2022 Valuation

Consultation Update

Introduction of second test to validate contribution decreases

Introduction

This paper sets out rationale for introducing a second test to validate whether contribution rates should reduce over the period 1 April 2023 to 31 March 2026.

There are several employer groups with different characteristics. This approach is not being applied to MDX, B&S and contractors.

There are also important technical, legislative and economic considerations relevant to the recommendation.

In summary:

- Using a time frame of c17 years and a probability of success of 70% within Hymans' Model suggests that contribution rates reduce for most employers.
- Playing in the observed reduction in long term real interest rates since 2019, commentary from the Scheme Advisory Board and a general requirement for stability we propose that a second test (test 2) is introduced which uses a slightly shorter timeframe of 15 years and probability of success of 80% - contributions will only decrease if they are assessed to do so under this second test..
- The combined result of Hymans' Model + test 2 is that for the majority of employers the contribution rate remains consistent with the 2019 rate.

The remainder of the paper consider the regulatory and economic context, more information on Hymans' modelling and an explanation of how Test 2 is applied.

Legislative and 2019 context

Legislative and regulatory context

The LGPS 2013 regulations each LGPS Fund to put in place a Rates and Adjustment certificate prepared by an Actuary – this is the legal document that imposes a contribution requirement on employers.

CIPFA guidance requires the contribution rate to be prudent.

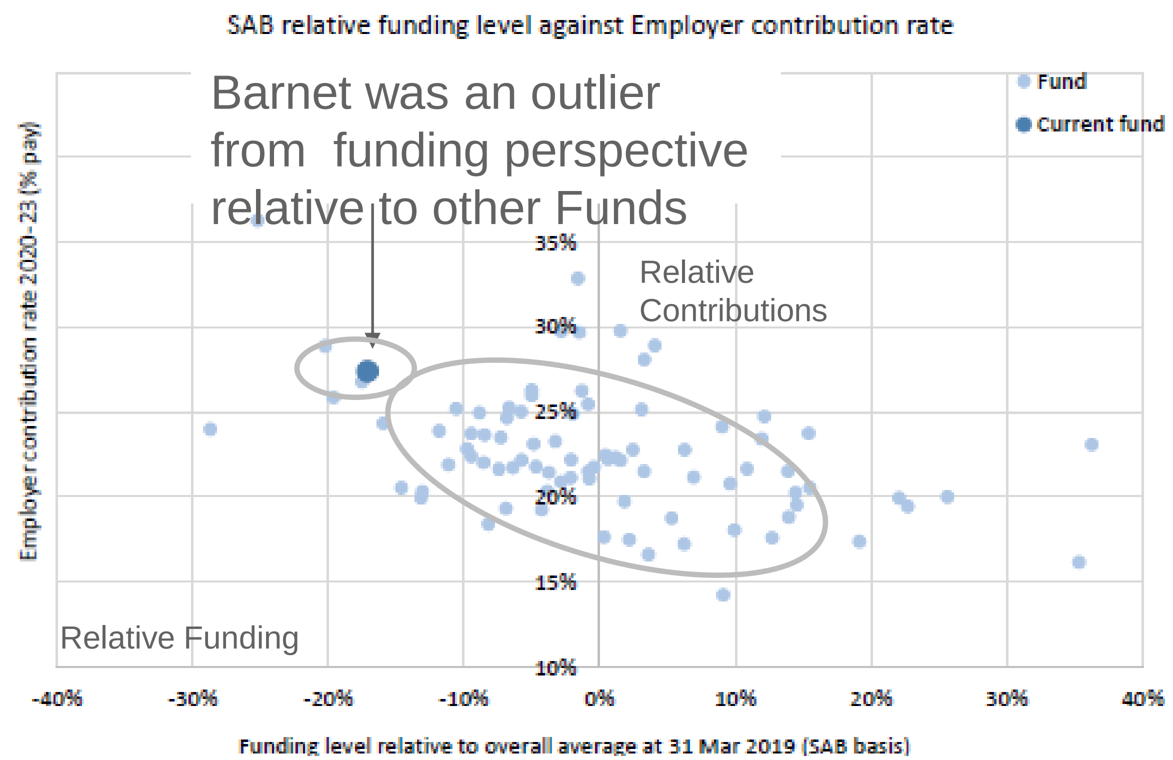
LGPS regulations require the method underpinning the rate to be stable.

The Government Actuaries Department ("GAD") undertake a triennial review of Funds to check for consistency and overall solvency. GAD will speak to funds where they believe there is a fundamental funding issue.

2019 Position

GAD's analysis of the 2019 valuation is shown in the chart to the right.

GAD's analysis shows that at the 2019 valuation, Barnet (the dark blue dot) was amongst least well funded funds (on GAD's standardised basis). GAD did not seek to speak to Barnet because Barnet were also paying amongst the highest contributions towards their fund.



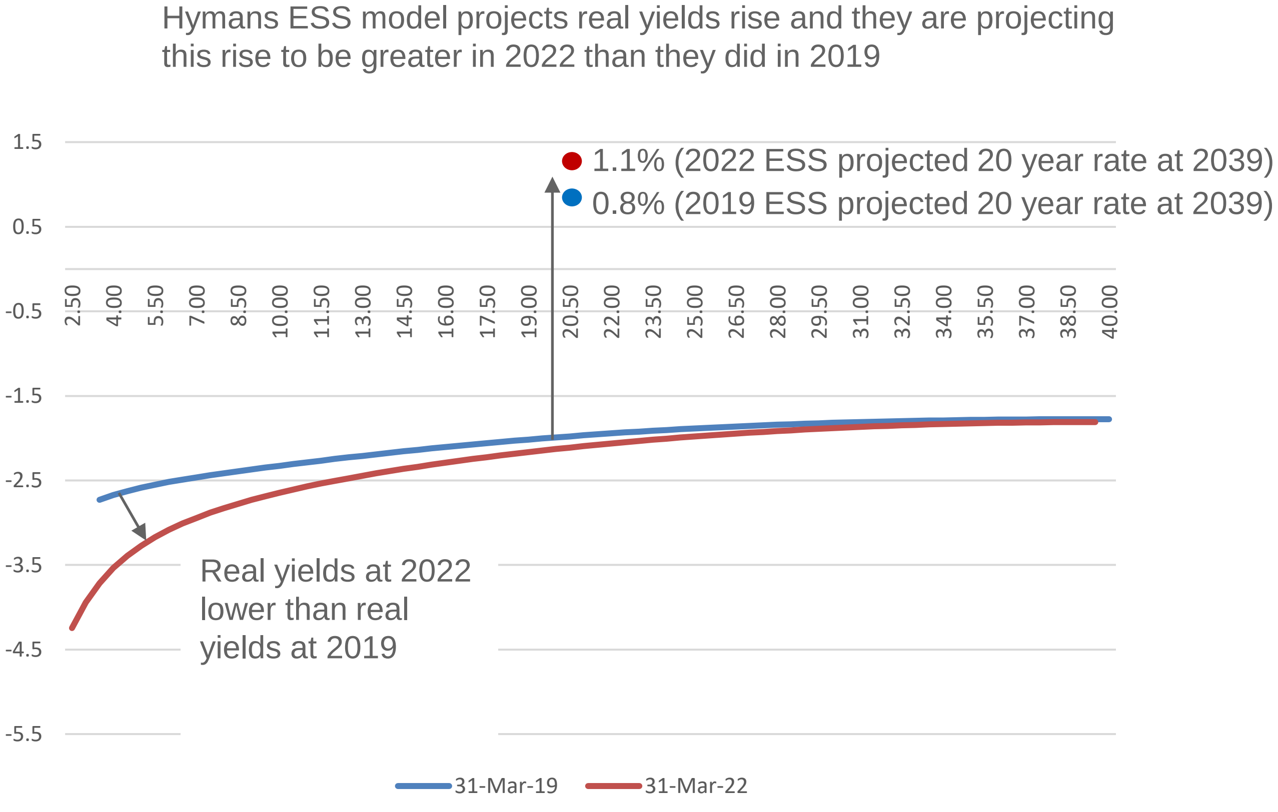
Source: GAD 2019 Section 13 analysis

We do not have information to confirm where Barnet sits relatively at 2022, however, whilst we may see some convergence towards the pack, Barnet is still likely to be a marginal outlier.

Economic and model context

Real Interest Rates

Long-term real interest rates are the primary driver for pension costs as they drive expectations around future investment returns. The real 'risk free' yield curve from market data at 2019 and 2022 is outlined below together with Hymans' Economic Scenario Service ("ESS") projection in 17 years time.



Source: LBB analysis / Hymans reports

The chart shows that real market interest rates (the **blue** (2019) line relative to the **red** (2022) lines) decreased over the three years. This is reflected in Hymans advice where they recommended discount rates as follows

Metric	2019	2022
Discount Rate	4.4%	4.6%
Inflation	2.3%	2.7%
Net rate	2.1%	1.9%

However, under Hymans' approach, the contribution rate is more influenced by the assumptions embedded within the ESS.

Hymans have increased the real Interest rates within the ESS (**Blue** dot to **Red** Dot) – i.e. a reversion to higher rate relative to market indicators.

In summary, this has led to Hymans' model indicating a reduction in contribution rates if we use a timeframe of 17 years and a probability of success (under the ESS model) of 70%.

Regulatory context and post valuation experience

Scheme Advisory Board (SAB) statement

Given economic headwinds' the SAB have cautioned against LGPS funds reducing contribution rates substantially. A link to the SAB's comment on this can be found here

Stability

It is a regulatory requirement that contribution rates are stable. To the extent contribution rates are reduced we will need to consider the ability for employers to be able to increase them again if required.

Post valuation experience

Inflation has turned out to be higher than anticipated at 31 March 2022 and investment markets are volatile. Whilst real interest rates have increased rapidly since the valuation it is too early to say how this might impact asset price growth over the long-term. Reflecting this, Hymans are cautious on funds seeking to reduce rates too heavily based on expectation at 31 March 2022.

In recognition of this, we have worked with Hymans to develop a two stage process for validating whether contribution rates reduce – see next page

Two stage contribution rate test

As noted, Hymans' ESS model assumes an increase in long-term real interest rates and a higher increase relative to what was assumed in 2019. A consequence of this is that Hymans' model is generating lower contribution rates relative to 2019 for many employers.

Given general economic uncertainty around investment markets and high inflation expectations, reducing contribution rates at this time may not be prudent. After discussions with Hymans we therefore propose a two stage test to validate whether contribution rates should reduce. The second test replicates the first test, but assumes a shorter timeframe and increased probability of success – note this test is not used for MDX, B&S college or contractors.

The process is summarised below: