



Briefing | June 2022

LGPS valuation - your questions answered

Three years is not long in terms of pension funding, but so much has happened since the last valuation. Asset volatility, a pandemic, a war in Europe, high and probably higher future inflation and interest rates, an ever-increasing focus on climate change and regulatory changes could all impact Local Government Pension Schemes (LGPS) funding levels and future contribution rates. In this briefing, we'll look at how we will manage these factors as part of the 2022 valuation.



Strong but volatile asset performance

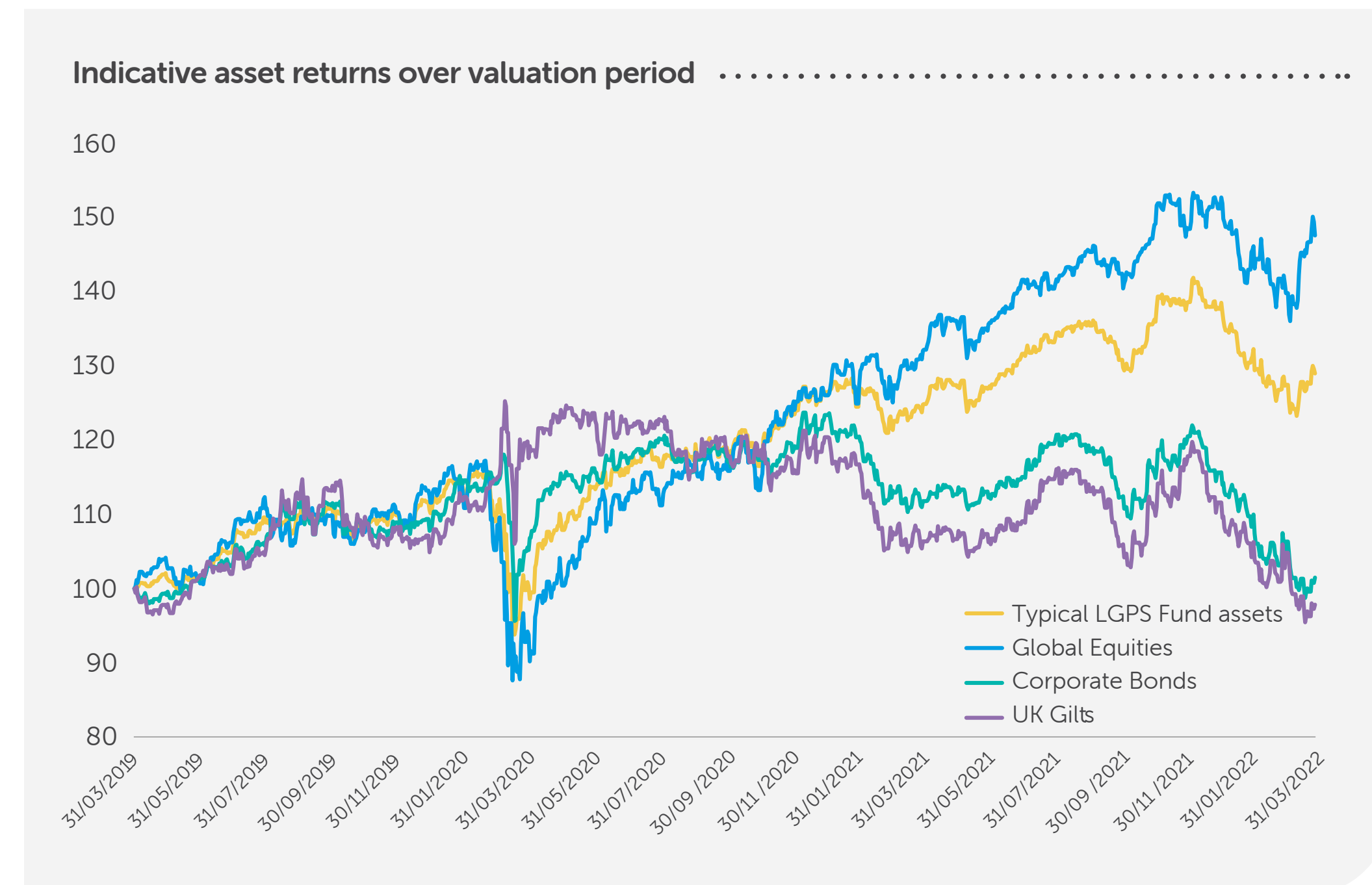
Asset returns have been very strong, with a typical fund returning around 30% over the three-year period. Of course, as asset allocations continue to be more diverse and fund specific, asset returns will be more varied across LGPS funds. Most funds also experienced significant volatility - most saw a negative return over the first year because of the pandemic, only for assets

to rebound quickly and very strongly. And despite a couple of blips along the way, markets have returned at higher levels than expected in 2019.

Asset returns will have outperformed the discount rate set at the 2019 valuation. This is good news for funding levels but what does this mean for future investment returns?

The best estimate return for your fund will depend on the asset allocation, but for a typical LGPS strategic asset allocation our view is that **long term best estimate return** will be similar to 2019 levels.

Of course, for the valuation we need to make a prudent estimate of future investment returns to derive our discount rate and value the liabilities. In fact, it is the **real discount rate** (the discount rate in excess of Consumer Price Index (CPI)) that is important when determining the funding level and employer contributions – more on that below.



Source: FTSE, Merrill Lynch, Barnett Waddingham

Inflation, inflation, inflation

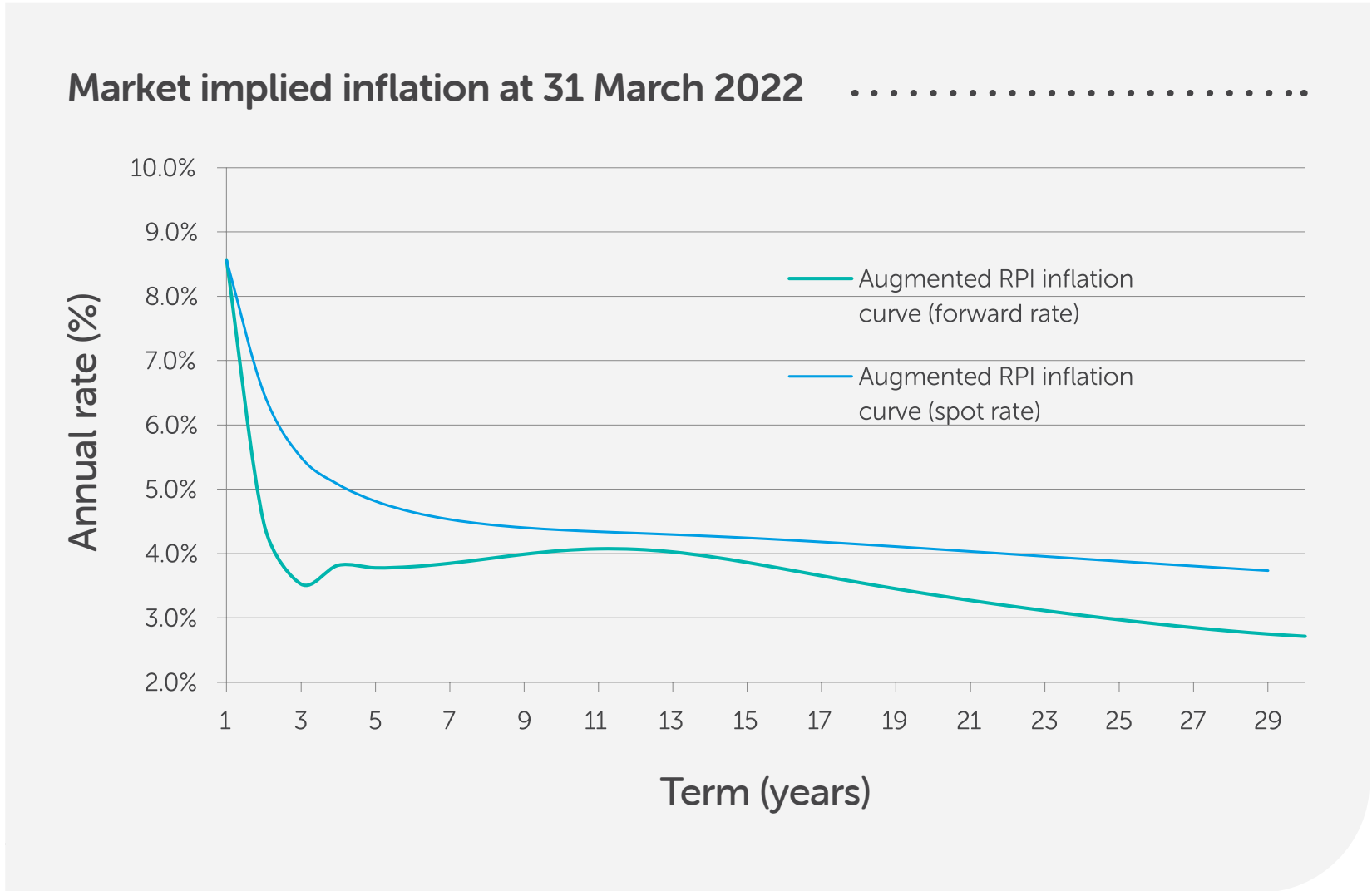
Inflation hit a 40-year high at the end of May. **What does this mean for the 2022 valuation?** Government support, the successful vaccination programme, increased demand for goods and services and the subsequent supply chain issues were all leading to higher short-term inflation in 2021. Of course, the Russia-Ukraine crisis and its impact on energy prices and supply issues of other commodities has increased inflation further. Many of these inflationary factors could be described as short-term or one-off events, but the question is how long will they persist and what will be their impact?

⋮ The longer-term economic factors that tend to drive inflation down remain – globalisation, high levels of debt and an ageing population and workforce, should help to bring inflation back down towards the Bank of England target. Although the labour market and wage inflation could still be a concern in the future.

There are a lot of factors to consider and lots of uncertainty. However, it is probably safe to say that there is a risk inflation will be higher in the long-term and higher than assumed in 2019.

The chart to the right shows market implied Retail Prices Index (RPI) inflation, based on the Bank of England forecasts, with the chart extrapolated at the earlier years where data is not available.

As expected, inflation is high at the short end, decreasing over time. As pension funding is a long-term game, we are more concerned about inflation over the long-term. The more positive news for funds is that over an appropriate term, RPI inflation averages around 3.6% - 3.7% p.a. which is more in line with what has previously been assumed.





Of course, LGPS benefits all now increase in line with CPI inflation. Historically, CPI inflation has been lower on average than RPI inflation. In addition, investors are more willing to pay a premium for inflation-linked products to provide protection against unexpected, high inflation. It therefore may be appropriate to allow for an inflation risk premium when determining the long-term inflation assumption.

We can see that there are many factors that will impact the CPI inflation assumption and this section has been simplified greatly. Much will depend on the actions of central banks. These could raise interest rates to curb inflation. Our understanding is that markets have already priced in six small interest rate rises over the next twelve months. If rates are raised too much or too quickly there is the chance of slipping into recession which would damage economies and impact assets. On the other hand, if rates are not increased enough or too slowly, we could have higher inflation for longer – assets might do well in the short term, but liabilities would increase too.

- ⋮ Bringing all this together, our assumption for CPI inflation at
- ⋮ 2022 will be higher than at 2019 and so will increase liabilities
- ⋮ and primary contribution rates (all else being equal).

The Russia-Ukraine crisis

Markets do not like uncertainty. And the Russia-Ukraine situation certainly increases that uncertainty. Most LGPS funds have only a small direct exposure to Russian assets, and LGPS funds have probably already written any such assets down to zero. **The consensus is that this will reduce funding levels by around 0.3% - 0.5%.**

But there may be a greater impact on wider markets. Some supply chains will be impacted, affecting a number of sectors and markets. Soaring energy prices have been heavily spotlighted, but the price of wheat has also shot up since January, and car manufacturing has been impacted as Russia is a large exporter of palladium, which is used in catalytic converters. This provides opportunities too, but timescales make it difficult for funds to take advantage.

Again, the main concern about the crisis has been more upward pressure on inflation when inflation was already increasing for the reasons discussed above. This may in turn see interest rates rising higher and more quickly than previously factored in, which could impact asset values through an economic slowdown.

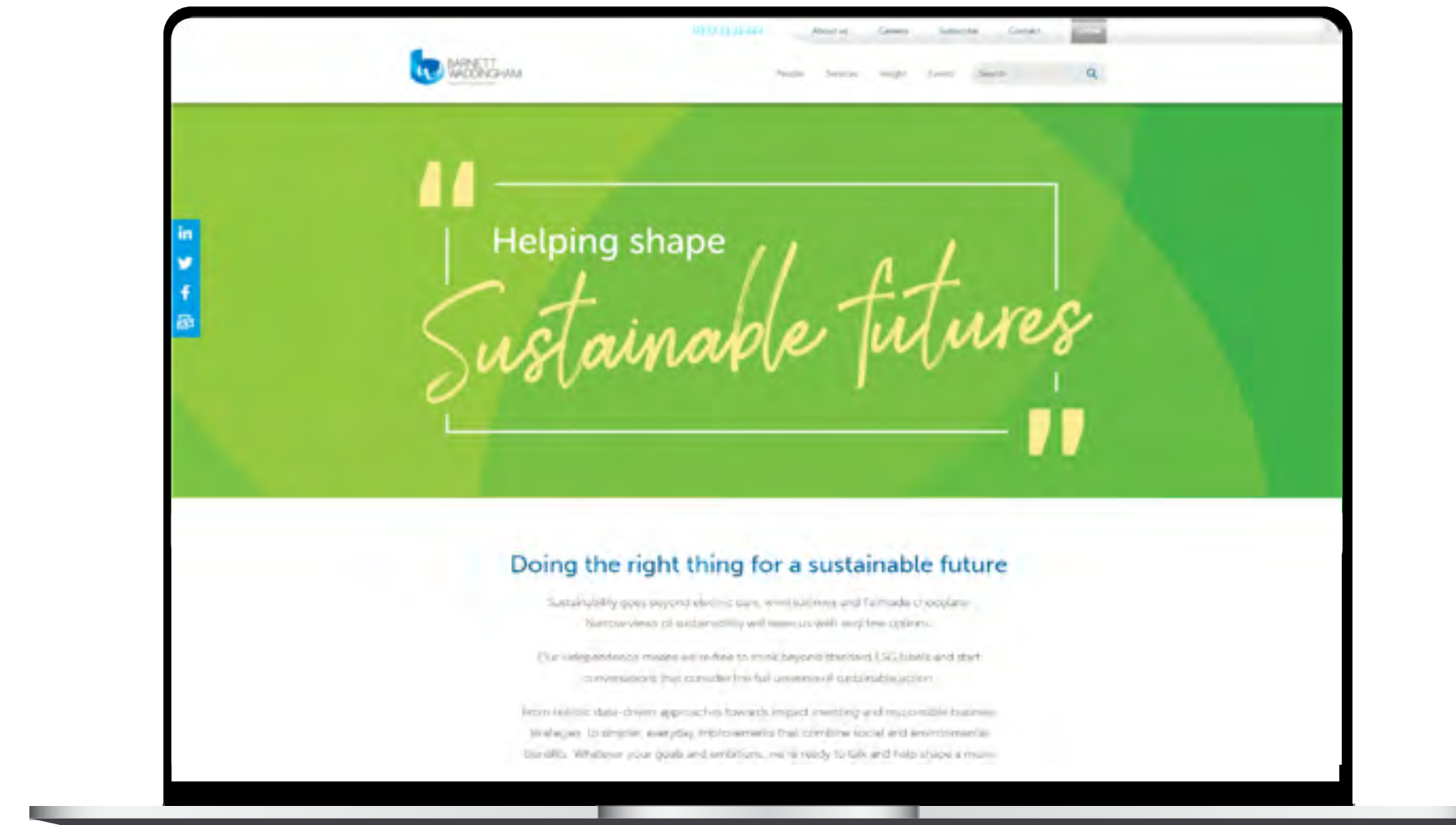
Climate change

Climate risk will be an important consideration for the 2022 valuation

It may have been considered by funds already when looking at strategic asset allocations and long-term best estimate returns, but may not have been considered in terms of liabilities, funding strategies and employer covenant.

The Task Force on Climate-related Financial Disclosures (TCFD) is a framework that aims to help companies and investors measure, manage, and report their climate-related risk exposures and opportunities in a consistent manner. As part of this, funds are expected to assess the resilience of their assets, liabilities and investment and funding strategies to climate-related risks by assessing the potential outcomes under several different climate-related scenarios. For example, this needs to assess how these would be affected by:

- a measured, orderly transition to a low carbon economy (early action);
- a sudden, disorderly transition to a low carbon economy (late action);
- and a “hot house world” (no additional action)



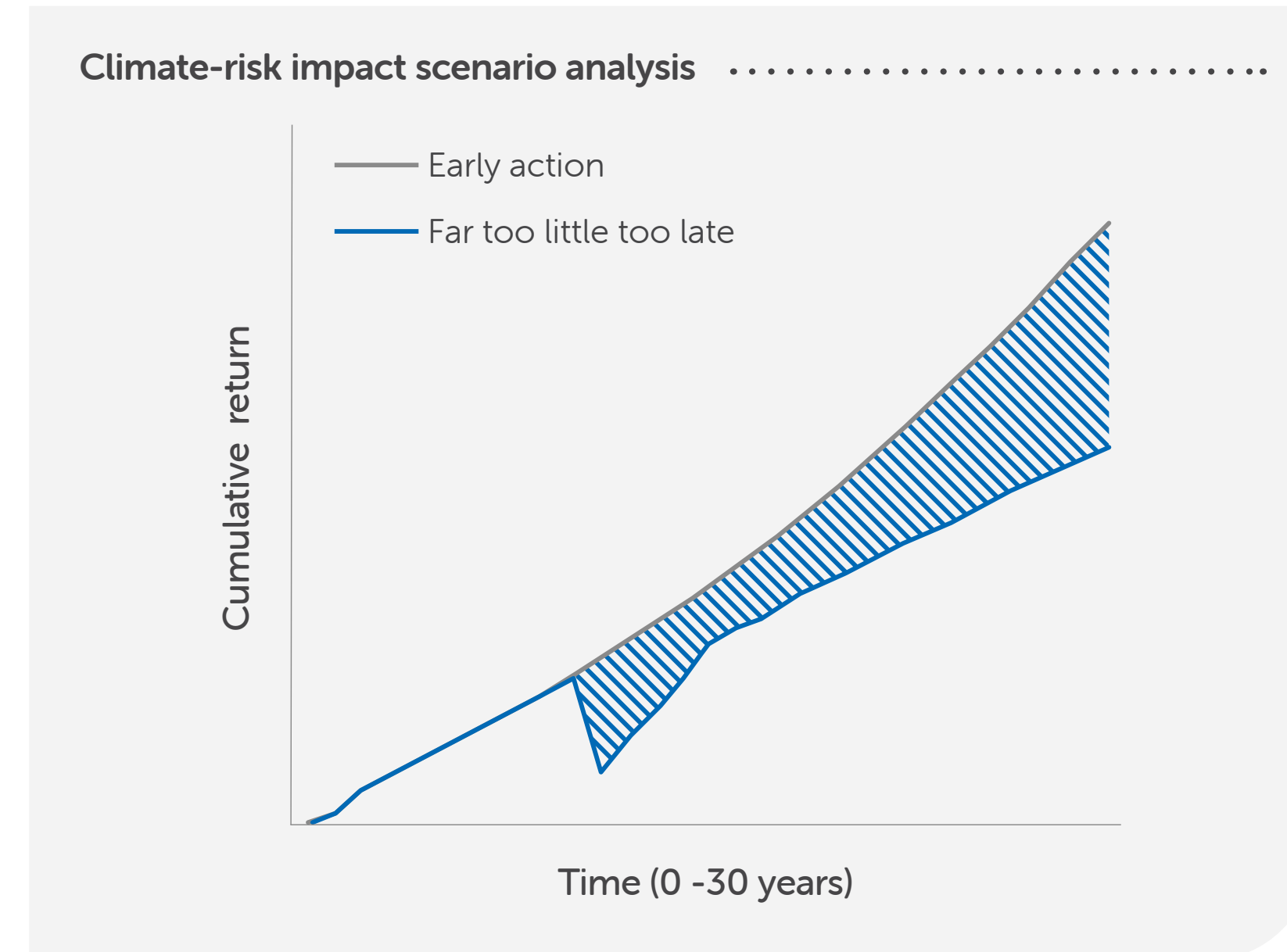
We understand climate risk will be a focus in future section 13 reports. Although the exact TCFD requirements are still to be consulted on for the LGPS, there is an expectation from the Government Actuary's Department (GAD) for funds to assess these risks now and make allowance for them in the 2022 valuation as far as possible. Discussions are currently ongoing between GAD and the actuarial advisors to ensure a consistent approach is adopted.

As part of the valuation, you will want to identify the impact of shorter-term climate risk (transition risk) and longer-term climate risk (physical risk) on your potential funding outcomes using scenario analysis.

Analysis should consider the potential impact on the future investment return outlook (and therefore discount rate) and inflation (and therefore inflation-linked assumptions), for the purpose of projecting asset and liability values and primary rates. You may also want to consider additional elements such as the potential impact on life expectancy changes and employer covenant.

The analysis will help you to assess whether the level of prudence in your funding strategy is appropriate and should be supported by qualitative commentary on what potential actions could be taken by the fund to improve resilience of the funding strategy to climate change.

Using the expertise of BW sustainability specialists, this analysis has been developed for LGPS funds based on the Department for Work and Pensions (DWP) regulations, and we would be happy to discuss and provide this analysis and reporting.



Source: Barnett Waddingham



Longevity

The Covid-19 pandemic will have had an impact on short-term mortality rates which will differ fund by fund. The effects of this will flow through each fund's funding levels as member experience is taken into account, but funds will also need to understand how the uncertainty caused by the pandemic will affect future mortality rates and improvements. However, in summary, and given work we have carried out with funds to date, **we do not believe the experience of funds' membership during the pandemic will have a material impact on the funding level at the 2022 valuation.**

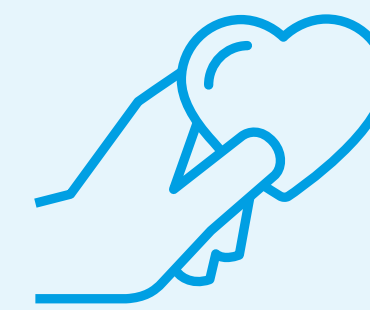
Even before the pandemic struck there was a great deal of uncertainty surrounding the direction of future mortality improvements and what we've observed over the past two years has only exacerbated this. Following decades of consistent, increasing life expectancy, we saw a slowing down of the rate of improvement from around 2011. That's not to say life expectancy was decreasing, just the rate of increase was decreasing. For example, instead of life expectancy improvements of two years per decade as previously, from 2011 it might only be one year per decade. The allowance for future mortality will be built into the mortality assumptions we make at the 2022 triennial valuation for each fund.

The pandemic has potentially changed the landscape for future mortality - listed opposite are several medical, economic and social factors which may impact future mortality improvements.



Increased life expectancy

- Advancements in vaccine science
- Greater public health awareness
- Stronger surviving population
- Healthier lifestyle through home working
- Better prepared for the next pandemic



Decreased life expectancy

- Future waves of Covid
- Individuals with "long Covid" health implications
- NHS backlogs – delays in diagnosis and treatment
- Economic recession – reduced healthcare spending and living standards
- Lockdown hangover – loss of support network and lifestyle impairments

⋮ We will be monitoring these factors closely to help form the decision on both the directional influence that Covid-19 will have on future mortality improvements and the magnitude of any impact.



McCloud and other regulatory issues

When the Government reformed public service pension schemes in 2014 and 2015, they introduced protections for older members. In December 2018 the Court of Appeal ruled that younger members of the Judges' and Firefighters' Pension schemes had been discriminated against because the protections do not apply to them. The Government has confirmed that there will be changes to all main public sector schemes, including the LGPS, to remove this age discrimination. Updated regulations are due to be consulted on over the course of 2022 with the effective date expected to be no earlier than April 2023.

For the 2022 valuation, we will assume that the legislation will bring forward the changes as currently proposed, and we will value the benefits in line with this. However, the data extracts will not yet include the full pay or service history required to value the cost of the anticipated benefit changes. Estimates (for active members only) will need to be made, based on the information that is held in the data extract provided which will involve projecting members' Career Average Revalued Earnings (CARE) benefits against the equivalent final salary benefit to determine, for each active member, whether the underpin may bite and the liability value if it does.

⋮ This is not expected to have a material impact at fund level although there may be greater significance at employer level.

The Treasury (HMT) cost control mechanism and Scheme Advisory Board (SAB) cost management reviews have also moved on slightly since 2019. The impact of any changes resulting from these reviews, present and future, is expected to be small.

Conclusion

As the funding levels and investment and funding strategies of funds continue to diverge, and the number and requirements of employers increase, it is very difficult (and dangerous) to draw conclusions on results and contribution rates at this stage.

However, what we can say is:

- **Assets** - investment performance has been strong and assets will have increased for most funds and employers

- **Liabilities** - higher expected inflation will put upward pressure on liabilities
- **Funding levels** - will have improved for most funds; many employers should see an improvement too but there will be more of a mixed bag depending on specific experience
- **Primary rate contributions** - are likely to increase because of higher inflation
- **Total contributions** - contributions should remain stable, but again with variation at employer level possible

To manage the peak in workloads, we have been working with funds to do as much preparation work in the inter-valuation period as possible, whether that be providing training, agreeing a funding strategy, employer covenant approach or a policy on risk benefits, or assisting with early cashflow and membership data cleansing using our innovative systems. Funds are now working to ensure membership data is fully cleansed and ready to go while we gear up for the calculation stage of the valuation. As ever, we will work with you along the way to highlight the impact of all the key issues raised in this note and more, helping you to provide informative and timely communication of results to employers.

Finally, despite the uncertainties raised in this note, one thing that is certain is that we are all set for the 2022 valuations and we look forward to supporting our funds through the process once again.



For professional use only - this report is for information and should not be construed as investment advice. Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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