Scheme Advisory Board

Triennial valuations in the LGPS (England & Wales)

Summary

The LGPS is a funded scheme and periodic assessments are needed to ensure the fund has sufficient assets meet its liabilities. Employer contribution rates may change depending on the results of valuations. Scheme regulations set out when valuations are to be carried out.

Each LGPS pension fund is required to appoint their own fund actuary, who carries out the fund's valuation. The fund actuary uses a number of assumptions to value the liabilities of the fund. Liabilities are split between those that relate to the past (the past service cost), and those that relate to the future (the future service cost). The results of the valuation may lead to changes in employer contribution rates for both future and past service costs.

The portion of the total employer contribution which relates to the past service cost is known as the deficit contribution, and is often payable in cash terms. The portion of the total employer contribution which relates to the future service cost is known as the future service rate and is normally payable in percentage of pay terms.

The results of the 2013 LGPS valuations show that LGPS funds generally have broadly similar funding levels to those in 2010, but with increased deficits in cash terms. However this overall picture is not reflected at individual employer level, where there have been significant variations in funding levels and contribution requirements.

Total employer contributions vary for a number of factors. Differences in membership profiles and experience can cause fluctuations, while funds may choose to vary factors such as deficit recovery periods between employers based on indicators such as perceived risk. From fund to fund, employer rates may also vary because of investment performance and differences in actuarial assumptions.

The LGPS is subject to a new cost management process, which is intended to make the scheme more sustainable. Under this process, extra valuations of the LGPS will be carried out at national (not local fund) level every three years from 31/03/2016. These national valuations are quite different from the local valuations in a few key areas. If this cost management process shows that the cost of the LGPS has changed then benefits and/or contribution levels may be changed for all employees in the LGPS as a whole (i.e. nationally).

This note principally focuses on the local valuations for funding purposes, but does also consider how those local valuations differ from those carried out nationally for cost management purposes.

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Why do valuations?

- Under LGPS regulations, valuations of the individual LGPS funds are required to take place triennially (every three years) as at 31st March 2010, 2013, 2016, etc.

- The LGPS is a funded scheme, meaning that contributions paid by employees and employers are set aside specifically for the payment of pensions. Valuations of the individual funds are carried out at a local level to mainly assess:

  a) How much in pension liabilities the fund is responsible for.
  b) How much in assets the pension fund has under its control to meet those liabilities.
  c) The corresponding funding level (the value of assets held by a fund expressed as a proportion of its liabilities).
  d) An appropriate level of contributions for employers to pay going forward.

- Valuations present a periodic opportunity for funds to review the total contribution payable by their participating employers. A wide range of factors, like the performance of fund investments since the previous valuation, and the individual profile of each employer's membership, can mean contributions increase, decrease, or remain static, in order for the fund to reach its funding objectives.

- Valuations also allow pension funds and employers to see the difference between:
  - liabilities which relate to the past (i.e. the past service cost), and
  - liabilities which relate to the future and which are based on the active membership at the time of the valuation (i.e. future service cost).

- If assets are not sufficient to meet past service costs a deficit exists and the total contribution rate will be expressed as two elements:
  - the past service deficit contribution (sometimes expressed as a percentage rate of payroll and sometimes as a cash amount), and
  - the future service contribution, normally expressed as a percentage rate of payroll.

KEY MESSAGE
The LGPS is a funded scheme and periodic assessments of the individual LGPS funds' liabilities are needed to compare the assets held in the fund with the assets expected to be needed to pay current and future pensions already promised to members. Employer contribution levels are set by these “local” valuations. Scheme regulations set out when these valuations are to be carried out by the individual LGPS funds.

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Results of the 2013 valuations

- The latest valuations for England and Wales were carried out during 2013-14 based on data as at 31st March 2013.

- The overall results show that the 2013 funding levels for funds are broadly similar to those from 2010. The average funding level across the LGPS in England and Wales as at 31st March 2013 is 79%.

- However in cash terms overall deficits have risen from a total of £37bn in 2010 to £47bn in 2013.

- It should be remembered that the funding levels and cash deficits for each fund are not directly comparable across funds as they may be calculated using different funding approaches and actuarial assumptions. Neither are funding levels the only relevant 'health' indicator for funds. Others include deficit recovery periods, employer contribution rates, funding strategy statements and perhaps most importantly the long term availability of cash flows.

- The major downward cost pressures for funds (the good news for funding levels) over the valuation period have generally been:

  (a) Asset performance (the performance of fund assets in investment markets)
  (b) New scheme (for some)
  (c) Pay restrictions
  (d) Actual contributions paid

- The major upward cost pressures for funds (the bad news for funding levels) over the valuation period have generally been:

  (a) Increases in longevity
  (b) Decreases in index linked gilt yields
  (c) Lower expected future investment returns

  Index linked gilt yields have in recent years been at historic low levels as a result of the Government's policy of quantitative easing and these low yields have had the effect of increasing the current value of liabilities calculated during the March 2013 fund valuations.

- For individual employers the results of the valuation can be quite different from those of the whole fund. A much wider range of differences in funding levels at the employer level has been seen. The reasons for different results could include:

  (a) Different membership profile (e.g. older than average workforce)
  (b) Different membership experience than for the fund (e.g. fewer leavers, more deaths, etc)

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- For individual employers the changes in contribution levels required have also varied greatly. Employer's contributions are made up of a future service element and a past service element. As many employers now meet deficit contributions through cash payments it is difficult to provide a comparator rate for past service contributions.

KEY MESSAGE
The 2013 valuations have generally produced broadly similar funding levels to the 2010 valuation, but with increases in deficits in cash terms. However the overall picture is not always reflected at individual employer level which has seen significant variations in funding levels and costs.

Why do employer rates vary, even in the same fund?

Future service rate

- The first element of the employer contribution is that relating to the build-up of benefit, the "future service rate". Although the benefits package is the same for all active members, variation in membership profiles can cause significant differences in future service rates across employers. Providing a benefit to an older employee generally costs more than providing the same benefit to a younger person (as for an older person the fund has less time to invest the contributions paid). So, if an employer has a high proportion of long-serving members who are nearing retirement, that employer's future service rate will be higher than an employer with a younger, shorter-serving membership. Further, employers with an older workforce may actually see their future service costs increase under the new Scheme.

Past service (deficit) contributions

- Deficit contributions will vary between employers within funds because of the circumstances of each employer. In simple terms, an employer's deficit contributions will reflect their own deficit and the period over which they are asked to remove it.

- In terms of the deficit recovery period for an employer:
    - Funds may have a risk based component in their funding strategy statement and change deficit recovery periods depending on the anticipated security of each employer.
    - Employers which are closed to new members may have shorter recovery periods than those open to new members as it is expected that, for those employers, a time when that employer has no members contributing to the fund will come around quicker.

- Employer contribution rates may also vary for reasons relating to the fund that they participate in. For instance, investment performance may differ or funds may have different attitudes to how employers deal with deficits or on the mechanism for pooling employers' contributions. Furthermore, funds may use different actuarial firms who may recommend differing approaches and/or different assumptions.

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KEY MESSAGE
Employer rates vary for a number of factors. Differences in membership profiles can cause fluctuations, and funds may choose to vary factors such as deficit recovery periods between employers based on indicators such as perceived risk. From fund to fund, employer rates may vary because of investment performance, and variations in actuarial assumptions.

How are individual LGPS fund valuations undertaken?

- The LGPS is a locally managed Scheme and valuations in the LGPS are undertaken at a local, individual fund level. Each fund is required to have appointed a qualified actuary for their pension fund, and it is this 'fund actuary' who performs the valuation calculations. ***These calculations determine the contributions to be paid by employers.***

- Each fund is required, under LGPS regulations, to produce and publish a funding strategy statement. This should clearly set out the approach to funding which each fund adopts, including how employers' liabilities will be best met by the participating employers. The funding strategy of the fund can be a significant influence on the contributions to be paid by employers.

- At the time of the valuation, each fund sends their actuary financial and membership details which form the basis of the actuary's calculations. These are sent in aggregate, but typically include a split at employer level so that individual assessments of employers can be undertaken.

- Pension liabilities fluctuate over time, depending on a number of variable factors. To account for such fluctuations, the fund actuary makes assumptions in a number of areas in order to assess the liabilities of the fund. These assumptions are split in to two types, demographic and financial:

    - Demographic assumptions are about the timing & frequency of events (e.g. how many ill health retirements there will be, how long pensions will be in payment for).
    - Financial assumptions are about amounts (e.g. the level of salary increases which will be earned by Scheme members in the future, the level of investment return which will be earned on fund assets).

  The assumptions used in each valuation will be agreed between the fund's pensions committee and the fund actuary based on recommendations made by the actuary.

- In the actuary's calculations, pension liabilities for the fund and for each employer are split in to two parts, the past service cost and the future service cost.

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- The past service cost is the portion of an employer's liabilities which relates to the benefits accrued up to and including the valuation date. This value is compared to the value of the assets allocated to the employer at that date.
- The future service cost is the portion of an employer's liabilities which, at the valuation date, have yet to be incurred.

Employers have two elements to their contribution rates - the future service rate and the past service element. The future service rate meets the future service cost, whilst the past service element deals with any difference between the past service cost and the assets of the employer (i.e. any surplus or deficit). Contributions in respect of the past service element are often payable in cash, whereas the future service rate is typically payable in percentage of pay terms.

KEY MESSAGE
Each individual LGPS pension fund is required to appoint a fund actuary, who carries outs the fund's local valuation. The fund actuary uses a number of assumptions to value the liabilities of the fund. Liabilities are split between those that relate to the past (the past service cost), and those that relate to the future (the future service cost). The results of this local valuation set the employer contribution rates, which may go up or down.

How do these local valuations relate to the cost management process?

- As part of the LGPS reforms agreed between Government, the LGA and the trade unions in November 2012, an LGPS cost management process to periodically review the costs of the reformed LGPS was agreed. The aim of this national cost management process is to increase the sustainability of the LGPS by sharing future variations in the cost of the LGPS between employers and members.

- In the national cost management process, the costs of the LGPS will be assessed in line with the agreed target future service rate for LGPS benefits of 19.5% of payroll (made up of an average yield of 6.5% in employee contributions and an average yield of 13% in employer contributions). A 2% or more movement from the target in either direction must result in agreed recommendations for action to move back to the target or a default process to move back to the target will be triggered, and recommendations for action may be made following changes of less than 2%.

- The cost management process will (when changes in cost become apparent) only lead to changes in benefit levels and/or employee contribution rates and these changes will apply to all employees in the LGPS. Any changes to benefit levels and/or employee contribution rates will be made at national level and so will impact on all participating employers. These changes will only impact on the actual contributions that employers pay when they are allowed for in the local valuations.

- As well as the LGPS cost management process, HM Treasury will also be adopting their own system for reviewing costs in the LGPS. This has some differences from the Board process and may result in differing figures. Further information on the HM

Treasury process may be found in the policy document published in March 2014, *Public service pensions: actuarial valuations and the employer cost cap mechanism*.

- Under the agreed processes, the future cost of the Scheme will be assessed at a national level every three years from 31st March 2016.

- As these national valuations for cost management have a very different purpose from the local valuations they are to be carried out quite differently. Some of the key differences in the cost management valuations are as follows:

  - Existing deficits at the start of the process are excluded from the process.
  - The national process will not take into account some of the effects of changes in costs which normally arise in the local actuarial valuations. The effects which are not taken into account include changes in costs due to investment returns and changes in market yields.
  - The valuations will be based on an aggregated, national 'model fund', with the calculations being carried out by the Government Actuary's Department (GAD).
  - The valuation assumptions will be set at a national level. Given that assumptions for fund valuations are set at a local level by the individual fund and their actuary, there will be differences in the assumptions and outputs of the local fund valuations and the national cost management process.

- Given the differences in purpose and assumptions employers should not expect their local future service rate to be the same as those falling out of the national cost management process.

KEY MESSAGE
Under the new cost management process, the costs of the LGPS will be reviewed every three years from 31/03/2016 to ensure that they remain in line with agreed targets. The process includes additional valuations that will be carried out at national level. The purpose, assumptions and output from these cost management valuations are all different from the local valuations carried out by LGPS funds. This cost management process can only lead to changes in benefit levels and/or employee contribution rates that will be made at national level.

This is the shadow Scheme Advisory Board's full summary of the 2013 LGPS fund valuations, also available as a formatted webpage here. A shorter overview of the 2013 valuations has also been published by the Board and is available here in PDF format and here as a formatted webpage.