HYMANS ROBERTSON

Sixty second summary

What to do at 100% funding

David Walker
Head of LGPS Investments

Strong equity market returns over the last few years have led to some funds enjoying meaningful improvements in their funding position. Whilst for many years the over-riding objective for most has been to eliminate their deficits, the focus for many is now starting to turn to how they can build on the recent improvements and keep the Scheme affordable and sustainable for the long-term.

Reacting to funding improvements

For funds approaching a fully funded position on their current funding basis, some key decisions need to be considered about how to approach funding in the future. The benefits can only be met either through cash contributions or asset returns - each fund needs to decide for themselves what their optimal mix of the two should look like going forward.

However, LGPS funds' valuation bases include an assumed level of asset performance (with the amount varying from Fund to Fund), therefore it is difficult to fully "lock down" the funding level and maintain contributions at affordable levels. However, a sustainable position can be defined and targeted which includes sustainable funding levels, sustainable contributions and sustainable levels of investment risk.

Keeping out of out of bounds

At our recent webinars we illustrated this focus on sustainability through a golfing analogy which discussed how funds might try to keep each of these factors within agreed bounds. The approach each Fund takes will impact both the long term target but also the acceptable bounds around this.

With these bounds defined it then allows funds to make informed decisions about their funding and investment strategy. For example:

- do I go for maximum reward but maximum risk within my investment strategy with the potential it could push funding levels or contributions out of bounds, or
- do I take less investment risk, but what impact does that do in terms of the ability to keep contributions within affordable bounds and impact on funding assumptions.

Each fund might want to consider the following:

- Should your long term target funding level be 100% on your current basis - with an expectation that you then pay the ongoing cost of benefit accrual?
- Or might you target a higher level (110%) as you would then be using additional investment returns to help subsidise / reduce the future service costs?

From this it is possible to set where the bounds lie and the ranges within which the funding level, contribution rates or investment risks would ideally be allowed to fluctuate. To do this some mechanism for monitoring the movement in the funding position between valuations is required, but it would be helpful to consider in advance what action might be considered should any of these factors move outside of those ranges.

Selecting the right club

The next key questions are:

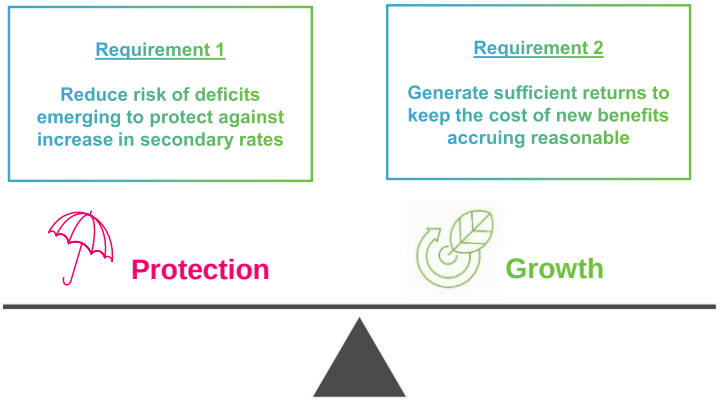
- What investment strategy is required to give you a good chance of maintaining this broad equilibrium?
- Is the current asset return assumption within the funding basis consistent with that investment strategy, or would it need to change to reflect a lower risk strategy?
- What is the expected level of contributions consistent with that investment strategy?

And in terms of risk:

- What are the chances that you find yourselves again in a 'material deficit' position in the future?
- What would that mean for contributions – and are you comfortable with that risk?

The requirement for 'stable and affordable' contributions continues to apply and the trade-off between the two remains - a lower level of investment risk (to reduce funding volatility) will generally require higher contributions (to ensure funding solvency) and vice versa.

While funding levels have improved for many, the potential to take less risk needs to be balanced with the need to generate the returns required to meet future service costs.



Although modelling can help inform these discussions, it will not provide an optimal solution by itself. Each fund needs to think in principle first about its attitude to funding the benefits and meeting the costs.