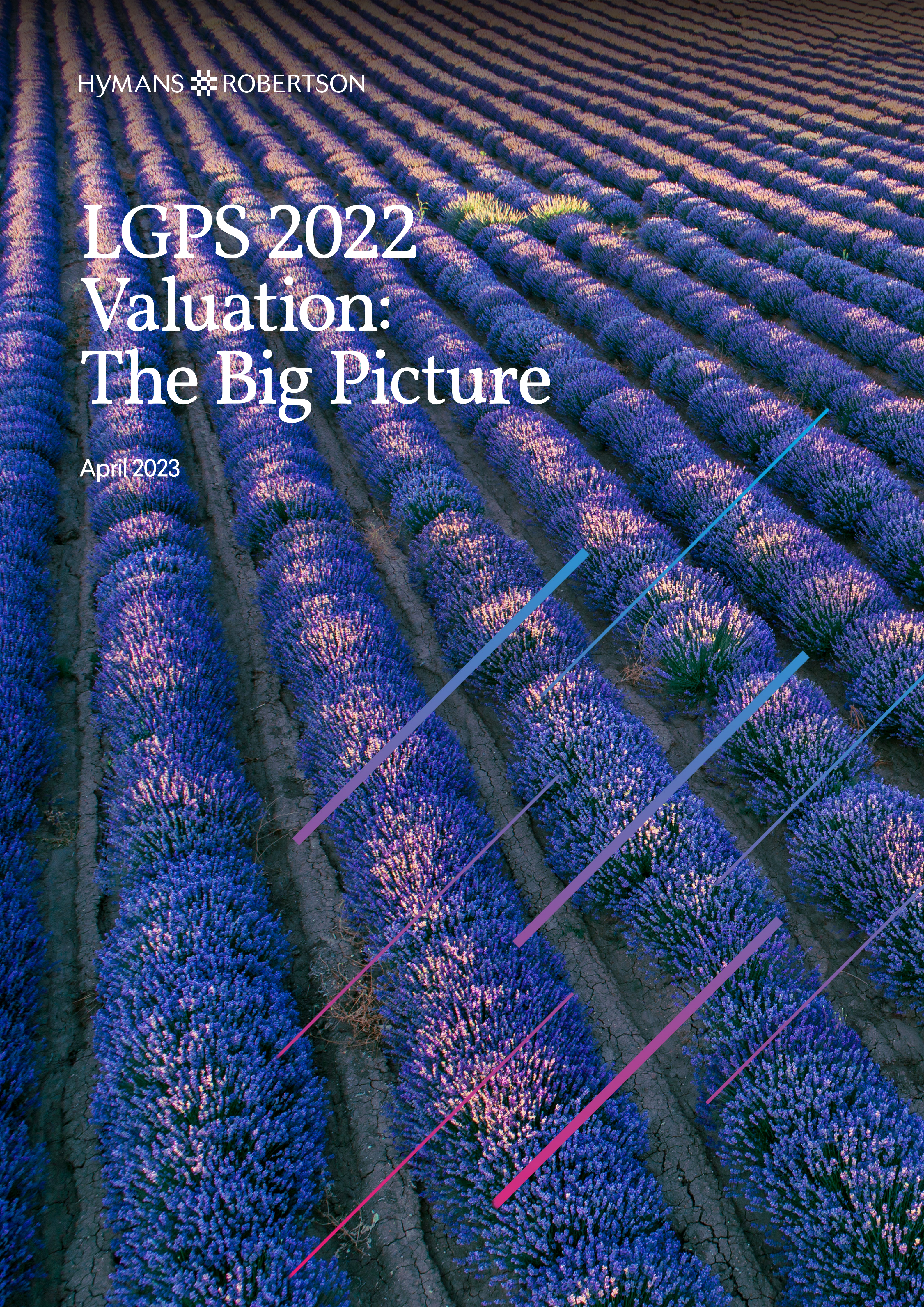
HYMANS ROBERTSON

LGPS 2022 Valuation: The Big Picture

April 2023



Executive summary

With the 2022 valuations in the LGPS in England & Wales now concluded, we've analysed results for 73 of the 86 funds to understand the national picture. And the results are very positive.

- The past service funding level is strong – an increase in the overall funding level from **98.5%** at 31 March 2019 to **107%** at 31 March 2022.
- Administering authorities have, on average, been able to offer some contribution rate relief. The average employer contribution rate has reduced from **21.9%** at 2019 to **20.8%** of pay at 2022.
- The outlook for the long-term sustainability of the scheme is robust. In aggregate, current LGPS funding plans have a more than **3-in-4** likelihood of being sustainable over the long-term.

This means that the LGPS is in a very strong and enviable position, not just within the public sector pension scheme environment, but also when compared against other open, long-term defined benefit pension schemes.

Introduction

11:59pm on 31 March 2023 saw the completion of the 2022 triennial valuations in the LGPS in England & Wales and a collective sigh of relief. The previous 12 months (and longer when planning and preparation is taken into account) saw LGPS administering authorities look inward as they reviewed their funding plans and set contribution rates for each individual participating employer. But now that the dust has settled, there's time to take a step back and look at the big picture – what's the overall position of the LGPS in England & Wales? And what is the variation between funds?

At the time of writing (18 April 2023), 73 of the 86 2022 local fund valuation reports were publicly available. Using this information, we've created the big picture, looking at the 2022 funding position and contribution rates for the English & Welsh LGPS, along with some other interesting outcomes.

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Funding position

National level

Even before the valuation date itself, most commentators were expecting the funding position of the LGPS to have improved, with rises in investment markets expected to more than offset increasing short-term inflation expectations. Now that the results are in, we can say that these predictions proved correct. The average increase in fund asset value between 31 March 2019 and 31 March 2022 was 27.5%, although this varies at individual fund level with observed increases ranging from 17% to 43%.

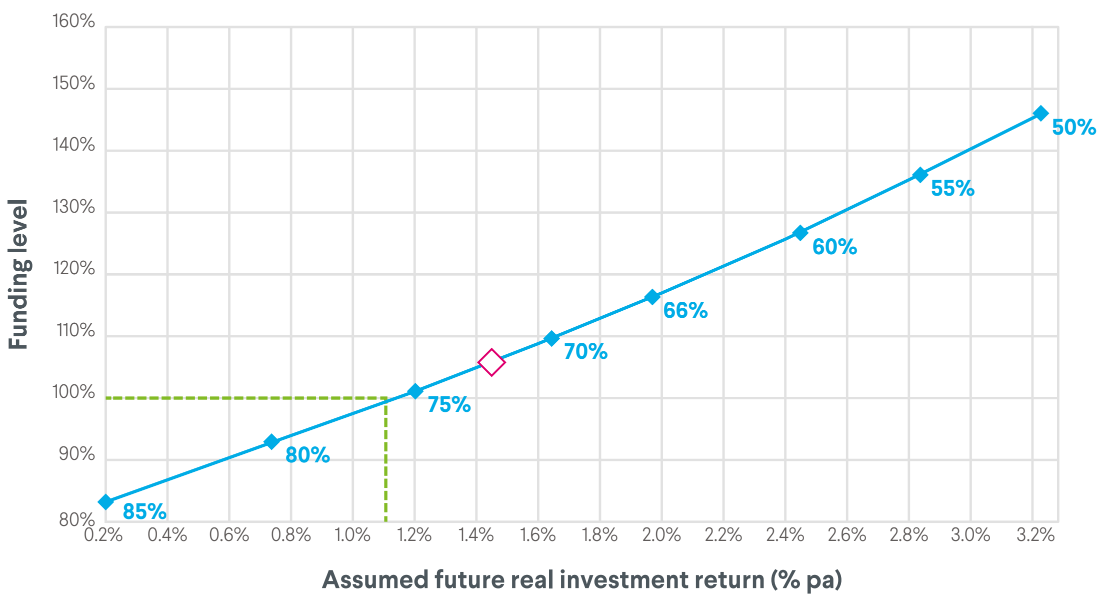
The much better than allowed for asset growth has led to the overall LGPS funding level improving from 98.5% at 31 March 2019 to 107% at 31 March 2022.

These numbers are a straight sum of each fund's reported funding position using their own assumptions.

However, when moving the results onto a consistent actuarial basis (set by the E&W LGPS Scheme Advisory Board and as reported in the dashboard in each fund's valuation report), the increase is similar.

Whilst a single funding level, the ratio of assets to liabilities, is an easy-to-understand high-level metric, it hides a lot of important detail. The market value of assets at the valuation date is known. However, the value of the liabilities is dependent on assumed future investment returns. Therefore, we've calculated the liabilities and funding level for the LGPS across a range of different real (net of CPI inflation) investment returns (the real discount rate). To help better understand funding risk, the likelihood of the LGPS's aggregated investments achieving each level of return has also been calculated (the numbers next to each blue diamond).

Chart 1: LGPS funding level across a range of future real investment returns



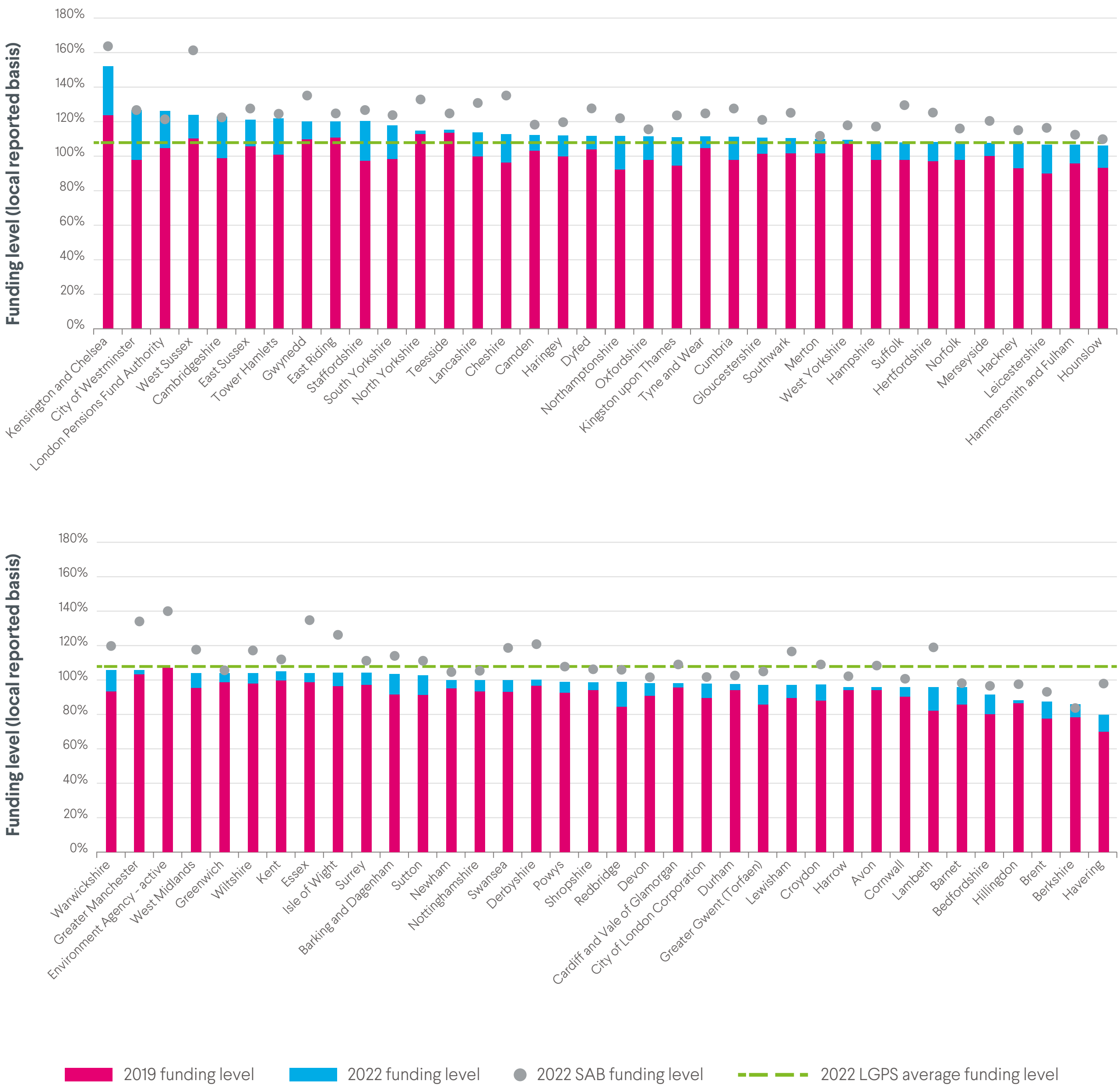
The **pink diamond** on the chart shows the total overall reported funding level mentioned earlier – 107%. This is based on an assumed future real investment return of c1.5% pa. The chart also shows that at 31 March 2022, the required real return for the LGPS to be 100% funded was only 1.2% pa. We estimate that there's around a 75% likelihood of the LGPS being able to deliver that level of real return over the next 20 years – a very high level given the current level of uncertainty in the financial markets.

This is a very positive funding position for the LGPS. Considering that, not so long ago, the Scheme Advisory Board had set up a 'Deficit Working Group' and the significant market events that the LGPS has had to navigate in recent years eg Brexit, Covid-19. Being in such a strong position is a testament to the diligent and hard work of administering authorities over the last decade.

Individual fund level

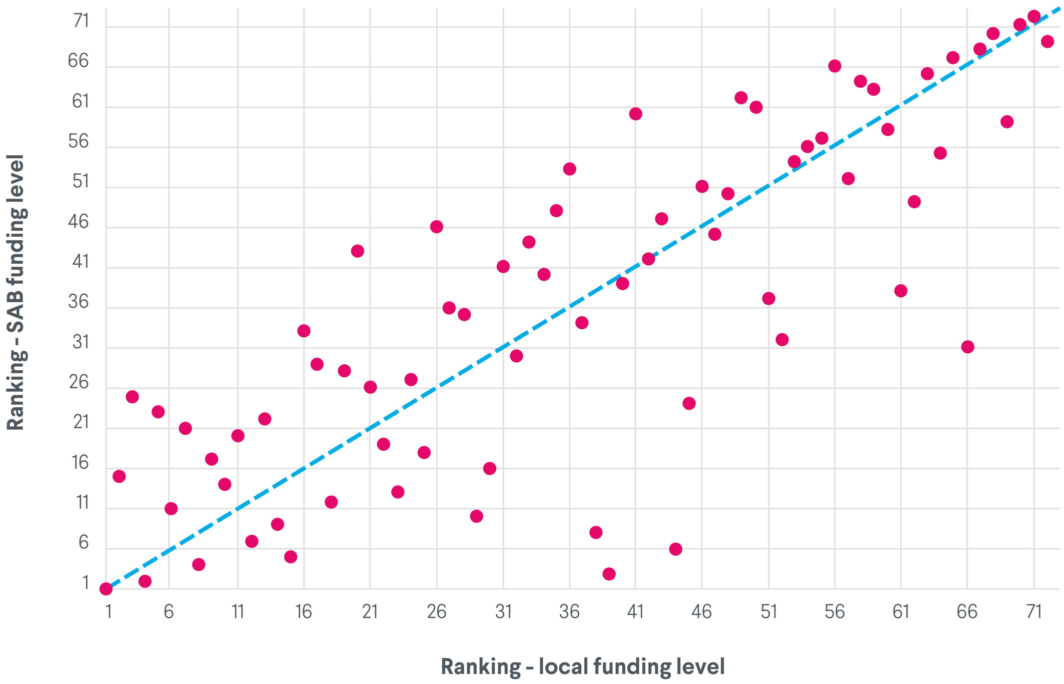
When moving from national level to individual fund level, the story is similar – there have been improvements in funding level since 2019 across the board – albeit there is some variation. There's also a general trend of those funds who were better funded in 2019 seeing bigger improvements in funding at 2022. This is a result of those funds holding more assets at 2019 so they benefit more from strong investment performance.

Chart 2: distribution of reported funding level across individual funds



Funding level is sometimes used to compare the relative funding strength of individual funds. But it's clouded by differences such as different underlying actuarial assumptions. Given this, funds also calculate a funding level using a set of standard assumptions. The assumptions are set by the Scheme Advisory Board (SAB) for the purpose of comparison; hence, it's known as the 'SAB funding level'. Chart 2 includes the SAB funding level for each fund and, whilst the chart is ordered by local reported funding level, there is no similar order or progression to the SAB funding level. This is even more apparent when each fund is ranked on local reported and SAB funding levels, as per Chart 3.

Chart 3: ranking of each fund on local reported and SAB funding level (1 = highest funding level, 73 = lowest)



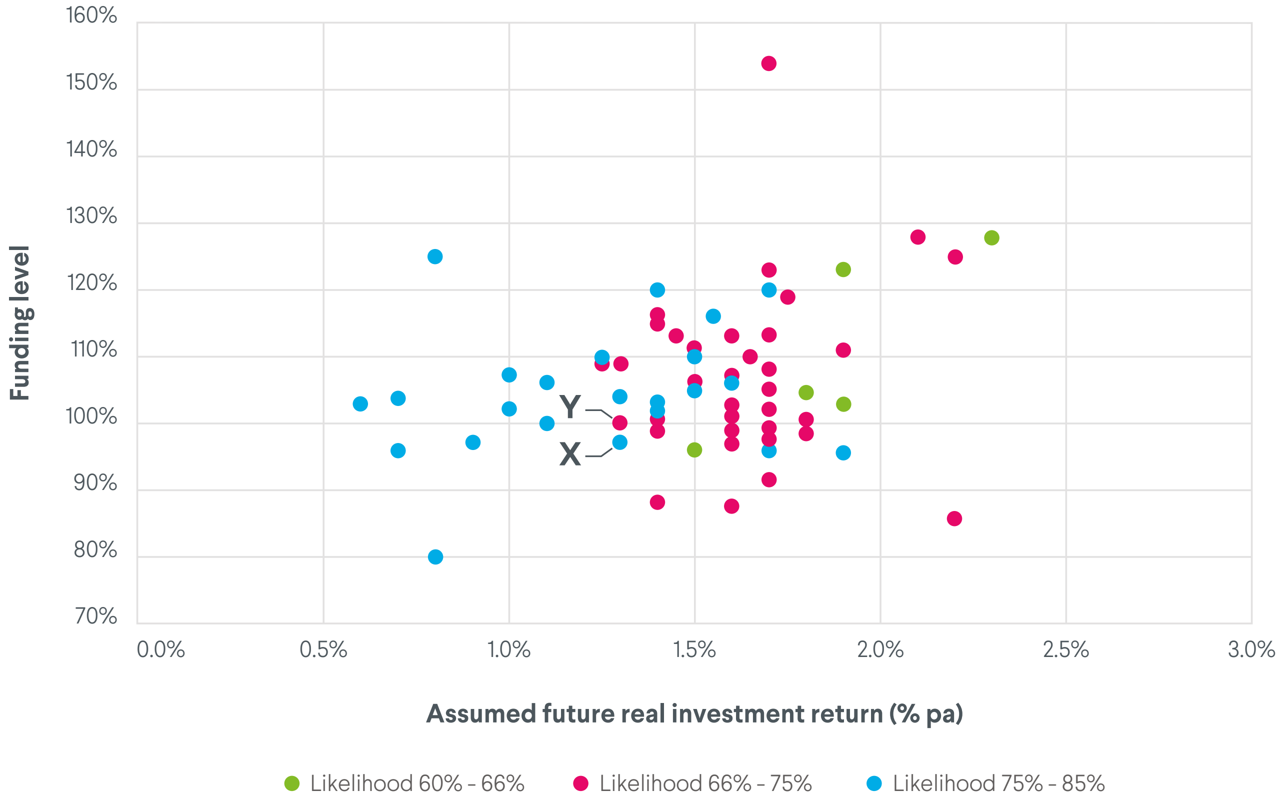
Funds below the blue line are those which appear to move up the rankings when the funds are compared on a consistent basis. It's tempting to conclude that the funds below the dotted line are more prudent than those above the dotted line. However, this analysis does not factor in that investment strategy is a significant factor. And in recent years, there has been increasing divergence in investment strategy between funds. So, Fund A may use a very low discount rate (expected future return on investments) when calculating the funding level, which looks more prudent than Fund B using a higher rate. However, if Fund A has a more defensive investment strategy than Fund B, then the likelihood of Fund A achieving its lower discount rate may actually be similar to the likelihood of Fund B achieving its higher rate from the higher allocation to return-seeking assets.

A better way of comparing current funding positions is to look at:

- the funding level;
- the real discount rate (ie future assumed real investment return) the funding level is based on; and
- the likelihood of the fund's investment strategy achieving the discount rate.

This is what has been done in Chart 4.

Chart 4: individual fund analysis of funding level, future expected real discount rate and likelihood of investment strategy achieving the discount rate



This gives users more information to understand, compare and contrast past service funding positions. For example, looking at Funds X and Y on the chart, they have broadly the same funding level and same future assumed real return. A natural conclusion would be that they're similarly funded. However, looking at the colours, we can see that Fund X has a higher likelihood of achieving the future assumed real return compared to Fund Y. So in fact, Fund X is probably in a stronger overall funding position. The good news for the LGPS is that there are no individual funds with a low funding level that are relying on a future investment return which has relatively low likelihood of being achieved (the lowest likelihood in our analysis was 60%).

Contribution rates

National level

The LGPS continues to offer future accrual of benefit to existing and new members. Given the 'open' status of the scheme, the main focus of a valuation is on the cost of providing the benefits, with any variation falling to employers. When setting contribution rates, LGPS administering authorities are seeking a balance between security (ensuring there will be enough money in the future to pay benefits), affordability (for the employer) and stability (avoiding significant changes, particularly increases). All three objectives conflict with each other so it's a difficult balancing act.

Going back to pre-valuation predictions, the messaging was that primary rates would likely be higher (due to increased inflation expectations) but secondary rates would be lower (due to improved past service funding levels). Again, these predictions were correct.

The average employer contribution rate for the LGPS in England & Wales at the 2022 valuation is 20.8% of pay. This is 1.1% of pay lower than the 2019 valuation (21.9% of pay).

	2022 valuation	2019 valuation
Primary rate	19.8% of pay	18.6% of pay
Secondary rate	1.0% of pay	3.3% of pay
Total employer rate	20.8% of pay	21.9% of pay

The reduction in secondary rate may seem significant at first glance. However, it's not when placed in the context of the change in net funding position. Distributing this funding improvement over a prudent period (20 years) and the total payroll at 2022 for the LGPS funds in our analysis (c£38bn) is equivalent to around 3.5% of pay.

The actual reduction in secondary rate is 2.3% of pay. This gives an insight into how funds are managing the balance between affordability, security and stability. On average, they're recognising a genuine improvement in funding and passing that on via a reduction in employer contribution rates. However, they have not passed on the full benefit and held back some to allocate against security and use as a buffer for any future adverse experience to help achieve the desire for contribution rate stability.

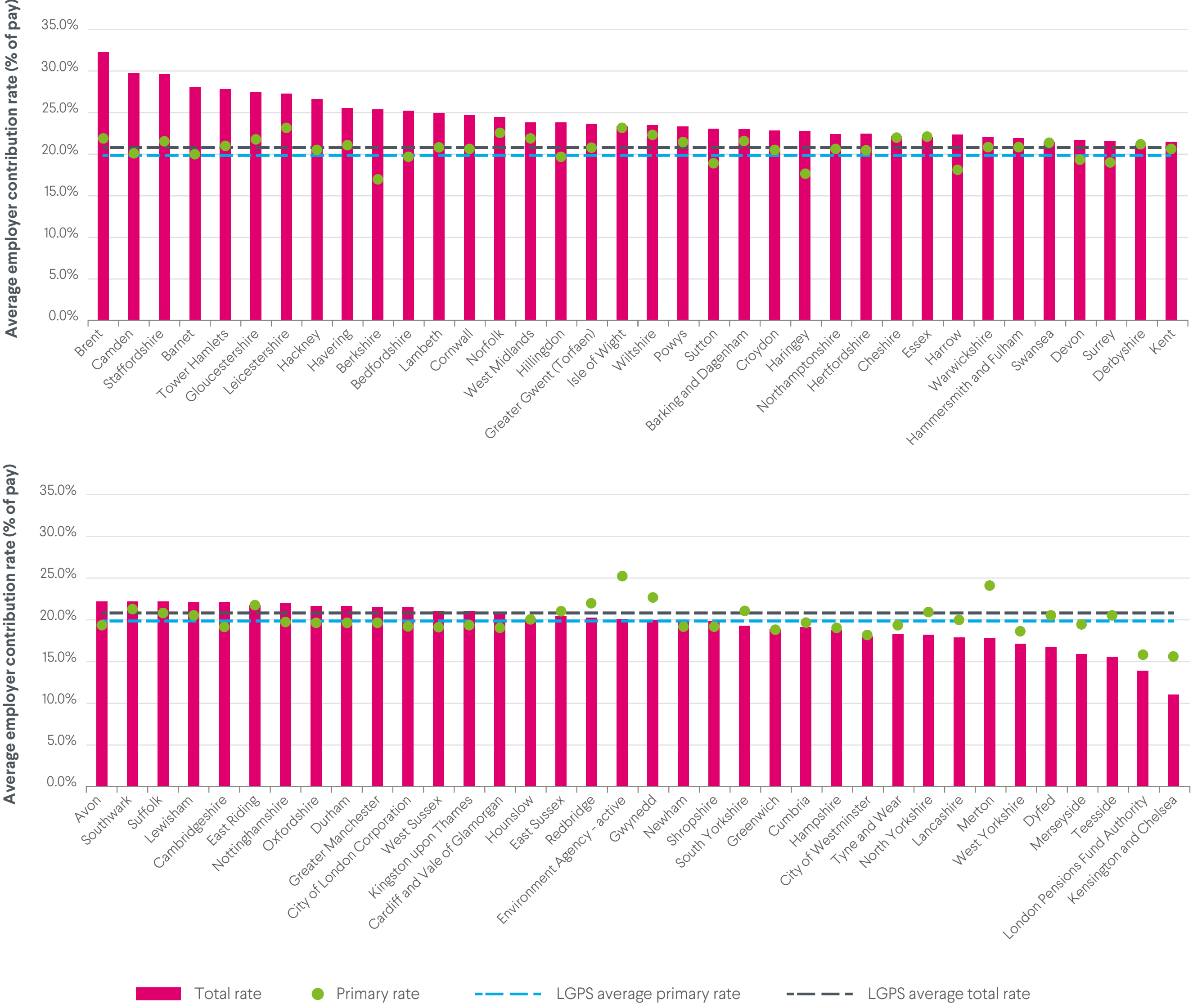
Similar to the funding position, the national picture for contribution rates is very positive. To be able to reduce contribution rates at a time of high inflation and significant pressure on employer budgets is again testament to the effectiveness of individual funds. These headline results are even starker when considered against the other (unfunded) public sector pension schemes, where significant contribution rate increases are expected as a result of lower GDP growth expectations .

Individual fund level

Although the LGPS is one scheme, the focus on local accountability allows each administering authority to decide how best to manage the funding of the benefits. These decisions lead to different employer contribution rates across the country.

Chart 5 shows the fund level average contribution rate at the 2022 valuation for each individual fund in our analysis. As well as the total rate, we've also shown the primary rate.

Chart 5: individual fund level average employer contribution rate at the 2022 valuation



There's a wide range of average rates across the funds. The most common question asked by observers is: what's driving these differences? And, why is everyone not paying the same, as in the national level public sector pension schemes? The main causes are local differences in investment strategy, past service funding position and the approach to balancing security, affordability and stability.

For example, there's strong correlation when comparing the average primary contribution rate for each fund at 2022 with the expected future real investment return (Chart 6). This shows the influence that investment strategy has – the higher the real expected return, the lower the primary rate.

The secondary rate has historically been linked to the past service funding level, with higher rates being paid by those with lower funding levels. At 2022, whilst this correlation still generally holds true, it's weaker than at recent valuations (see Chart 7). This is evidence of funds looking to increase the stability in contribution rates, instead of immediately giving full credit for the recent improvements in the past service funding level. This is a sensible approach for a long-term, open pension scheme like the LGPS.

Chart 6: individual fund average primary rate and expected future real investment return

Chart 7: individual fund average secondary rate and past service funding level

Given these variables, and others such as membership profile and experience, care does need to be made when comparing and contrasting contribution rates between funds and individual employers. When doing such a comparison, the purpose is to really understand the robustness of the funding plan, ie **"how likely is it that the combination of current funding position, contribution rate and investment strategy result in there being enough money to pay benefits in the future"**.

Using modern risk-based modelling techniques, we can quantify this likelihood for each individual fund and at an aggregate LGPS scheme level. The likelihood is expressed as a percentage. When thinking about the likelihood measure and what a number actually means, the Ministry of Defence's (MOD) Defence Intelligence probability yardstick is a useful reference source.

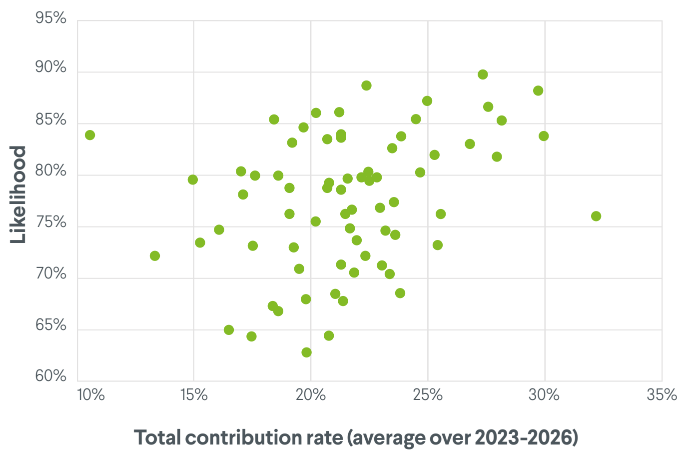
Assuming that investment strategies remain unchanged and contribution rates are fixed at the level set at the 2022 valuation, at an aggregate level, we estimate that the England and Wales LGPS has more than a 3-in-4 (77%) likelihood of having sufficient money in the future to be able to pay benefits. Given the sources of uncertainty for an open, defined-benefit pension scheme (inflation, investment returns, longevity), to have such a high likelihood represents a very strong position. And again, much better than the other public sector pension schemes which have no assets and rely on future generations of taxpayers to pay for benefits being earned today, resulting in higher and more volatile contributions as a result.

Looking at individual fund level, the good news continues. All funds have a likelihood of over 50% (the minimum is 63%). So all LGPS funds have a better than evens chance (or, using the MoD's language, "likely") of having enough money in the future to fund benefits – satisfying the requirement to have prudent funding plans in place. And also showing clear evidence that funds are solvent and have long-term cost-efficient plans – two of the main funding requirements under Section 13 of the Public Service Pensions Act 2013.

The other interesting outcome from this likelihood analysis is looking to see if there's a direct link or correlation between the likelihood of success and current funding level and contribution rate. Charts 8 and 9 have every fund lined up in likelihood order and show that there's no discernible pattern for either funding level or contribution rate. This would imply that funds with lower funding levels today have a strong investment strategy and contribution plans in place to ensure future success, and funds with higher funding levels still need to work hard to meet the cost of new benefit accrual. This highlights the necessity to look past these high-level metrics before concluding whether a fund's funding plan is robust.

Chart 8: likelihood vs funding level

Chart 9: likelihood vs contribution rate



Other areas of interest

When looking at the big picture, we have not solely focussed on funding position and contribution rates.

Life expectancy

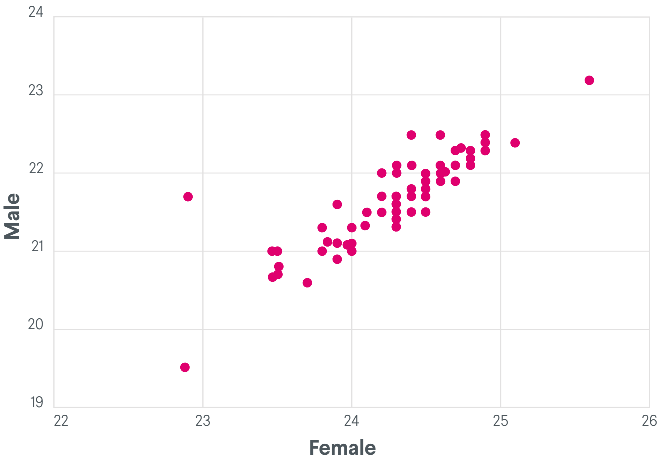
One of the most significant events to occur since the last valuation in 2019 was the Covid-19 pandemic. This resulted in increased focus on the assumption around future life expectancy at the 2022 valuation. Based on recent trends, we may normally expect life expectancy to improve by around two years over a decade, roughly three LGPS valuation cycles. So over one valuation cycle, we may expect life expectancies to increase by around 0.5-0.6 years. However, this is not the case when looking at the weighted average life expectancy for the LGPS as a whole – life expectancy is broadly static compared to 2019. This is evidence of administering authorities taking some of the recent heavier mortality experience and potential slowdown in future life expectancy into account.

Life expectancy from age 65

	2022	2019
Females	24.1	24.0
Males	21.5	21.7

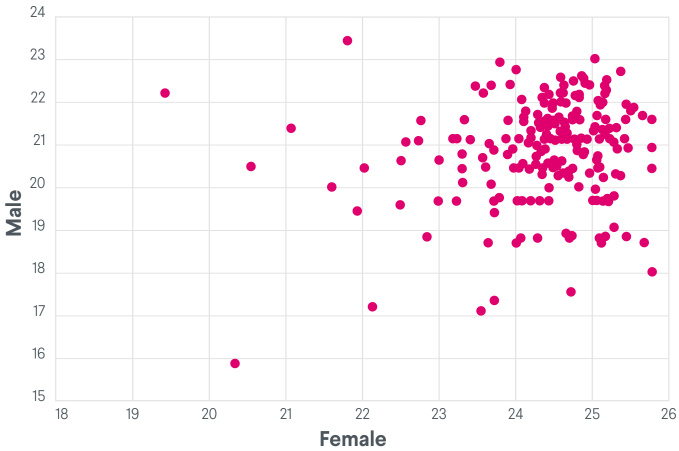
But this doesn't tell the full story as there's variation in life expectancy between different individual LGPS funds (see Chart 10).

Chart 10: individual fund's average assumed life expectancy for a 65 year old at 2022



1. A variation in outlook: each administering authority will probably have differing views on future life expectancy improvement trends. A perfectly valid source of difference as no-one knows what will happen to life expectancy in the long-term.
2. Profile of the fund's membership: it's well known that life expectancy can vary significantly between individuals depending on factors such a lifestyle and affluence (the difference can be in excess of 10 years). The impact of this variation can be best understood by looking at life expectancy at employer level within a LGPS fund (this is how we set most longevity assumptions at the 2022 valuation). Chart 11 shows such a life expectancy distribution for an employer group in a sample LGPS fund.

Chart 11: employer level assumed life expectancy for a 65 year old at 2022



The variation in life expectancy is even greater at employer level than fund level. Employers have smaller groups of members who may differ significantly in expected longevity profile from the fund or LGPS average. Whilst this emphasises the importance of setting assumptions that fully reflect the membership profile of each fund (and employer), it also raises questions for future policymakers to consider when thinking about equality and fairness of benefits (similar to recent national discussions about the fairness of changes to the State Pension Age).

McCloud

There has been a significant amount of discussion about McCloud in recent years. At the 2022 valuation, every fund made allowance for the potential impact McCloud could have on members' benefits (in line with guidance from Department for Levelling Up, Housing and Communities). On average, the impact of McCloud is estimated to be a 0.4% increase in liabilities (equivalent to around £1.3bn for the 73 funds included in our analysis).

Employee contribution rates

The focus on contribution rates has so far been limited to employer costs. However, employees also contribute to their LGPS benefits. At the 2022 valuation, the average employee contribution rate was 6.5% of pay. This is a small increase from the average at the 2019 valuation (6.4% of pay). This suggests that, on average, wage growth across the LGPS has been slightly higher than CPI inflation (given the tiered nature of the employee contribution rate bands and annual inflationary increases to the band thresholds). Anecdotally, we understand that this wage growth has been a result of above inflation increases to the Minimum and National Living Wages over the inter-valuation period.

The UK is currently in the midst of a cost-of-living crisis with household finances being increasingly stretched. It's perfectly understandable that people will be questioning every item of expense, including pension contributions. However, given that our analysis shows the total average cost of LGPS benefits is around 26% of pay, members are getting very good value-for-money from their contributions. We hope this analysis can be used to complement the good work already being done by administering authorities and the Scheme Advisory Board in raising awareness of the LGPS's value-for-money with members and helping avoid mass opt-outs (which could potentially store up pensioner poverty problems for the future).

Reflections

At the 2022 valuation, the LGPS is in a very strong position.

- The past service funding level is strong, with enough money set aside to pay for the benefits earned.
- Administering authorities have, on average, been able to offer some contribution rate relief.
- The outlook for the long-term sustainability of the scheme is robust.

This is not an accident. It's a result of the hard work across the whole scheme. Actions such as increasing rates during the adverse times in the early 2010s, monitoring, reviewing and diversifying investment strategies as the financial environment frequently changed and increasing engagement with participating employers on a more regular basis have all contributed to the successful outcome we see today.

Outlook for 2025

The environment in which the LGPS operates never stands still. For example, since 31 March 2022, there have been significant changes in financial markets with rapid increases in interest rates and inflation running at over 10%. Whilst it would be foolhardy to predict the funding position of the LGPS at the next valuation in 2025, we can be certain that there will be a new set of challenges to overcome and risks to manage. To be in the best place possible, we would encourage LGPS funds to use the next two years to systematically review all their funding risks. To help with this, we will be running a series of webinars over 2023 focussing on some of these key risks and discussing what funds can do ahead of the next valuation.

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