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60 SECOND

NEWS SUMMARY

PUBLIC | SECTOR

STOCKMARKET TURMOIL AND FUNDING THE LGPS

August 2011

Recent market events have sent LGPS funding levels to depths not seen since autumn 2008. Back then we advised that the very long term time horizon of most employers means LGPS funds can ride out short term volatility in market conditions; unlike very mature private sector funds, they do not need to sell assets now in order to pay benefits. We also advised that there was no need for an immediate rise in employer contribution rates.

These sentiments still hold true today, despite the drop in the number of contributing members which most funds are experiencing, as this briefing note explains.

This note also contains a brief summary of the more immediate issues, from an actuarial perspective, which relate to situations where any deficit is crystallised, such as:

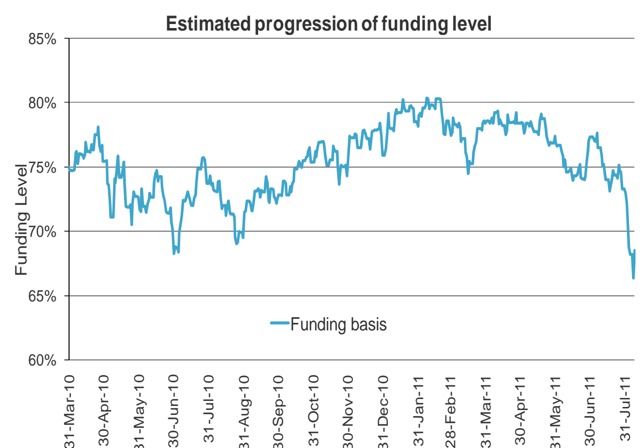
- cessation valuations;
- bulk transfers, and
- even transactions within the fund – yet another headache in relation to any academies about to join?!

FALLING FUNDING LEVELS, GROWING DEFICITS

Turmoil in the financial markets has dominated headlines in the last week or so. Weak economic growth, fears over sovereign debt and the threat of a double-dip recession in both the US and Europe have all had a part to play in the recent dramatic falls in asset values. The fall in UK gilt yields is a double whammy for pension funds as liabilities increase in value.

For a typical fund in England and Wales, the funding level at 31 March 2010 was around 75%. Based on prevailing prices (9 August), we estimate that the funding level has dropped to around 68%. This has come about not just from falling asset values; the value of liabilities has increased due to lower long term real yields and hence a lower net discount rate.

The chart below shows the sharp drop in funding level that the 'typical' fund has experienced in recent weeks.



WHAT DOES THIS MEAN FOR CONTRIBUTION RATES?

Higher deficits generally mean higher employer contributions, a greater reliance on future investment returns or a combination of the two.

For the long-term, secure employers funds may be content to accept that, unless conditions do improve, the chances of reaching their long-term funding target are diminished. In the main this will be the far

more palatable option than asking already cash-strapped local authorities to pay in more to prop up the funding level.

Whilst it would be disingenuous to pretend that LGPS funds are immune to market events, we would support funds in not increasing employer contributions to the LGPS immediately, for the following reasons:

- The next valuation is not due until 2013 and market conditions (asset values and real bond yields) may yet improve.
- Funds are generating more than enough investment income to cover any shortfall of contributions compared to benefit payments so there is no need to sell assets to meet benefit payments (albeit the processes to draw down income may not be in place for many funds).
- With member contributions and future benefits under review a knee-jerk reaction to market movements would appear to be an over-reaction.

In any event, there is no power in the regulations to increase employer contributions due to adverse market conditions.

Recent events do however highlight the risks associated with the current growth-biased investment strategy of most funds and the need to think carefully about whether the current strategy remains appropriate for private companies and employers who no longer admit new entrants. Some funds are already re-considering their funding and investment strategy for mature employers and we would encourage others to do the same.

WHAT SHOULD YOU DO NOW?

INVESTMENTS

Investment issues have been covered in our recent Capital Markets Service note. Local authority funds have typically invested a high proportion of their funds in return-seeking assets such as equities, because they are expected to deliver higher returns over the longer term for an acceptable level of risk. This does result in volatility, which local authority funds can generally accommodate because of their long term nature. The acceleration in the maturity of fund membership due to redundancies, possible opt-outs and, for Councils, the establishment of academies, may mean funds' appetite for investment risk may diminish over time. Whilst we are not advocating any immediate action, we do support the re-appraisal of investment risk that some funds are already undertaking – recent events act as a clear reminder that many funds remain heavily reliant on equities as their main source of growth.

COMMUNICATIONS AND MANAGING EXPECTATIONS

If market conditions continue as they are, administering authorities may wish to warn employers about the potential impact on the outlook for contribution rates at the 2013 valuation. Any increases are likely to be greatest for shorter term employers whose participation in the fund may end in the reasonably near future and employers (often less financially secure) who are required to repay deficits over a shorter period than tax-raising bodies.

The statutory nature of members' benefits mean members should have nothing to fear from recent market events. You may find it worthwhile to communicate this to members, some of whom might think that stock-market falls could affect their pension. Member communication is particularly important in today's environment given the uncertainty and anxiety surrounding the review of public service pensions.

ADMISSION AGREEMENTS COMING TO AN END

We would encourage funds to review contribution rates for any employers whose admission agreements are scheduled to end over the next 3-4 years. As deficits have grown; higher contributions now will reduce the likelihood of an unaffordable shortfall when the agreement ends, which would be passed on to other employers in the fund.

Other options include extending admission agreements which are due to end soon to see if market conditions improve; or, where no delay in termination is possible but the employer will continue to exist, deferring settlement of the final deficit amount. If market conditions improve, the amount could then be adjusted to take this into account.

BONDS

Bonds are typically for the protection of awarding authorities letting contracts. More and more bonds now include some allowance for financial risks and are intended to incorporate an allowance for any deficit at the date of bond review (usually carried out no more frequently than annually).

Funds may wish to discuss with awarding authorities, whether or not to review (and increase) bond amounts, although this will be unwelcome at a time when employers are perhaps facing other financial challenges. We would suggest that administering authorities engage with the employers for whose protection the bond exists before taking any action.

PASS THROUGH ARRANGEMENTS

Where a pass through approach is taken, the investment risk associated with the pension benefits of outsourced workers remains with the awarding authority. In this case, the increase in the deficit attributable to the awarding authority will be higher than would otherwise be the case, and will be a higher percentage of the pay of members who have remained in the employment of the local authority.

OUTSOURCINGS

Outsourcings are usually on a fully funded basis, with assets transferring from the awarding authority to the new employer equal to the value of the transferring liabilities, irrespective of the funding level. In current conditions this could lead to unintended consequences for both parties; reducing the residual funding level for the awarding authority, and generating a surplus for the new employer if market conditions improve.

There are various ways of dealing with this, but the most appropriate approach will depend on the specific circumstances.

ACADEMIES

The admission of academies has already been a fraught process for many LGPS funds. In current conditions transferring a share of the Council's deficit in relation to deferred members and pensioners to an academy may mean a zero or even negative transfer of assets, a situation which is very unlikely to appeal to any academies.

Administering authorities may wish to consider whether there are any alternatives to calculating the funding level and assets to transfer based on market conditions on the transfer date. Alternatively, they could consider limiting the extent to which academies are asked to make good the deficit in relation to deferred members and pensioners which has arisen due to recent market events.

BULK TRANSFERS

We would recommend that administering authorities consider delaying payment of any bulk transfers out of the fund where there is no provision to reduce the amount paid due to adverse market conditions. To do otherwise could crystallise a significant deficit for the transferring employer.

Alison Murray
Partner
11 August 2011

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