100 HYMANS ROBERTSON

Will I be 100% funded at the next valuation?

With less than 12 months before the next round of valuations for the LGPS in England & Wales, attention will be turning towards what the valuation will have in store.

As a group of actuaries who live and breathe the LGPS, our team at Hymans Robertson are no different and challenged ourselves to answer three of the most common questions that will be asked over the next 12 months:

1. **"Will I be 100% funded at the next valuation?"**
2. **"Now I'm 100% funded, will I stay that way?"**
3. **"Is my 100% funded the same as my neighbour's 100% funded?"**

Over the next few weeks, we will be releasing a short paper which considers each of these questions in turn, along with a supporting podcast discussion.

We hope the following content gives you food for thought and something to discuss further with your own Hymans Robertson consultant as you put your own valuation plans in place.

Robert Bilton
Head of LGPS Valuations
robert.bilton@hymans.co.uk
0141 566 7936

Where better to start our series than with a, if not 'the', favourite question for anyone with an interest in an LGPS fund: "Will I be 100% funded at the 2022 valuation?"

On the face of it, the question is simple. And the reason for asking it straightforward – to find out if the fund will have enough money to pay all of its member's benefits.

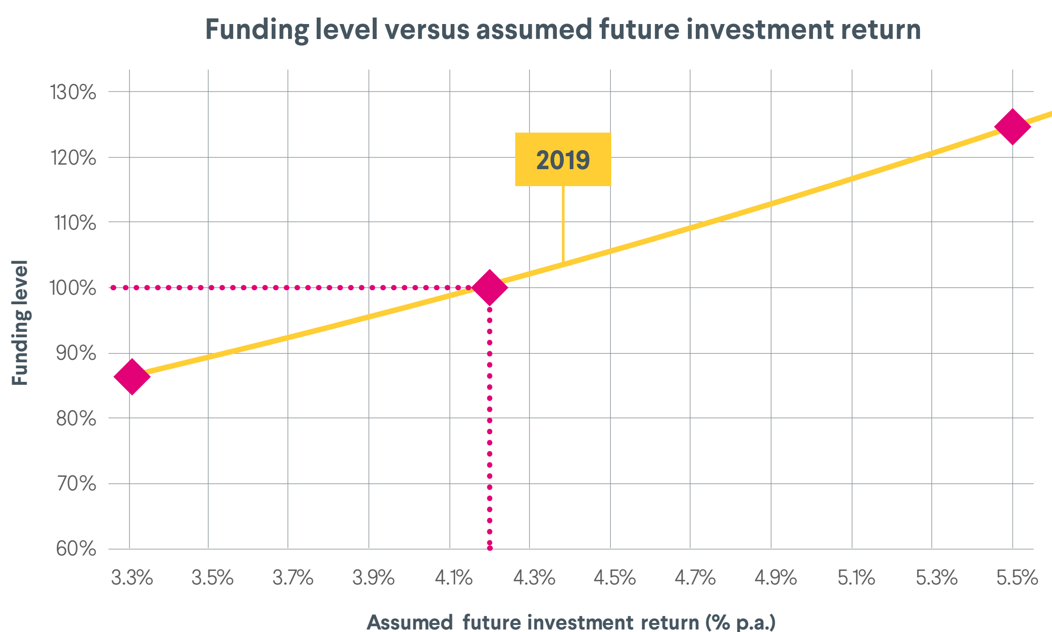
Simple question, simple answer

Unusually for an actuary, we can give a definite answer to this simple question – yes, at the 2022 valuation every LGPS fund will be 100% funded.

A rather brave statement to open with! However, as with most things that appear simple and straightforward, once you start to pick it apart, you realise how much complexity is hidden by the simple, single summary statistic that is the funding level.

Simple question, more helpful answer

The funding level is directly linked to the underlying actuarial assumptions. The chart below shows how a real-life LGPS fund's funding level varied with the assumed future investment return (sometimes referred to as the discount rate) at the 2019 valuation.



At the 2019 valuation, this LGPS fund was **100% funded...**

...if the assets were assumed to return **4.2% p.a.** in future years.

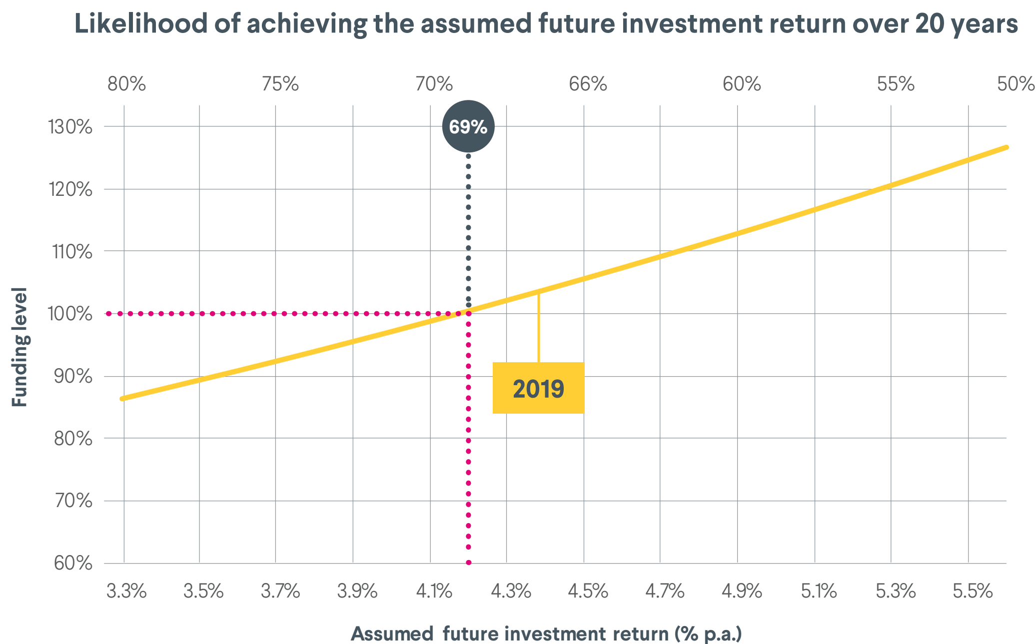
If we had assumed they would deliver only **3.3% p.a.** in future, then the funding level was around **85%**

If we had assumed **5.5% p.a.**, then the funding level was **125%**

This **'if'** is very important when thinking about the funding level and is the reason we can be so confident that every LGPS fund will be 100% funded at 2022. A fund will be 100% funded if it can achieve a certain level of future investment return.

Understanding the absolute level of required investment return is helpful, but the real insight comes from answering *"How likely is it that the fund's investments will achieve the required return?"*.

In the example on the previous page, the fund's assets were expected to deliver the required return, 4.2% p.a., 69 times out of 100 (a 69% likelihood). In fact, adding an extra axis to the top of the previous chart provides a lot more information about the funding position.



THE LGPS ENGLAND & WALES

At the 2019 valuation, the LGPS England and Wales was **100% funded** if the assets were assumed to return 4.3% p.a. in future years.

Based on the LGPS's average investment strategy, there was just over a **6 in 10 likelihood** of achieving this return (62%).

Estimated using data from https://www.lgpsboard.org/index.php/2019-valuations-report

This was a healthy position to be in and represented an improved funding position from previous position in 2016. This healthy position has improved further since 2019.

As at 31 March 2021, the required return for 100% funding had fallen to 3.5% p.a. which now has a **72% likelihood** of being achieved.

Estimated using data from https://www.lgpsboard.org/index.php/2019-valuations-report

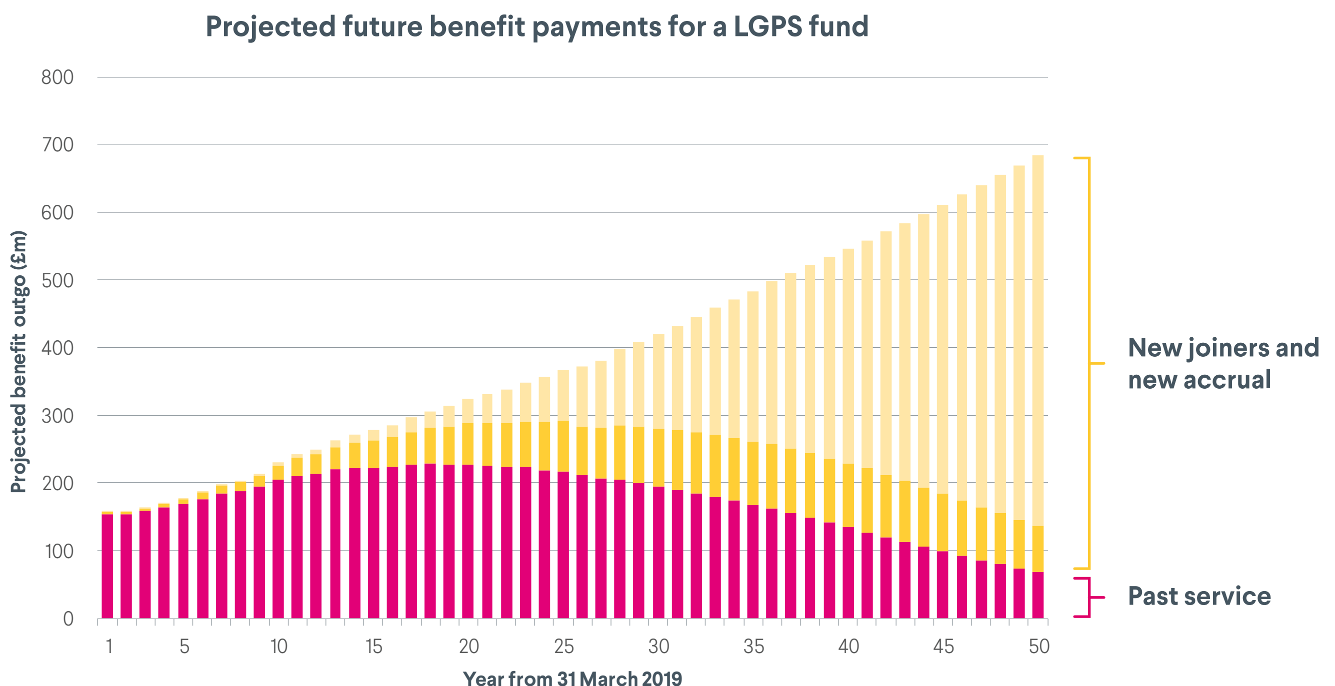
In other words, strong investment returns have improved the past service position of the LGPS as a whole, meaning that the return required to be 'fully funded' is now lower than it was, and more likely to be achieved.

This information adds an extra dimension to understanding the current funding position of a LGPS fund and shows that most funds should be in a good position heading into the 2022 valuations.

Good news ahead?

If thinking only about the past service funding position then yes, the future does look bright. However, being 100%, or close to it, in a scheme like the LGPS which is both open to future accrual and new entrants, is not the endgame.

For the average employer, two-thirds of the benefit payments made over the next 50 years will be in respect of benefits yet to be earned. This will include benefits earned by existing members (new accrual) and benefits earned by new members who begin service in the LGPS after the valuation date (new joiners). The assets held today only cover past service benefits – we still need to fund those benefits yet to be earned.



Given the relatively strong funding position of the LGPS as a whole, the majority of LGPS employer contribution rates are currently in respect of the Primary Rate (payment towards future accrual of new benefits).

> The average LGPS employer contribution rate is **22.9%** of pay, of which **18.6%** of pay is in respect of the Primary Rate.

Based on data from https://www.lgpsboard.org/index.php/2019-valuations-report

As most employers are in the scheme for the long-term, their primary focus will be on contribution rates (both current levels and future direction) instead of the funding balance sheet (which will not be crystallising in the foreseeable future). Therefore, when looking ahead to the 2022 valuation, as well as focussing on whether the funding position is 100%, we need to also consider the factors that may affect the cost of future benefit accrual.

What are some of the key factors?

Investment risk has already been discussed in the context of past service. In the earlier example, even at 100% funding, there was still around a one-in-three chance that future investment returns would not be sufficient to fully fund all the accrued benefits. A similar level of investment risk also applies to future benefit accrual.

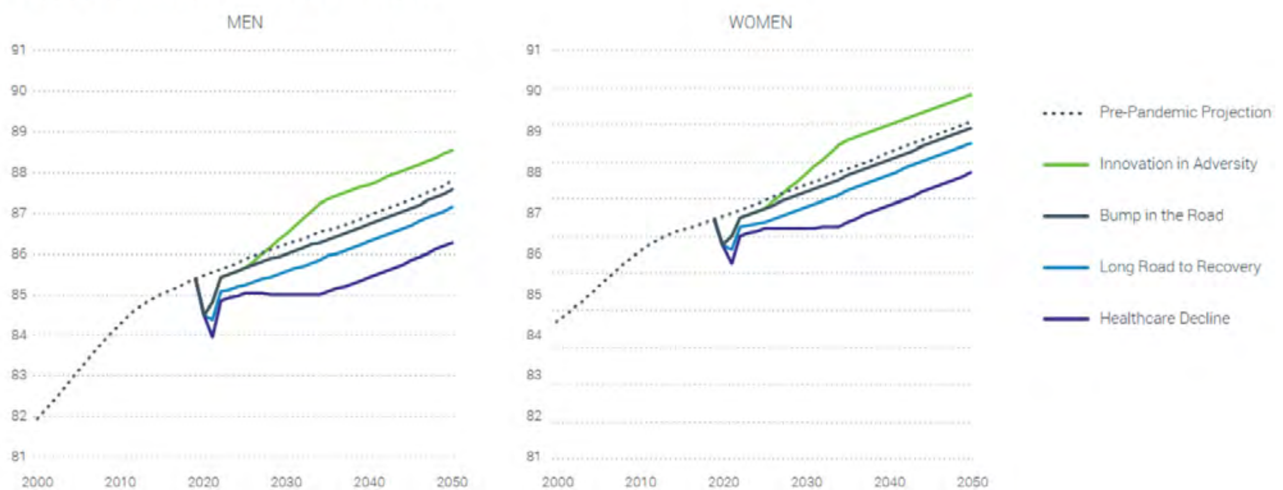
Other major risks that are likely to be of important focus at the 2022 valuations are life expectancy and climate change.

Life expectancy

As a result of the ongoing pandemic, funds will have likely experienced a higher than expected number of deaths. This will result in a reduction to the liabilities. However, given that deaths associated with the pandemic have typically been at older ages, there is unlikely to be a significant impact on liabilities.

Looking forward, the impact of the pandemic is likely to be a big consideration when setting life expectancy assumptions for the 2022 valuation. Club Vita have recently published a paper considering how the pandemic may affect future life expectancies under four different scenarios, as shown in the charts below.

PERIOD LIFE EXPECTANCY FROM AGE 65



The 'Innovation in Adversity' scenario would result in an increase in life expectancies and therefore, a deterioration in funding strength and increase the required investment return by around 0.1% p.a.. The 'Long Road to Recovery' and 'Healthcare Decline' scenarios would have the opposite effect and see reductions in the required return of 0.1% p.a. and 0.3% p.a..

Given that nobody knows the long-term impact of COVID-19 on life expectancies, and the long-term nature of the LGPS, this is a risk that will need careful evaluation and factoring in to the 2022 valuation.

Climate change

Climate change is a key risk for pension schemes, particularly the LGPS with its open-ended time horizons. Whether it's rising temperatures themselves, or the measures taken to avoid them, we could see a significant impact on investment returns, financial and economic conditions, and demographic factors like life expectancy. Understanding the risk of climate change blowing your funding strategy off course, even if you have a robust funding plan in place, should be high on the list of priorities at the 2022 valuations.

No-one can say for sure what the impact of climate change will be, but we can come up with a handful of scenarios representing a range of possible climate futures. These scenarios can be used to 'stress test' the resilience of your funding strategy; both the impact on assets and liabilities.

If you're deciding between two different strategies which both meet your funding objectives, the scenario analysis might show that in a particularly difficult climate scenario, one strategy is less successful than the other. We don't know the likelihood of this climate scenario happening, and we can't say that the other strategy completely protects you from climate risk, but we can say that it's a more resilient option. And equally, you might instead stick with the first option for other reasons. But, at least you know that even in an extreme climate scenario, the impact on the funding strategy isn't catastrophic so it's a risk you're happy to take.

This modelling will not 'solve' the question of climate risk, but by trying to put a number on that uncertainty you can make much more informed decisions: whether it's about your strategy in 2022 or your strategy for the future.

Cards on the table

Although our bold opening prediction about the 2022 valuation has been shown to be less definitive than initial appearances, we have sat around the (virtual) round-table and sought to predict what is in store for the 2022 valuations.

Overall, we currently expect that it will be a relatively steady valuation in terms of contribution rate outlook. Although investments have generally performed well since 2019, these gains are likely to be countered by lower expected future investment returns and a possible future inflationary environment as a result of recent Government stimulus packages. A wait-and-see approach will also likely be adopted regarding the risks around future longevity improvements and climate change.

Given the ongoing pandemic, we do expect there to be a lot of focus on working with smaller employers, such as charities and housing associations, to help them manage their LGPS participation. Making use of the new regulatory powers granted in September 2020 – deferred spreading arrangements and deferred debt arrangements – are likely to be some of the most popular solutions explored.

And finally, instead of focussing on the binary question of "are we 100% funded?", we will be working with funds to ensure everyone understands the exposure to future funding risks and the likelihood that the current strategy will provide enough monies to pay future benefits.

This will be the key to making the 2022 valuation the most successful yet.

Contact us

If you have any further questions please contact:

Catherine McFadyen
Head of Public Sector Consulting
0141 566 7784
catherine.mcfadyen@hymans.co.uk

Robert Bilton
Head of LGPS Valuations
0141 566 7936
robert.bilton@hymans.co.uk

Peter MacRae
Actuary
0141 566 7671
peter.macrae@hymans.co.uk

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