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Sixty second summary

You're fully funded. What next?

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If ever there was a time to celebrate, it's surely when you learn that your fund is fully funded. All that meticulous planning has paid off, and the outlook for funding is much brighter. What an accomplishment!

But when the euphoria has worn off, you might be scratching your head about the next steps for the fund, especially for those in England & Wales who will be reviewing the funding strategy as part of the 2022 valuation. Those next steps are our focus in this 60-second update – we hope you find it useful.

How big is your surplus?

Now that you're fully funded, you might be considering a change to the level of contributions or the investment strategy. Your first step is to ascertain how big your surplus really is. It's also important to remember that there is no single estimate – all estimates reflect various assumptions, including the long-term assumed return, which in turn is affected by investment risk. See this paper for discussion on what full funding really means.

Therefore, for a LGPS fund there are three broad choices when it becomes fully funded. You can focus on accumulation, affordability, or stability.

Options for fully funded schemes

#1 Accumulation	#2 Affordability	#3 Stability
Maintain contribution rate	**Reduce** contribution rate	**Maintain** contribution rate
Maintain investment risk	**Maintain** investment risk	**Reduce** investment risk

If you focus on **accumulation**, you can maintain both contribution rates and investment risk. Your aim is to build up a larger surplus or 'rainy day' fund over time, essentially increasing the prudence in your funding strategy, while the existing surplus gives you the confidence to continue taking risk.

If **affordability** is a priority for your Fund, you can put your surplus to work by reducing contribution rates. In this scenario, it would probably be preferable to maintain your exposure to investment risk. It's also important to make sure that contributions are reduced in a prudent way, so that the Fund has a decent likelihood of staying fully funded in the long term and reduces the risk of contribution rate increases at the next valuation.

Lastly, if **stability** is the key consideration for your Fund, you could consider maintaining contribution rates, but reducing investment risk. This would reduce the risk of a deficit opening up in the future, which may need a future rise in contribution rates to tackle it.

As you've probably worked out, there is a trade-off between the affordability of contributions (today) and the level of investment risk taken/stability of contributions (tomorrow). The right balance will be specific to each Fund; de-risking is not always the right choice, and indeed the chosen approach may involve a mixture of the three options.

If de-risking is your preferred route, there is a need to be realistic about how much investment risk can be removed. There are material constraints to de-risking, such as the need to ensure future contributions are affordable (the majority of most employers' contributions are in respect of future benefit accrual), and the possibility of higher costs relating to benefits. And before removing too much risk, it's worth remembering that some assets that produce capital growth or income offer good long-term protection against key risks that are hard or expensive to mitigate in other ways – such as inflation. Finally, please remember to consider the Fund's capacity to implement changes within the next valuation cycle.

Finally, if you are fortunate enough to be fully funded, keep a broad mind when deciding what to do next. Asset-liability modelling will be an important tool to help decision-making, but also be mindful of other external factors such as the impact of climate change risk and views of affected stakeholders.

Key takeaways

- Being fully funded gives you the opportunity to review contribution rates and your investment strategy.
- De-risking is not the only option. It may not be the best option, and the scope to de-risk may be limited.
- Your choice should reflect a trade-off between the affordability of contributions and the level of investment risk.
- Thinking about and setting the right balance for your fund now will make for a smoother 2022 valuation.

Contact us

To discuss the circumstances specific to your Fund, please contact your usual Hymans Robertson consultant. We'd be delighted to help.

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