Managing Deficits – The zero sum game

- LGPS Funds are being asked more and more about how they are managing their deficits: in hard terms this usually means reducing the employer contributions;
- In reality this is a “zero sum game” eventually, where Cash contributions + Investment returns = Benefit payments;
- Therefore, if we wish to reduce an employer’s cash contribution obligations, something else has to give: the contribution being shared somehow, investment returns being improved, or benefit payments reduced;
- For some employers, the “crystallisation maze” offers other opportunities;
- There may not be any magic bullets, but there are a few practical solutions which can be applied here.

What’s it all about?

There’s much talk in the Local Government Pension Scheme (LGPS) world these days about “managing deficits”. Some commentators go so far as to imply that, if only we were more inventive or daring, we could somehow make those annoying deficits magically disappear.

However, simple maths suggests that this can’t be true. Instead, if we wish to “manage” deficits then we must first acknowledge an important truth: in order to reduce an employer’s contributions, then something else has to compensate. It is, after all, a zero sum game.

We have previously written about how:

So far, so theoretical. But what can funds and employers actually do to reduce, or at least control, the employers’ cash obligations? (Assuming that’s what we really mean when we talk about “managing deficits”).
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Some practical solutions
Here are some thoughts: in all cases they focus on what else needs to “give” in order to reduce contributions. Remember this zero sum:

\[ \text{Cash contributions} + \text{Investment returns} = \text{Benefit payments} \]

Looking at it this way, if an employer wants to reduce its deficit contributions, then this boils down to three options:

(a) Get someone else to pay part of the cash contributions
(b) Improve (net of fees) investment returns
(c) Reduce benefit payments

Let’s consider each of these in turn, and some of the specific actions an employer might be able to take.

(a) Get someone else to pay part of the cash contributions
The idea here is that, whilst the same overall contributions are needed by the Fund, the employer offloads some of its cash obligation to another party by managing potential risks. How might this happen?

- Hedging inflation or longevity – if inflation or pensioner longevity rises beyond a certain limit, this materially adds to the benefit payments and hence the cash contributions required. Hedging can help as the counterparty pays for some of this added cost, in those circumstances.
- Ill health insurance – in the event of an ill-health early retirement, the insurer pays the strain cost. Such strains can be a huge element of the pension obligation of a small or medium-sized employer.
- Risk-sharing / pass-through – when a council or other Scheme Employer awards an outsourcing contract, the pension obligations of the contractor can be largely fixed at the outset. This allows the contractor to avoid potential market-driven rises in the contribution rate. It also allows (at least in theory) a keener contract price and thus added savings for the Scheme Employer to redirect into added pension contributions of its own.

Of course, the sharp-eyed reader will have spotted that these are all forms of insurance: the employer only passes on costs to another party in certain circumstances. But that is the “zero sum game”: the same combined contributions must be paid, and the circumstances dictate how these are split.

(b) Improve (net of fees) investment returns
If the same benefits are to be paid by the Fund, the required cash contributions can only be reduced at the expense of higher net returns. Either the investment returns are improved and/or the investment fees are reduced. Such things are most definitely easier said than done, but not impossible:
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- **Objective Driven Investment** [http://www.hymans.co.uk/knowledge-centre/publications/public-sector-publications/objectives-driven-investing.aspx](http://www.hymans.co.uk/knowledge-centre/publications/public-sector-publications/objectives-driven-investing.aspx) – it requires careful planning to set up, but asset gains can be systematically crystallised as and when they arise, rather than being left to erode when markets fall again.

- Vary investment strategies by employer – more keenly targeted asset allocation approaches can work better for employers in different circumstances. There is growing interest in this within the LGPS, and some Funds are moving away from the “one size fits all” investment strategy approach. For instance, a poorer funded employer may want to take more risk and seek higher returns: it has less to lose and more to gain. Conversely, a more risk-averse approach would be relevant for employers seeking to lock in their better funding position.

- Pooling – this is of course the topic of the moment, following July’s Budget announcement. The aim is to reduce fees but maintain returns. You will have seen our own efforts in this area. [http://www.hymans.co.uk/knowledge-centre/publications/public-sector-publications/lgps-investment-pooling-responding-to-government.aspx](http://www.hymans.co.uk/knowledge-centre/publications/public-sector-publications/lgps-investment-pooling-responding-to-government.aspx)

- Basic maths – A bird in the Fund is worth two in the bush. If you have the option to pay £100 contribution this year, but decline to do so, you miss out on the investment return: if that return was 5%, then your alternative next year is to pay £105 (not £100). Another way of thinking about this is that, if you only have £80 of assets for £100 of liabilities, and liabilities grow at 5% every year, then you need an investment return of more than 6.25% every year if you want to reduce the deficit (5% x £100 = £5, which is 6.25% x £80).

  (c) **Reduce benefit payments**

  If returns are steady but contributions are to reduce, then the eventual benefits need to be lower to balance the zero sum game. Of course the LGPS Regulations place severe restrictions on what can be done here, but there are some strategies worthy of an employer’s consideration:

  - Watch pay growth – the pre-2014 accrual of benefits for current active members will continue to rise in line with their pensionable pay. Lower increases mean lower benefits. Could some pay increases be diverted into non-pensionable elements?

  - Restrict instances of unreduced benefits on early retirement – the Government has done some of this for English councils and academies, with its recently proposed £95k exit package cap (despite our warnings of the unintended consequences. [http://www.hymans.co.uk/knowledge-centre/publications/public-sector-publications/public-sector-exit-payment-cap-proposed-unintended-consequences.aspx](http://www.hymans.co.uk/knowledge-centre/publications/public-sector-publications/public-sector-exit-payment-cap-proposed-unintended-consequences.aspx) However, it has always made funding sense for employers to watch out for this, bearing in mind age discrimination and employment law aspects of course.

  - Cease accrual and/or new entrants – this seems like an obvious move to stem the flow of future pension obligations. But beware the consequent move into a cessation situation for the employer. We are aware of some consultants advising employers to leap from the frying pan, but are less aware that the employers understand the fire they potentially get into.

  - Members may take up the recently introduced 50/50 or Freedom & Choice options – these will typically reduce the benefit obligation to be funded by the employer.
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These options all involve reductions in member benefits, to permit reductions in employer contributions. As an aside, beware of the message that what works in the private sector can be imported to the LGPS. Private sector schemes have been managing their deficits using tools not available in the LGPS: reductions in benefits, increases to member contributions, enhanced CETVs, or pension increase exchange. These simply cannot be applied in the LGPS due to regulatory restrictions.

The ultimate example of this is the cost control mechanism which is laid down in statute. It could reduce statutory benefits, and so under a zero sum game allow more contributions to be diverted to deficit repair. But that same mechanism has also locked in the central cost to be maintained, so employers shouldn’t hold their breath on this.

The crystallisation maze

There are some specific instances worth considering for those employers heading for cessation. Cessation means the Fund charges a final exit contribution to the employer: this will eventually prove to be either insufficient (leaving other Fund employers to pick up the bill) or overly conservative (i.e. the ceasing employer has overpaid).

The “zero sum” is therefore in relation to the other employers in the Fund, after the ceasing employer has crystallised its final deficit measurement. Can the Fund handle the maze of options more cleverly?

- Ceased employers could continue to fund on an ongoing basis, instead of the more prudent cessation basis. This would require the employer to provide the Fund with sufficient security. It does have the advantage of capping the employer’s cash liability, and the Fund has more security than before the employer “ceased” (i.e. often none).

- Employer covenant should be assessed and monitored, to minimise the risk of the employer hastily leaving the Fund when unable to pay its deficit (thus leaving this to be picked up by others). In general, it makes sense for both the employer and the Fund to have high contributions as early as possible, rather than leaving things until the employer is less able to afford its obligations. This is compounded by the investment return mathematics point mentioned under (b) above.

- In general, a more bespoke and consistent combined funding and investment strategy would result in better outcomes for the employer. This is an extension of the investment strategies point mentioned above. It would reduce total contributions relative to a gilts basis whilst providing more protection for the Fund: the “zero sum” is achieved by limiting the possibility that the employer overpays on cessation.

Those most commonly affected by these crystallisation issues are Community Admission Bodies (to use the old parlance), and Town and Parish Councils, which have closed to new entrants. Negotiating this maze will be a challenge for such employers given the potential cessation contributions and adviser fees.
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Those magic bullets
Perhaps you’ve heard about some alternative approaches to “managing deficits”? Remember the old maxim, if something seems too good to be true, then it probably is. For instance:

- Special Purpose Vehicles (SPVs) – these can help with smoothing or reducing contributions; but it is important to appreciate that they just provide security, they don’t actually reduce the physical need to pay contributions other than on the failure of an employer.

- Interest rate LDI – Liability Driven Investment based around interest rate movements is at risk of targeting the wrong thing – a stable funding level. For employers heading to cessation it may be appropriate, but for most others it is the stability of contributions (not stability of funding level) which is really important.

- Simply paying lower contributions without quantifying and understanding the risks: this may be dressed up as:
  (i) adopting overly optimistic funding assumptions, or
  (ii) targeting a lower funding level.

In all cases however, the result is the same: the contributions have just reduced, in the face of the reality of the zero sum game. The consequence, all too often, is that for every £100 of asset growth missed, an added £100 of contributions is needed later. Reducing short term contributions doesn’t just defer the obligation, but like any other debt that attracts interest, it increases the obligation too.

Conclusion
Deficits cannot be made to disappear, any more than debts can be written off. It is helpful to always appreciate this is a zero sum game, where a reduction in cash obligation is only possible when something else gives.

There are no magic bullets, but there are less-dramatic practical steps which can be taken.

We would be delighted to discuss these possible steps with you: please contact your usual Hymans Robertson consultant.