2022 LGPS valuation – Funding snapshot at the valuation date

Bulletin 2 of 4

May 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 this process and reach out to their LGPS Funds.

This is the second bulletin in our LGPS valuation series. In this bulletin we examine market conditions on the 31 March 2022 valuation date and what impact this may have on employer contribution rates, considering both Primary Rates (in relation to future service) and Secondary Rates (in relation to any past service surplus or deficit).

The funding approaches taken by the different regional Funds and their Fund Actuaries can differ considerably. This can lead to wide variations in employer contributions depending on which regional Fund they are in – in effect a 'postcode lottery'. We explore the key drivers of contributions rates and how they may differ between Funds.

The valuation process

The contribution rates employers will be required to pay following the 2022 LGPS valuation will depend on a wide range of factors and decisions made by each LGPS Fund and their actuary.

We first consider how the funding position and cost of building up new benefits may have changed for a typical LGPS Fund, allowing for market conditions as at the valuation date, approximate investment returns since 2019 and the potential impact of RPI reform.

What are the key financial assumptions for the LGPS valuation?

Future inflation

LGPS benefits are linked to CPI inflation, with no upper limit. The CPI inflation assumption is typically derived by applying a deduction to market implied RPI inflation. At the 2019 valuation, LGPS funds typically applied a deduction of around 1% per annum. Since the 2019 valuation, the Government has announced that RPI will be aligned with CPI-H from 2030. This means a deduction of 1% per annum is no longer appropriate and a smaller deduction should be applied. What might be considered an appropriate deduction to apply is highly subjective and for each Fund actuary to determine.

Investment return (discount rate)

The long term expected return on an LGPS Fund's assets with a deduction for prudence. Some LGPS Funds set the discount rate relative to gilt yields, others relative to CPI inflation and others simply use a nominal investment return assumption (which is subjective and likely to be used to help smooth valuation outcomes, normally finding a balance between the gilts and CPI approaches).

How have financial conditions changed since the 2019 valuation?

	31 March 2019	31 March 2022	Change over the period
Gilt yield	1.45%	1.70%	↑ 0.25%
Market implied RPI inflation	3.45%	3.85%	↑ 0.40%
Illustrative CPI	2.45%	3.25%*	↑ 0.80%

20-year cashflow weighted yields, p.a.

**Illustrative CPI set as market implied RPI less 0.6% p.a. This represents just one possible view and in practice each Fund actuary will have a different approach to allowing for the impact of RPI reform.*

What does this mean for future service (Primary Rates)?

The cost of building up new benefits increases as the net discount rate falls. The net discount rate is the difference between the discount rate and CPI inflation assumption.

The table below sets out the illustrative change in net discount rate since the 2019 valuation and the estimated impact on a typical employer's Primary Rate. The impact is shown relative to a Primary Rate of 20% at the 2019 valuation.

Discount rate methodology	Change in net discount rate (p.a.)	Revised Primary Rate (from 20% in 2019)
Gilts-based	Fall of 0.55%	25%
CPI based	No impact	20%

Assumes a 30-year duration for future service.

The cost of providing benefits has increased

Our analysis highlights that the cost of providing new benefits on a like for like basis has increased since 2019, due to the slight deterioration in market conditions and the impact of RPI reform. Employers in LGPS Funds with gilts-based discount rate methodologies may see increases of up to around 25% in their Primary Rates.

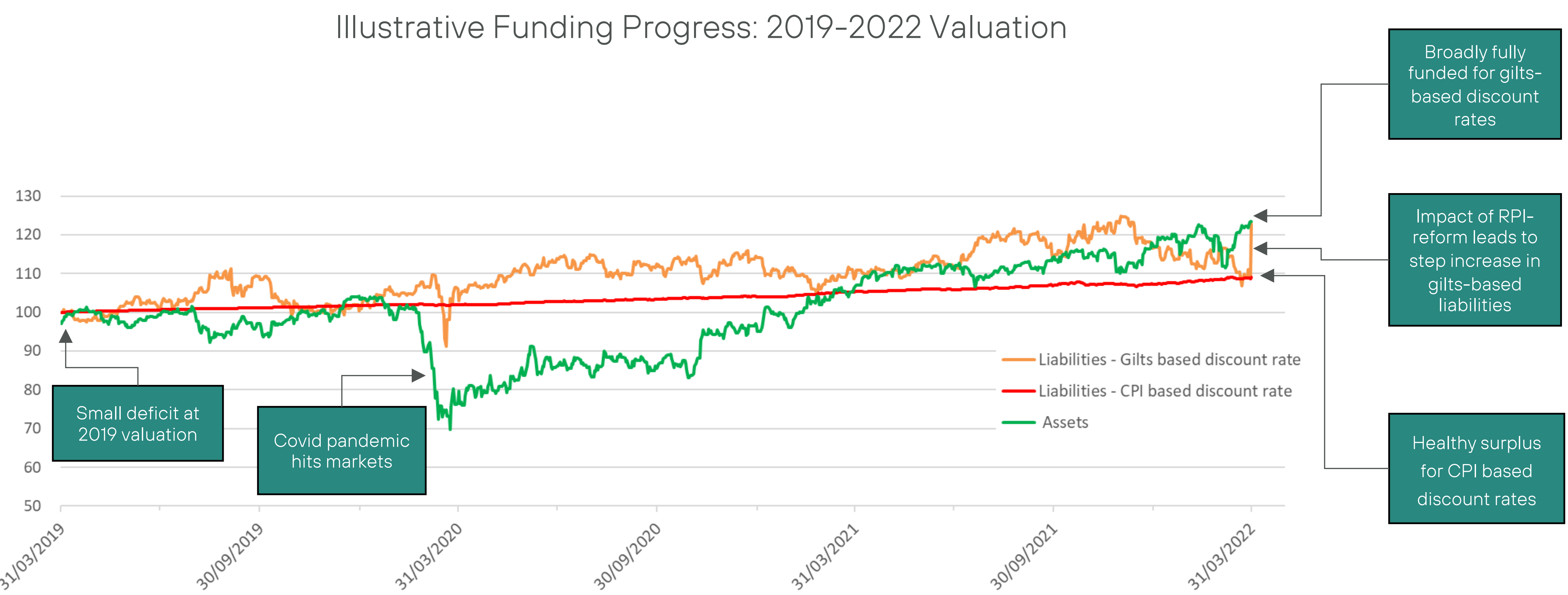
Although the CPI based discount rate methodology is shown to be unaffected, the increases in inflation expectations since 2019 and the impact of RPI reform are likely to put pressure on the discount rate margin above CPI. Fund actuaries will need to assess whether this margin remains appropriate, or whether it should be reduced. If the margin used in 2019 is retained, we would view this as the Fund actuary removing prudence from the basis.

Funds with gilts-based and nominal investment return discount rate methodologies will also need to reassess their view of future investment returns although we see less pressure to apply a downward adjustment for these Funds.

What does this mean for past service (Secondary Rates)?

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.

As well as changes to the net discount rate, an LGPS Fund's funding position will also be impacted by investment returns since the 2019 valuation.



Strong investment returns since 2019

Very strong investment returns since 2019 are expected to have improved funding positions, even after allowing for the slight deterioration in market conditions. In our illustrative example, an LGPS participation that was close to fully funded at the 2019 valuation would be expected to have a healthy surplus before allowing for RPI-reform. However, the impact of RPI-reform may lead to funding levels falling back to broadly the 2019 position for those with gilts-based and nominal investment return discount rate methodologies. This is illustrated by the step-increase in liabilities at the 2022 valuation date.

The graph illustrates the smoothing effect of CPI based discount methodologies on an employer's liabilities although, as noted above, we see significant downward pressures on CPI discount rate margins at the 2022 valuation. Any reduction in the discount rate margin would see a step-increase to employer's liabilities.

Overall impact on contribution rates

The cost of providing new benefits has increased since 2019. Unless Fund actuaries remove prudence, Primary Rates payable by employers are therefore likely to increase. Strong investment returns since the 2019 valuation may help to offset those increases if these have led to an overall improvement in an employer's funding level and hence lead to a reduction in an employer's Secondary Rates. The overall impact on an employer's contribution rates will depend on the relative size of their active membership and how well their Fund's investment strategy has performed.

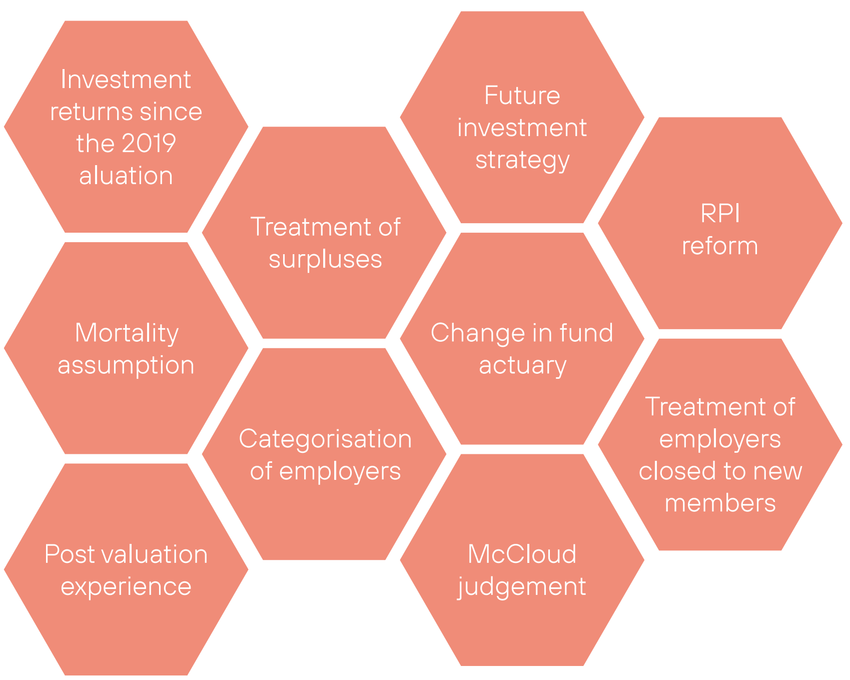
We discuss the other key drivers of contribution rates in the following section which demonstrate why it is so difficult to predict the outcome for individual employers.

Key drivers of contribution rates

The funding snapshot at 31 March 2022 illustrates the potential changes in contributions for a typical LGPS Fund, allowing for the impact of changes in financial conditions and RPI-reform only.

There are however many wide ranging factors that will impact contribution rates at the 2022 valuation and the approaches taken by the different regional Funds and their Fund actuaries can differ considerably. This can lead to wide variations in employer contributions depending on which regional Fund they are in – in effect a 'postcode lottery'.

Click on each of the key drivers below to find out more.



Conclusion

Although we have shown an illustrative snapshot of the 31 March 2022 valuation position for a typical LGPS Fund, the wide-ranging drivers of contribution rates shows that it is impossible to predict the outcome for each LGPS Fund and each individual employer within that Fund. Two very similar employers within different LGPS Funds could see very different valuation outcomes because of the LGPS 'postcode lottery'.

Our first LGPS bulletin in this series, "Planning for the 2022 LGPS valuation", encouraged employers to understand their Fund's timetable and highlighted the benefits of early engagement with their Fund.

Early engagement with LGPS Funds is key to helping employers understand their Fund's proposed approach and to put forward their desired outcome, aligned with their objectives. We believe early engagement with LGPS Fund's increases the chances of a positive valuation outcome for employers.

Know your fund

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

Follow the four step plan below:

We encourage all employers to request a pre-consultation meeting with their LGPS Fund and to engage in and understand the valuation process and timetable. We encourage LGPS Funds to welcome such engagement.

Employers should consider whether the Fund's draft Funding Strategy Statement provides an indication of any changes to the funding methodology and their potential impact. Funds should be willing to engage with Employers to explain these changes.

Employers should consider the appropriateness of their LGPS investment strategy. Where LGPS Funds provide investment options, we encourage those Funds to provide sufficient information to enable employers to make an informed choice based on their own specific objectives.

For both sets of stakeholders to be prepared to be flexible and negotiate the best outcome, within the parameters that can leveraged.

How can Isio help employers?

Isio will help you navigate the process:

- Understand the risks and agree your objectives
- Engage with LGPS Funds and respond to consultation in a meaningful way and in a timely manner
- Support engagement with the Fund, and any negotiation to deliver the preferred outcome

Contact

Please contact Isio for further support using the details below.

Urrffa Rafiq

+44 (0)7789 271 104
urrffa.rafiq@isio.com

Alan Armstrong

+44 (0)7795 591 754
alan.armstrong@isio.com

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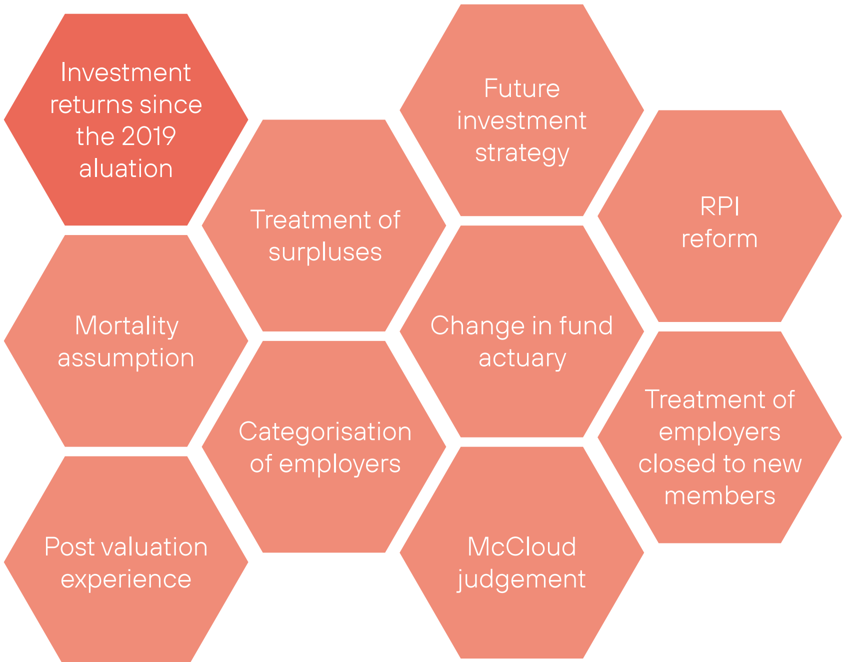
Key drivers of contribution rates



Investment returns since the 2019 valuation

LGPS Funds have typically experienced very strong investment returns over the 3 years since the 2019 valuation, which has led to significant improvements in funding levels. There are however wide variations in investment returns across different Funds.

Analysis of a sample of a dozen LGPS Funds shows that they achieved investment returns of between 10% and 20% over the two years from 31 March 2019 to 31 March 2021. The strong performance of asset classes typically held by LGPS Funds continued over the year 31 March 2021 to 31 March 2022 but with similar wide variations across asset classes.

The significant variations in investment returns could lead to large differences in funding levels and consequently Secondary Rates between regional LGPS Funds.

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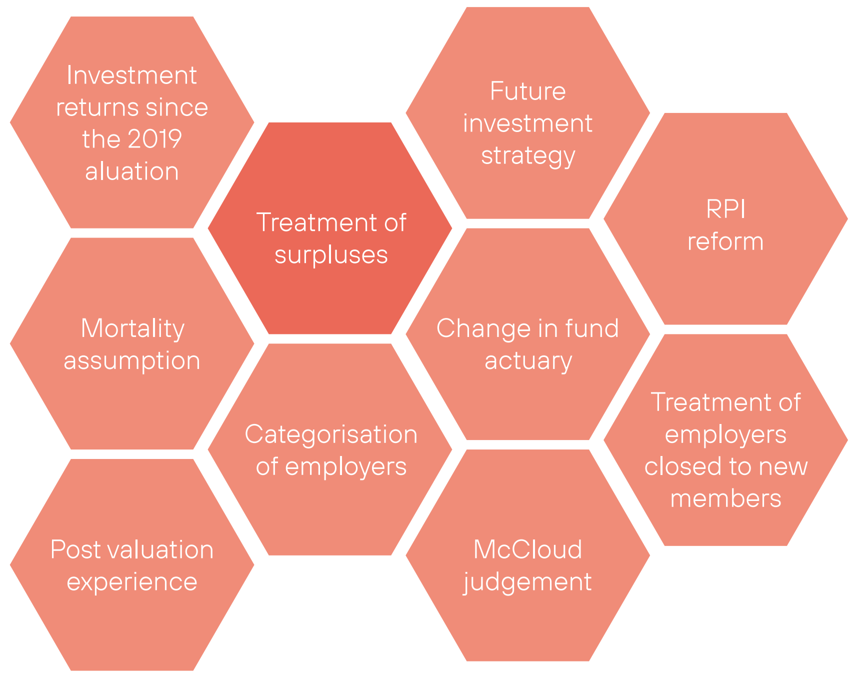
Key drivers of contribution rates



Treatment of surpluses

Given the strong investment returns LGPS Funds have experienced since the 2019 valuation, many employers may have a funding surplus at the 2022 valuation. The potential treatment of surpluses will vary between regional Funds.

We encourage Funds to be transparent and reasonable in their treatment of surpluses and encourage employers to understand their LGPS Fund's approach to surpluses and how these might be allowed for within their Secondary Rate.

Employers may look to challenge their Fund's approach if they do not believe the Fund is making a reasonable allowance for surpluses.

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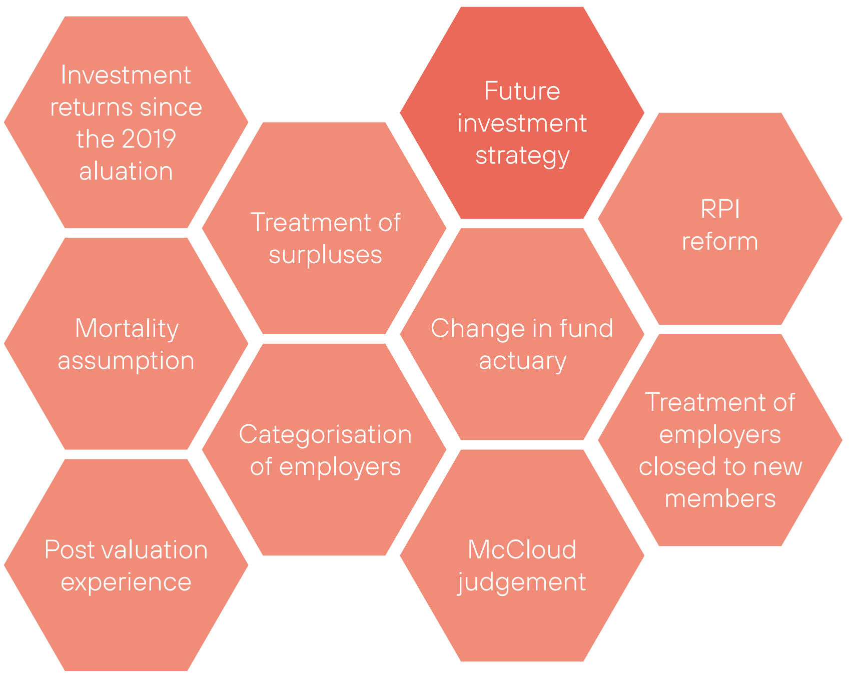
Key drivers of contribution rates



Future investment strategy

Many LGPS Funds now have a range of investment buckets, ranging from higher risk to lower risk. Typically, those employers deemed to have stronger covenants (for example, Local Authorities) are placed in the higher risk buckets, whereas those who are deemed to have weaker covenants are placed in medium or lower risk buckets.

The higher risk buckets will have higher expected investment returns, leading to higher discount rates used in the valuation and consequently lower contribution rates are required.

LGPS Funds will often provide employers with the option to move between investment buckets but exercising this choice requires engagement with the Fund. It is therefore important for employers to understand their investment options and whether the bucket they have been placed in meets their objectives.

We encourage Funds to engage openly with employers who wish to adopt an alternative investment strategy and recommend employers obtain specialist advice to underpin any investment choices made.

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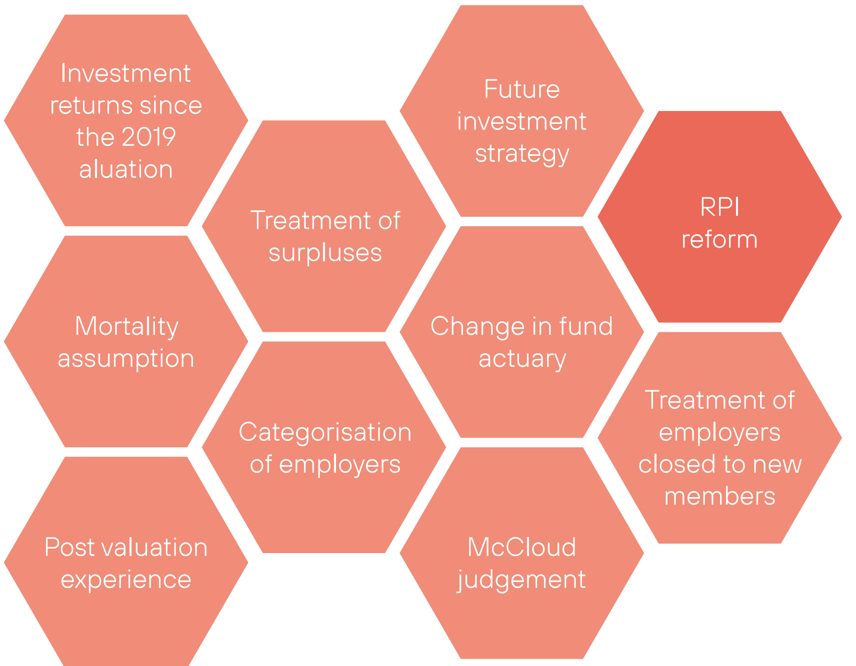
Key drivers of contribution rates



RPI reform

Our funding snapshot includes an illustrative allowance for the impact of RPI-reform, deriving the CPI inflation assumption by applying a deduction of 0.6% to market implied RPI. However, what might be considered an appropriate deduction to apply is highly subjective and each Fund actuary's decision will have a material impact on both the cost of future service benefits and past service liabilities for its participating employers.

The approach taken by the different LGPS Funds is likely to vary significantly and so it is important for employers to understand their Fund's proposed approach to allowing for RPI-reform, which should be including within each Fund's draft Funding Strategy Statement (FSS.)

This is a key area for employers to look out for when responding to their Fund's consultation on the FSS.

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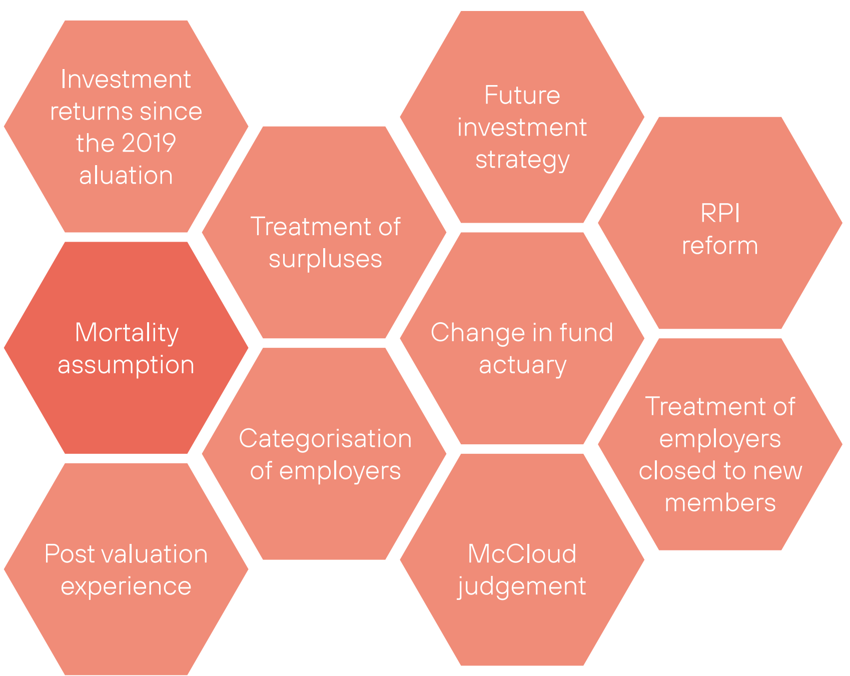

Mortality assumption

The mortality assumption is highly subjective and will have a significant impact on contribution rates. Each Fund and its actuary will revisit the mortality assumption for the 2022 valuation. The mortality assumption is made up of several parameters, with the latest parameters introduced since 2019 giving actuaries a choice of how much allowance is made for mortality experience during the Covid pandemic.

The broad industry view is that life expectancies are lower now than would have been projected in 2019 which would be expected to lead to a reduction in liabilities. By way of an example, a 1 year fall in life expectancy will typically reduce liabilities by 3% to 4%.

The approach taken by different LGPS Funds is likely to vary significantly and so it is important for employers to understand their Fund's proposed approach to setting the mortality assumption and how this compares to the assumption used in 2019.

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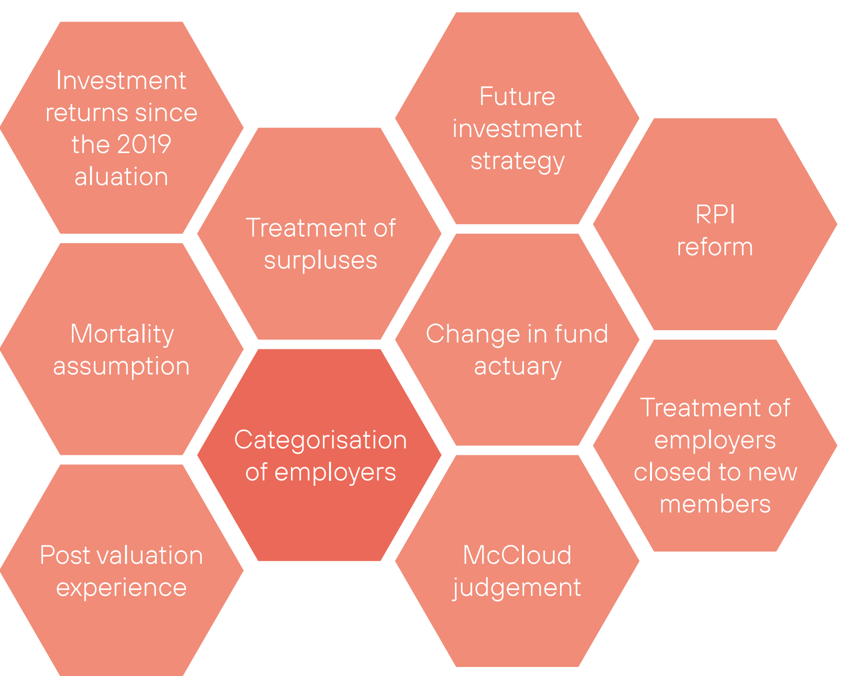

Categorisation of employers

LGPS Funds are becoming increasing granular in their funding approach for different categories of employers, based on strength of employer covenant which is reflected in the recent introduction of investment buckets for many LGPS Funds.

An LGPS Fund's approach to categorising employers can have a significant impact on those employers' contribution rates. Employers who are deemed to have a stronger covenant (typically tax-raising bodies such as local authorities) are generally treated more favourably than those who are deemed to have weaker covenants (such as tier 3 employers). For example, those with stronger covenants will often be permitted to have longer recovery periods with a less prudent funding basis.

It is therefore important that LGPS Funds adequately reflect each employer's covenant strength at the 2022 valuation. We encourage early engagement between LGPS Funds and employers to establish what supporting evidence is required, for example, to demonstrate an employer has a very strong covenant to justify more favourable treatment by the Fund. To the extent that security is being requested, employers should understand the underlying parameters being offered in exchange for the provision of security,

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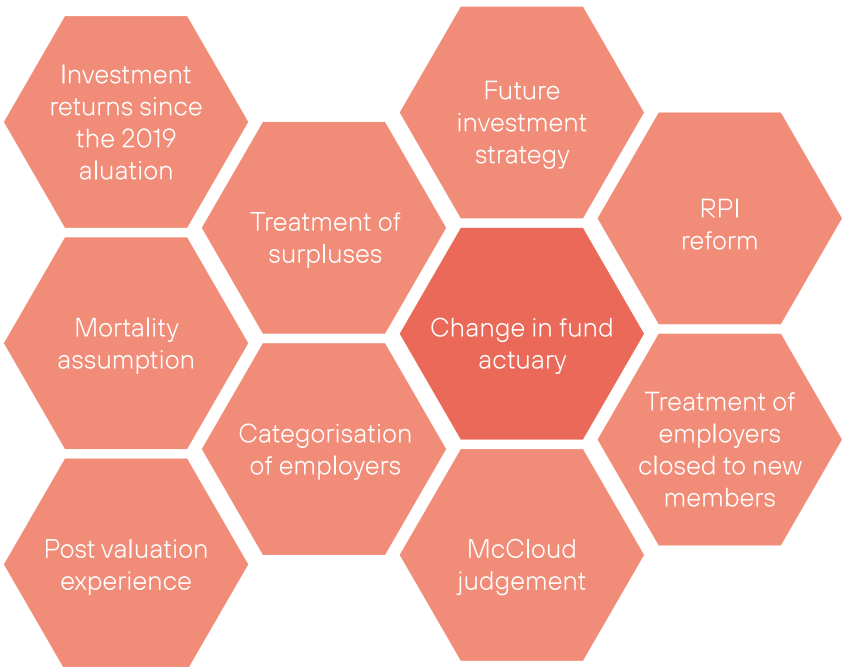
Key drivers of contribution rates



Change in fund actuary

Some Funds have changed their actuary since the 2019 valuation. Employers in these Funds could therefore see a fundamental change in the funding methodology which could lead to a step change in contributions at the 2022 valuation.

We encourage Funds who have changed their actuary since the 2019 valuation to inform employers at the earliest possible opportunity of any fundamental changes to their funding approach. Similarly, we encourage employers to engage with their LGPS Fund to understand the Fund's view on how the change in actuary might impact their contribution rates at the 2022 valuation.

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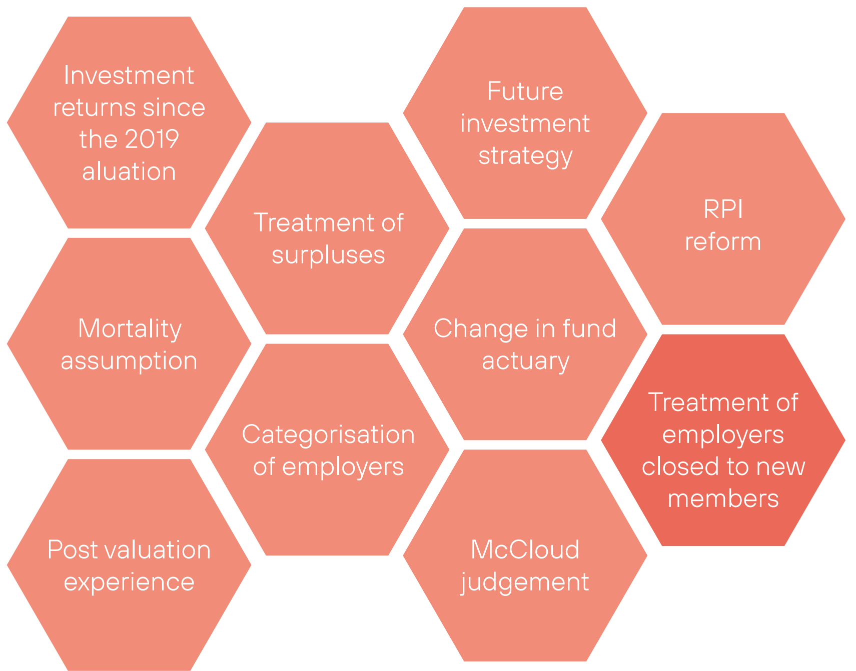

Treatment of employers closed to new members

Many LGPS Funds will target the termination position, rather than the ongoing funding position, for employers who are closed to new members. This can lead to very significant increases in contribution rates for affected employers.

Affected employers should engage with their Funds to ensure the contribution methodology is aligned with their objectives. For example, the recently introduced employer flexibilities means there are alternatives to paying a termination debt as a lump sum when the last active member leaves a participation, and so targeting the termination position over a short period may be unnecessarily unaffordable for some employers.

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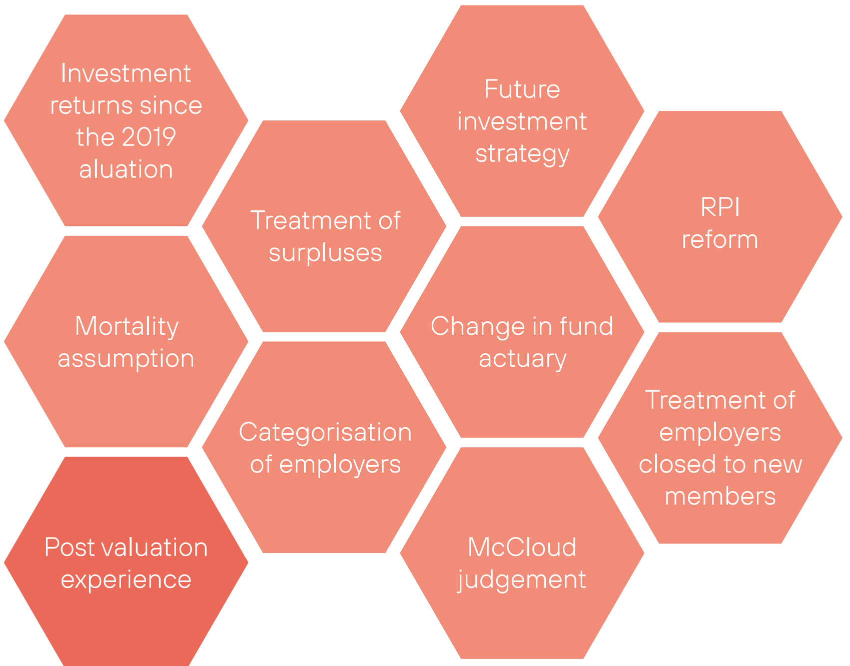

Post valuation experience

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.

Given heightened volatility and global risks, there is the possibility that market conditions deteriorate significantly in the coming months.

We encourage Funds to be transparent on the circumstances under which they will allow for post valuation experience. For example, employers should have a clear understanding as to whether any negative post valuation experience would be allowed for at the 2022 valuation and consequently lead to increased contribution rates.

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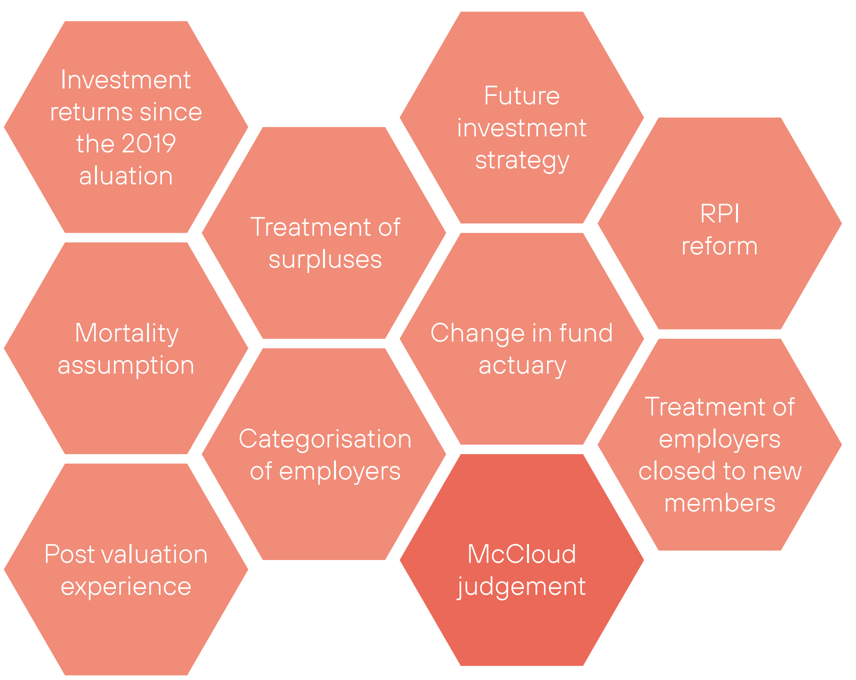

McCloud judgement

Allowance for the McCloud judgement at the 2019 valuation varied between LGPS Funds. Although perhaps less significant to overall contribution rates, we would encourage employers to understand their Fund's approach to McCloud at the 2019 valuation, and whether a change in approach in 2022 is likely to impact contribution rates.

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