2022 LGPS valuation –

Post valuation date experience

Employer bulletin 3 of 4

August 2022

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CIPFA

The Local Government Pension Scheme ("LGPS") valuation in England, Wales and Northern Ireland is now underway, based on an effective date of 31 March 2022. The process will conclude on 31 March 2023 with revised employer contribution rates coming into effect from 1 April 2023. We encourage employers to engage early in the process and reach out to their LGPS Funds and there is more detail on this in our previous bulletins:

Bulletin 1 **Bulletin 2**

This is the third bulletin in our LGPS valuation series. In this bulletin we examine the risks that remain in spite of the valuation date having passed and how this could affect resulting contribution rates.

We will look at how market conditions have changed since the 31 March 2022 valuation date and consider:

- whether the impact of these changes will be taken into account in a Fund's Funding Strategy Statement
- how assumptions may be updated to allow for post valuation experience and,
- how the current high inflationary environment could be factored in.

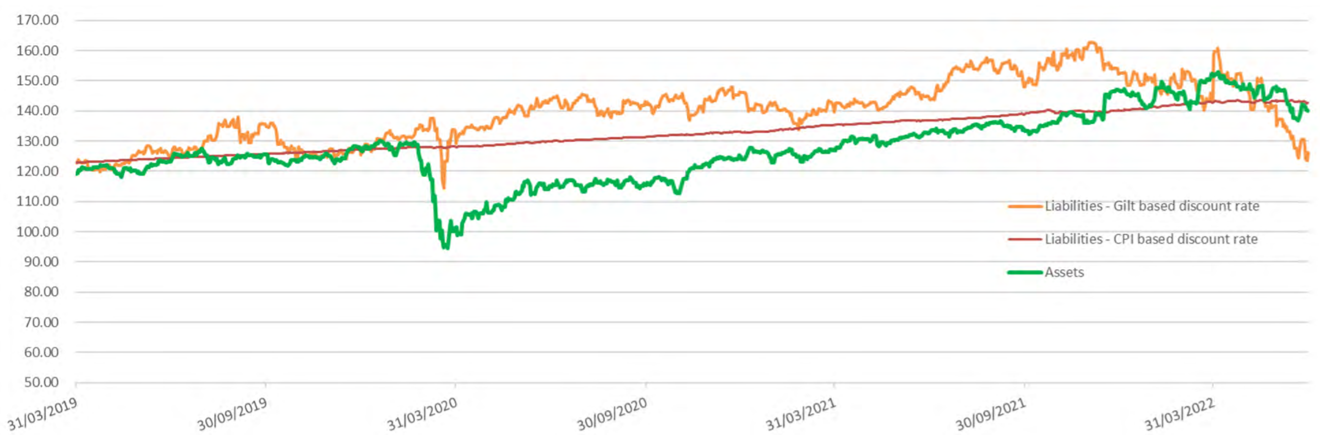
Whilst there is elevated market volatility creating uncertainty, the way in which Fund's and their Actuaries will allow for market conditions is also uncertain.

How can a certain outcome be agreed against a backdrop of so much uncertainty?

Market movements since 31 March 2022

Although 31 March is the key valuation date, it is possible to allow for post valuation experience when setting contribution rates. Some Funds have used this flexibility at previous valuations, referencing positive post valuation experience as justification for reducing contribution rates. However, adverse post valuation experience could equally be used to increase contribution rates, especially in the midst of elevated market volatility and increasing economic uncertainty.

The graph below illustrates how the funding position of a typical LGPS participation may have changed since the 2019 valuation. The graph shows the evolution of liabilities using both gilts-based and CPI based discount rates.



Focussing on the period since the valuation date, we can see that:

- Gilts linked liabilities have fallen – potentially leading to surpluses
- CPI linked liabilities have remained relatively stable – potentially leading to small deficits

However, this is against the backdrop where assets have been volatile.

What do movements in market conditions mean for liabilities?

Have gilt yields improved?

Since the valuation date, long term nominal and real gilt yields have increased. This is driven by the Bank of England increasing the base interest rate with further rises widely expected to come and being priced in by the market. These short-term rate rises have fed through to longer term expectations too.

Given the discount rate used to value liabilities is largely driven by long term UK gilt yields, the higher yield could result in a higher discount rate and therefore a lower value being place on liabilities, all else being equal. A higher discount rate would also reduce the cost of future service (primary contribution rates). The effect on each Fund will be specific to the actuarial approach followed and the discount rate methodology used by the Actuary.

Will Fund Actuaries take this positive post valuation experience into account when setting the Funding Strategy Statement?

Spotlight on inflation!

We are all aware that short term realised inflation has significantly increased and continues to do so. This is as a result of supply side shocks including supply chain issues, labour supply and a disturbance in commodity markets as a result of the Russia/Ukraine war. However, the market is not pricing in higher inflation expectations in the longer term, with long term market implied RPI inflation, which underpins the CPI assumption used to value liabilities, decreasing slightly since the valuation date.

A lower long term CPI assumption, all else being equal, would result in a lower value being placed on liabilities, given LGPS benefits are on the whole linked to CPI. It would also reduce the cost of future service.

However, Fund Actuaries will need to factor in the current high inflationary environment and what that has done to the profile of each Fund given members benefits increase in line with CPI in both deferment and retirement.

How is RPI reform being allowed for?

Outside of the current inflation market dynamics, and as highlighted in our second bulletin, there is significant uncertainty around how Fund Actuaries will allow for RPI reform. With more inflation data now available, and with differing pictures in the short and long-term, uncertainty remains around how Fund Actuaries will approach inflation in their valuations.

What about movements in assets?

It is also important to consider how assets have performed in the volatile period since the valuation date. The value of growth assets (particularly equities, credit and diversified growth assets) in which LGPS Funds tend to be heavily invested, have decreased over the period since the valuation date.

- Equities have fallen in value, as the market continues to price slowing global economic growth, tightening monetary policy stances from a variety of global central banks, and more recently, the impact of a potential recessionary environment on corporate earnings. Equity volatility has also been elevated in recent months, with a number of geo-political and economic risks contributing to ongoing uncertainty amongst investors. Currency hedged holdings have underperformed unhedged equivalents, with Sterling depreciating significantly against a number of developed market currencies – most notably the US Dollar – over the period.
- Corporate bonds have also posted negative returns, driven by both rising long-dated gilt yields and widening credit spreads, with the former reflecting increasingly hawkish expectations around monetary policy, and the latter driven by increasing pessimism towards future economic growth and corporate earnings. Longer dated, more interest rate sensitive, credit assets have typically underperformed those with shorter maturities over the period, given the strong upward trend in interest rates we have seen.

Given the heightened volatility and global geopolitical risks, there is the possibility that Fund Actuaries will take post valuation experience into account and there has been past evidence of Funds doing.

Whilst there may be good news post valuation date on liabilities, asset experience since the valuation is less positive. Will Fund Actuaries bake in the good news, or add prudence to reflect the market volatility?

Typically, post valuation experience has been exercised via changes to the Funding Strategy Statement. Such changes could delay the consultation on Funding Strategy Statements whilst Fund Actuaries decide if and how to make an appropriate allowance. However, it is uncertain as to whether Fund Actuaries will make an allowance and if so, at what point will they look to finalise results and how market conditions will play out between now and that point. Employers should look to engage with the Funds early and seek to understand whether the Actuary will make any post valuation experience allowance.

Conclusion

Given the significant volatility we have in the market since the March 2022 valuation date, we believe there is a higher likelihood that Funds will allow for post valuation experience in this actuarial valuation cycle. Whether or not this is the case and how that will be done is a post code lottery and different Funds will approach it in very different ways. It is important that Funds are transparent in this with employers and set out clearly how any post valuation experience is allowed for. The first step for employers is to engage early in the valuation process to find out when the Funding Strategy Statement will be shared for consultation.

We can help… engage early in the valuation process to secure certainty, against the backdrop of so much uncertainty.

Spotlight on exit debts!

Certain employers may be looking to close out of LGPS accrual for various reasons. There are different flexibilities available to such employers, ranging from paying the exit debt as a one off lump sum to agreeing a deferred debt arrangement with the Fund.

Given recent movements in market conditions, we are seeing exit debts significantly reducing, with some falling by up to 70% over the course of this year. This is due to the reversion of gilt yields back to pre COVID levels. Depending on the Fund's approach to valuing termination liabilities, increased gilt yields can result in an increased discount rate used to value termination liabilities. The higher the discount rate, the lower the liabilities. Whilst the strong asset performance experienced has dropped off slightly, the fall in assets is not expected to outweigh the fall in termination liabilities. Therefore, exit debts are expected to be significantly lower than earlier this year.

This represents a valuable opportunity for employers to investigate with their Fund whether closing out of accrual is the right course of action to take, whilst acknowledging the employee relations considerations.

Isio can help in this journey having experience of working on closing out of the LGPS, providing full member consultation support and working closely with Funds to help achieve the best outcome for all parties.

Know your fund

What should LGPS Funds, their actuaries and employers do now?

Follow the four step plan below:

01 ✓

LGPS Funds should ensure FSS consultation is meaningful and transparent, and employers should engage to understand key considerations such as allowance for RPI reform, treatment of surpluses.

02 ✓

LGPS Funds and actuaries should be transparent with employers on how post valuation experience will be treated, and employers should ascertain if it will have a negative or positive impact?

03 ✓

Employers can work with LGPS Funds to understand their own funding position as at 31 March 2022 and use the Fund's draft FSS to understand the impact of any changes.

04 ✓

All stakeholders understand that there are options for taking advantage of any flexibility. Given exit debts have significantly improved, is that an option for employers to explore with their LGPS funds?

How can Isio help employers?

Isio will help you navigate the process:

- Understand the risks and agree your objectives
- Engage with Fund early and engage and respond to consultation in a meaningful way and in a timely manner
- Negotiate with the Fund and deliver your preferred outcome

Contact

Please contact Isio for further support using the details below.

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