. Additionally, the LGPS 2014 retirement age is set equal to the State Pension Age, which should change in line with changes in life expectancy. All these factors mean that unexpected future changes in life expectancy causing a deterioration in funding are much less likely to occur.

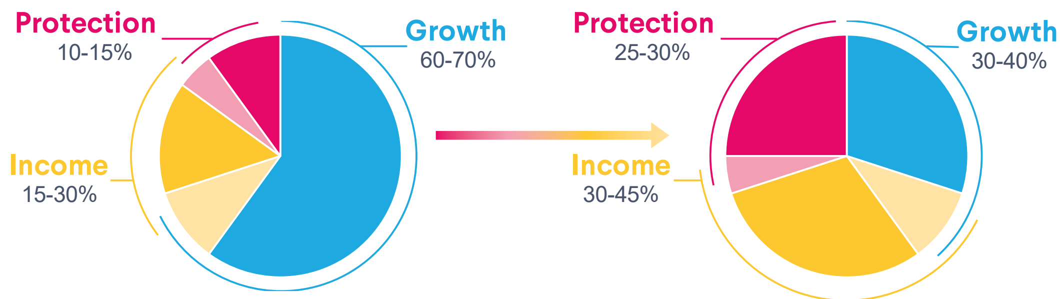
How to take advantage of this opportunity

For any pension fund, the way to solidify a strong funding position is to remove or reduce future sources of risk. Given the previous comments on longevity and current day tools to manage the risk, this leaves investment risk as the most significant threat for the LGPS. Management of this risk is typically achieved by 'de-risking' the investment strategy.

What does de-risking mean?

De-risking means many different things to many different people. Someone may see de-risking as removing exposure to a very specific risk in the investment strategy e.g. currency risk. Others may see de-risking as putting all the assets into low risk assets such as gilts, or even just sticking it all under the mattress.

For LGPS funds at 2022, the answer lies somewhere in the middle of these two extremes. Historically, LGPS funds' investment strategies have been very growth-orientated (at 2019, the average allocation to equities was 54%). Therefore, for a LGPS fund to de-risk it does not require the use of complex products such as equity protection or leveraged hedging. Instead, there is likely to be plenty of scope to remove some investment risk within a fund's current manager structure. Such a change may look something like this:



At a high level, there are three ways to achieve this transition listed below in increasing order of complexity and cost.

CUT THE RISK:

Quite simply, buy protection assets such as gilts by selling equities. Whilst at the time of writing (June 2021) gilts are still priced near historical highs, so too are equities.

DIVERSIFY THE RISK:

Increase the allocation to assets which pay alternative risk premia, such as property, infrastructure, private debt. An added bonus with this approach is that income accounts for a high proportion of the return on these assets, which may be increasingly helpful in managing cashflow requirements.

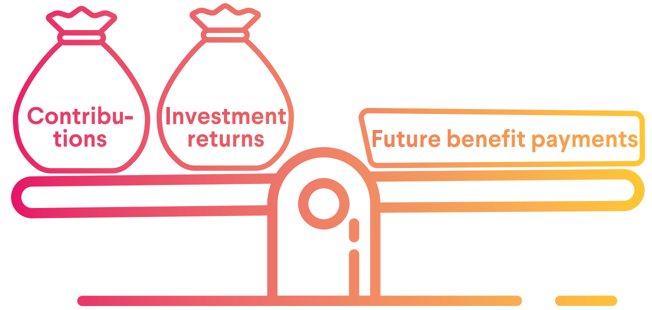
HEDGE THE RISK:

Implement strategies that involve derivatives or fixed income assets to explicitly hedge specific risks. Whilst these strategies are typically complex and often expensive, they may have a role to play in specific circumstances such as protecting exiting employers from unexpectedly large exit payments.

LGPS funds should consider all three of the above, but with a bias towards simplicity and low costs.

Don't forget about future service

One of the challenges for the LGPS when thinking about de-risking is the fact that the scheme is open to both new accrual and new joiners. This puts a natural brake on how far a LGPS fund is able to remove investment risk. You can't remove it all with the aim of solely protecting the past service funding position, otherwise the cost of future benefit accrual becomes unaffordable.



When reviewing the investment strategy at the 2022 valuation, funds will need to grapple with a careful balancing act between contributions and investment returns to fund future benefit payments.

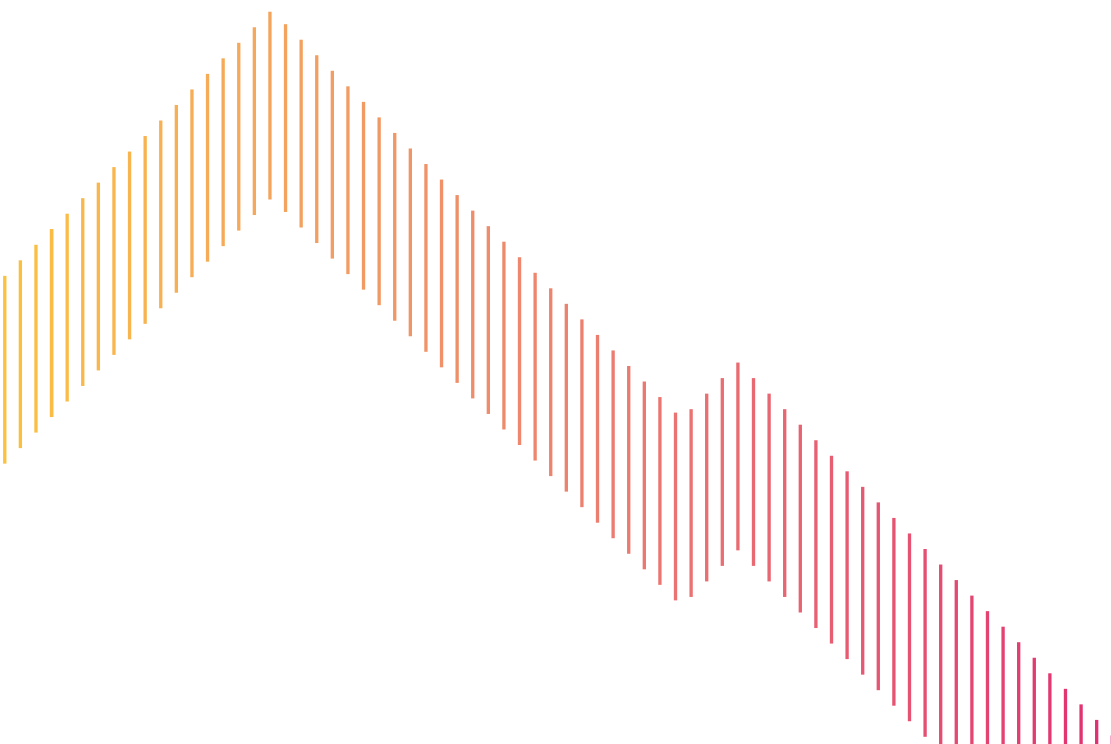
A heavier reliance on investment returns, leads to lower contributions but increases the likelihood of contribution rate increases in future years. Conversely, less reliance on investment returns leads to more predictable and stable contribution rates, but at the expense of affordability.

To help bring this balancing act to life, we have considered how affordability and volatility of contribution rates varies with different investment strategy growth allocations for a typical LGPS fund. For each investment strategy tested, the table shows:

- The contribution rate required to maintain full funding over 20 years with a 66% likelihood of success
- The likelihood that the contribution would need to increase by 2% or 5% of pay at the next valuation (ignoring any stabilisation mechanisms)

Growth allocation	80%	65%	50%	35%	20%
Required contribution rate	22% of pay	25% of pay	29% of pay	33% of pay	38% of pay
Likelihood of 2% of pay increase	38%	32%	29%	28%	24%
Likelihood of 5% of pay increase	24%	18%	11%	8%	4%

When reviewing the investment strategy, this type of analysis will be crucial to ensure that the investment strategy complements the funding strategy and achieves the funding objectives as set out in the Funding Strategy Statement.



Does one size fits all?

Historically, LGPS funds only operated a single investment strategy for all participating employers. In recent years, as the diversity of employers and their funding requirements has increased, some funds have implemented multiple investment strategies. The aim of this is to provide an investment strategy that better suits each employer's funding profile and deliver the best funding outcomes for all employers in the fund.

This consideration takes on even more importance when considering if the investment strategy should de-risk.

Whilst at whole fund level it may look an appropriate course of action, at employer level there may be some who would not be best served by a reduction in growth allocation (e.g. poorly funded employers).

For those thinking about whether multiple investment strategies are a route they want to consider, the table below offers a good starting point for considering whether this is needed and what such strategies may look like.

Strategy	Consideration	Strategy
Ongoing employers – lower risk	• Main group of employers in the fund • Protect strong funding position whilst keeping future contributions affordable	• Reduce allocation to growth in favour of income and protection assets
Ongoing employers – higher risk	• Employers who are poorly funded and need extra investment returns to improve • Possibly immature employers with very long-term time horizon or low current asset value	• Keep current strategy or maybe increase allocation to growth • Consider if dynamic investment strategy appropriate to bank gains over time
Exiting employers	• Employers looking to exit the fund in short-medium term on low-risk exit basis • Employers will be balance sheet focussed and wish to minimise risk of unexpected large exit payment • Investment strategy may be used to help manage covenant risk	• Larger allocation to protection assets to help stabilise the funding balance sheet • If sufficient magnitude of assets, consider hedging strategy
Exited employers	• Employers who have exited the fund and paid a low-risk exit payment. • High priority to avoid a future deficit emerging which would fall to remaining fund employers	• Very high allocation to protection assets e.g. gilts • If sufficient magnitude of assets, consider cashflow matching strategy

When can action be taken?

For those who have been kept awake at night thinking about this topic, you don't need to wait until the valuation itself to do something. A strategy review can be carried out at any time. Indeed, reviewing the investment strategy before the valuation is probably more preferable – it gives you ample time to consider all the issues raised here and then frees up 2022 to focus on communicating the valuation results to employers.

Summary

Through the combination of a higher level of contributions being paid, the enhanced management of longevity risk and a commitment to focus on the long term rather than market volatility, the 2022 valuations offer an excellent opportunity to remove some investment risk and consolidate recent strong returns to protect future outcomes.

Whether it's through **cutting, diversifying** or **hedging** investment risk, if LGPS funds manage this, it will put the LGPS on a long-term sustainable footing and reduce the risk of "funding boom and bust".

Contact us

If you have any further questions please contact:

Catherine McFadyen
Head of Public Sector Consulting
0141 566 7784
catherine.mcfadyen@hymans.co.uk

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

Philip Pearson
Head of LGPS Investment
0207 082 6325
philip.pearson@hymans.co.uk

Peter MacRae
Actuary
0141 566 7671
peter.macrae@hymans.co.uk

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities. A member of Abelica Global. © Hymans Robertson LLP.