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POLICY BRIEFING NOTE:

Autumn Budget 2024: LGPS inclusion in fiscal targets

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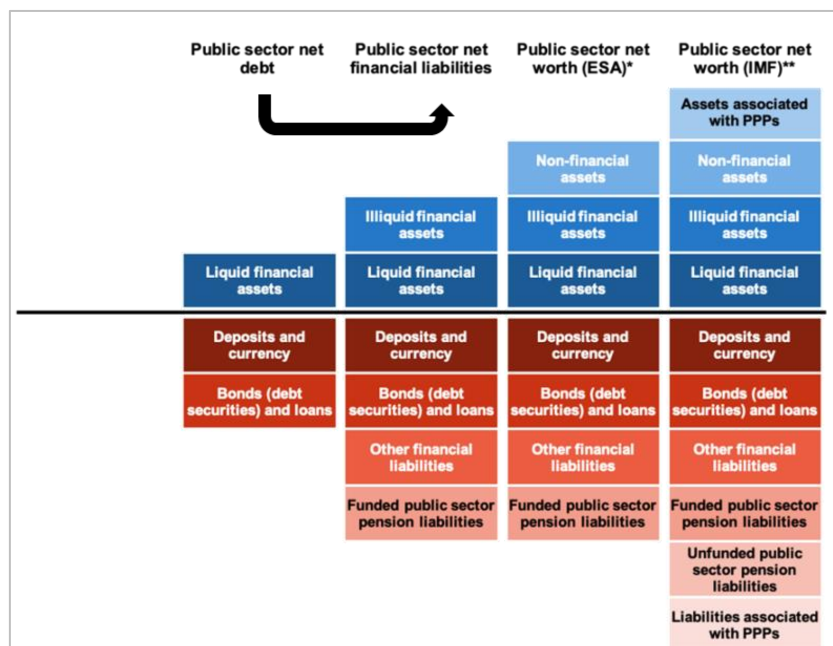
It's fair to say that many in the LGPS community were awaiting the details of the Budget with bated breath – was this where we would hear more details on government's plans for pooling, consolidation and UK investment? The short answer was "no", and it looks as though we'll need to wait for the initial report from the Pension Investment Review to get more information (we understand this will be released in November).

However, there was one part of the Budget that may have implications for the LGPS. As was widely reported in the week before the Budget, the government changed the measure of public debt for its fiscal targets. As summarised in the diagram, the target measure has switched from Public Sector Net Debt (PSND) to Public Sector Net Financial Liabilities (PSNFL), which creates around £50bn of fiscal space for investment into the economy. This is because PSNFL includes longer-term public sector liabilities and assets in the measure. Examples of these assets and liabilities are shares (eg the government's remaining shareholding in the NatWest Group) and money owed to the government (eg from student loans). Notably, this broader statistic now includes the assets and liabilities of funded public pensions (predominantly the LGPS – including England, Wales, Scotland and NI) but doesn't directly include the liabilities of the unfunded public sector pension schemes.



The change was accompanied by a promise from the government to have the measure falling as a share of the economy by the end of the parliament.

Source (amended): https://ifs.org.uk/publications/public-sector-net-worth-fiscal-target

What does this mean for government?

It means that the funding position of the LGPS as a whole can more directly impact the amount the government can borrow and invest in the UK economy. They have changed the rule to include this at a time when the LGPS is estimated to be in surplus, which will be helpful for them.

How is the LGPS allowed for within the PSNFL calculations?

We understand the PSNFL calculations carried out by the Government Actuary's Department (GAD) value LGPS liabilities using a single 3% real (net of inflation), 5% nominal discount rate and take the assets at market value.

This fixed discount rate is based on long-term estimates and is periodically updated by the ONS to reflect economic conditions. It's the same real rate used to value all public sector schemes. This means that market-driven shorter-term changes to the LGPS liabilities would not impact the PSNFL measure.

Of course, this also means the measurement of funding as part of local triennial valuations has no direct impact on the PSNFL calculation (other than future balance-sheet outcomes from changes in contribution and investment strategy).

However, changes in the market value of the assets held by the LGPS would have a direct impact on the measure. Therefore, big swings would not be welcomed by the government.

We estimate that of the extra £550bn assets and £507bn of liabilities included in the PSNFL measure (ie compared to the PSND measure), around 80% are from the LGPS.

Source:https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/methodologies/pensionsinthepublicsectorfinancesamethodologicalguide

How might this impact the LGPS?

The purpose of the LGPS continues to be to prioritise the interests of its members and employers. However, as recent discussions have shown, the government are potentially willing to utilise the LGPS to help achieve their policy aims.

The government have made it extremely clear that their number one goal is to stimulate economic growth. This is already having some potential impacts on the LGPS. While they aim to achieve part of this economic growth through investment directly from government, given their difficult financial position, they're also looking to the LGPS to contribute.

It would be fair to assume that this change in the public debt measurement will lead to further government interest in the LGPS. For example, should the LGPS fall back into deficit, it would reduce the level to which government can borrow and invest, reducing their capacity to drive economic growth.

The level of government interest and potential increased scrutiny, however, could depend on the size of any changes in proportion to the total debt level. As at 31 March 2024, the LGPS had assets of around £450bn. However, to put this into context, the latest calculation of the government's net debt position on the new calculation basis is £2.4tn.

What could this lead to?

The government will now be more interested in the LGPS remaining in, and most likely growing, its estimated surplus. So, what might government want to see from the LGPS?

Greater investment returns?

Stronger returns will, all else equal, help to grow the surplus, freeing up more for government to borrow and invest. However, this also requires taking greater risk, which could see surpluses shrink or become deficits.

Greater risk management?

Given the importance of economic growth to this government, their ability to borrow and invest is a priority for them. Could this reduce their appetite for risk-taking and encourage a focus on keeping the funding position from materially worsening?

Shorter time horizons?

The LGPS greatly benefits from its long time horizon. This allows it to take relatively greater levels of risk, as it has the time to recover from shorter-term market volatility. However, if government suddenly have a lack of appetite for the funding position to fluctuate over shorter time periods, due to their need to borrow regularly, will this lead to influencing shorter-term decision-making?

With LGPS funds' primary concerns being their own local funding levels and their fiduciary duties to members and employers, it remains to be seen whether these potential central Government aims could lead to greater tension between central Government and the LGPS on what LGPS investments are for.

Should the LGPS consider risk management measures?

There are two key drivers of the funding position in pensions – the value of the assets and the value placed on the liabilities. Within closed private sector pensions, protecting against changes in the ratio of assets to liabilities, or the funding level, has been their priority in recent years. This has been driven by the sponsoring employers looking to manage the risk of deficits growing and their need to put more money into the scheme. This has led to liability-driven investment (LDI) strategies being used, whereby they invest in assets whose value will move in tandem with the value placed on the liabilities.

For private sector schemes, this has been relatively straightforward to implement. The value placed on their liabilities has been based on government bonds, meaning holding government bonds as assets provides strong protection – if government bonds rise in value, the value placed on the liabilities rises, but so do the assets.

For the most part, liabilities across the LGPS are valued with reference to the assets the individual funds actually hold. Whereas (as above) the measure of liabilities within the PSNFL calculation is based on a long-term fixed rate. We would, therefore, make two observations:

- it would not be straightforward or desirable to create an LDI strategy with simultaneous strong ties to both these measures; and
- the PSNFL measure of liabilities currently has no direct link to the individual funds' objectives. LGPS funds are there to pay pensions, not help the government to borrow. Therefore, we do not believe it is an important factor in LGPS strategy development and decision-making.

What about UK investment?

As noted earlier, the government also want to see the LGPS investing in the UK. Given their increased incentives for the LGPS to remain in a strong funding position, we would hope this gives the government extra motivation to make sure there are ample attractive investment opportunities that will provide adequate returns (without excessive risk) for the LGPS.

Where from here?

While this action could be perceived as central government taking steps towards taking more control of the LGPS, it's important to note that LGPS assets and liabilities were already included in the Whole of Government Accounts.

Any bearing on the LGPS because of this change in the measure of public debt is likely to be driven by how the scheme's health impacts PSNFL and thus the government's plans. While the LGPS is in a strong position, government may remain content. However, should the position significantly worsen to the point it challenges their ability to borrow and invest, government may well take a strong interest. In any case, it is reasonable to assume that scrutiny of the LGPS will increase.

However, much is yet to be seen; we would not currently suggest any immediate actions from here as a result of the changes.

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