ASSOCIATION OF CONSULTING ACTUARIES

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For the attention of the LGPS Scheme Advisory Board – England & Wales

LGPS employer exit valuations

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** regarding the above matter.

Members of the Association are all qualified actuaries and are subject to the Actuaries' Code of the Institute and Faculty of Actuaries. Advice given to clients is independent and impartial.

The ACA is effectively the "trade association" for consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

Members of the ACA provide advice to thousands of pension schemes, including most of the funded public service schemes – most notably the funds that make up the Local Government Pension Scheme or LGPS. Members however are also involved in advising some of the employers that participate in the LGPS.

The Association of Consulting Actuaries has a Pensions in Public Services (PiPS) committee which considers actuarial issues and wider matters relevant to the pensions industry as far as they relate to public services pension schemes. At a recent Committee meeting, the consistency of exit valuations for employers in the Local Government Pension Scheme (LGPS) was discussed.

In particular:

- The differences in exit valuation outcomes across the LGPS which can have a direct and indirect impact on participating employers.
- The calibration of some exit valuation approaches is leading to a more prudent valuation of liabilities than based on current gilt or bond-yields.
- How a lack of transparency around exit valuations can hinder the ability for employers to understand the costs of exit and make appropriate plans.

We are writing to the Scheme Advisory Board to raise the issue and ask that they consider whether the LGPS would benefit from a clear set of exit valuation principles which cover consideration of the appropriate distribution of resources between exiting and remaining employers and the need for transparency and consultation on the approaches used to determine exit valuations.

The principles could then be communicated via a guidance note from the SAB (similar to the December 2023 statement on surpluses) and form part of funding strategy considerations by LGPS funds as part of the upcoming 2025 valuations.

Further detail about the issues is set out in the **appendix** to this letter.

The Committee acknowledges that this is not necessarily straightforward, but we would be happy to further engage with the SAB on the contents of this letter if helpful. In that event, please contact me at Robert.Bilton@hymans.co.uk on **0141 566 7936**.

Yours faithfully

Robert Bilton
Chair, Pension in Public Services Committee
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

Introduction

The Association of Consulting Actuaries has a Pensions in Public Services (PiPS) committee which considers actuarial issues and wider matters relevant to the pensions industry as far as they relate to public services pension schemes and the other pension schemes across public services. A range of actuarial consulting firms are represented. The majority of the current PiPS committee members are involved in advising LGPS employers and there are also some PiPS committee members who specialise in LGPS fund actuary work.

At a recent Committee meeting an agenda item about concerns over the consistency of LGPS employer exit valuations was tabled and discussed. As part of the discussion, it was agreed that an appropriate next step would be to write to the LGPS (England & Wales) Scheme Advisory Board ("SAB"). We believe that this sits well with the remit of the Compliance and Reporting Committee.

The PiPS Committee's discussions, and therefore comments on inconsistency, transparency and outcomes in this note, are only with reference to exit valuations and do not apply to wider aspects of the funding strategy and valuation methodology.

It should be noted that committee members, and those who advise LGPS funds in particular, will have client knowledge which cannot necessarily be shared with the PiPS committee. Therefore, the level of insight below reflects the collective shared position of the PiPS committee and not that of any individual PiPS committee member or their respective firm.

Background

Exit valuation approaches are set by each LGPS fund and form part of each fund's funding strategy. They are reviewed from time to time as part of a Funding Strategy Statement review, a process which requires consultation with employers.

This note considers exit valuations for non-guaranteed employers (a different approach to exit normally applies to existing bodies who have a guarantor). It directly affects a range of employers, including charities, housing associations and a number of universities. There is also an indirect impact on all participating employers in a LGPS fund whose financial position in a fund may be affected by the terms on which other employers leave.

Historically, most exit valuation bases under Regulation 64 used discount rates based on long-dated gilt yields, with inflation assumptions derived from gilt market information. Some exit valuation discount rates are based on high-quality corporate bond yields which leads to slightly lower liabilities.   This approach of using gilt yields is akin to exits in multi-employer trust-based pension schemes, under Section 75, and the cost of purchasing annuities with insurers. Whilst Section 75 doesn't apply to the LGPS, some employers and their advisers are familiar with the approach under Section 75 through their wider background.

In recent years, there has been a move away from the use of gilt or bond yield based exit valuations by some LGPS funds to a long-term valuation approach. This is more akin to the methodology for ongoing funding bases used by LGPS funds. The Committee understands the current position is that an increasing number of LGPS funds are using long-term valuation approaches for exit valuations.

Long-term valuation approaches lead to cessation valuations that are relatively stable, but which can be significantly different from a gilt or corporate bond yields based approach. The long-term approaches are not all the same and so can create inconsistencies between funds when funds apply materially differing prudence targets in setting these ongoing termination bases or have different investment strategies.

We understand that the first shift to the long-term approach, by at least one fund, was in response to very low gilt yields, prior to the significant gilt yield increases in 2022. These were causing exit valuations to put a very high value on liabilities, leading to high and, in most cases, unaffordable exit debts. In this case and at the time of introduction, we understand the shift to a long-term funding approach led to a higher single-equivalent net discount rate and helped employers consider exit at a time when future pension costs were high and increasing.

However, the more significant shift to the long-term approach has taken place since the 31 March 2022 valuation; either as part of the Funding Strategy Statement review undertaken as part of the 2022 valuation or in subsequent reviews of the exit valuation part of the FSS. Taking into account the need for client confidentiality, anecdotes from the committee's employer advisors highlight that this is leading to some very significant differences between the long-term liability valuation and a gilt-yield based valuation. In some cases, since the increase in gilt yields this has led to exit liabilities on the long term approach being over 50% higher than on a gilts based approach. (Note, as a broad rule of thumb liabilities can increase by 15% to 20% for each 1% reduction in the discount rate).

Overall, there are two separate areas for consideration:

1. The underlying methodology (gilt yield based vs long-term approach)
2. The calibration of that methodology and resulting outcomes

The PiPS committee's discussion was primarily focused on the differences in calibration which is causing greater inconsistency in outcomes than had previously been the case (ie point 2 above).

This note does not cover or consider the decision making around whether any exit surplus should be paid to an employer.

Finally, there were different views and perspectives from Committee members expressed during the PiPS's discussion. We have noted where they have occurred during the rest of this note.

Discussion points

It is perhaps an obvious point that higher gilt yields have increased the interest in, and activity relating to, employer exits. Exit valuations have a direct bearing on employer decisions and some believe raise questions around how the interests of all stakeholders are being taken into account and the associated reputational risks.

The PiPS Committee had a robust discussion about the current position as set out above, which we have relayed in the points below. This short note is not intended to go into detail on each of the points and each of them could be explored in more detail. At this stage we are highlighting that there are a number of issues which we believe should be considered carefully as part of the application of the Funding Strategy Statement ("FSS") guidance and LGPS funds' own FSS's given the ongoing risk of outcomes that lead to large differences in the exit costs across different funds and some exit valuations being more prudent (ie higher) than those based on gilt yields (noting that once exit valuations have crystallised they are not typically reversible). We would of course be happy to provide more detailed input if requested.

Outcomes

- The committee's discussions were set in the context that the LGPS provides a defined benefit pension for eligible employees of exiting employers and that there is no recourse to the employer in the event of future worse than expected experience, including investment performance (ignoring any deferred debt arrangements).
- The committee did not discuss the merits of a long-term approach versus a gilt yield based approach. The focus was on the outcomes resulting where the long-term exit valuation calibration was leading to relatively more prudent valuations in current market conditions.
- One of the outcomes of differences in calibration is that some employers may be less likely to exit, either because the exit valuation position becomes less affordable or is considered to be poor value (for the reasons discussed below). Whilst it was felt that discouraging or blocking exit was, in general, not the motivation for the choice of calibration, some of the employer advisers noted that this is the effect.
- Whilst, on the whole, employers continuing to provide LGPS is a good thing, it is a concern if those employers who have decided it is best for them to leave are unable to do so for the reasons set out in this paper.

Liability valuation considerations

- It was noted that there is, as there always has been, a market price for pension liabilities which relates to the price at which an insurer will take in pension liabilities without any future recourse to any other party, provided a scheme's rules allow pension liabilities to be secured via an insurer. The insurance market is currently very active due to a very significant increase in the number of trust-based schemes insuring their liabilities and the actuarial consulting community holds a significant amount of intelligence in relation to these prices. These market prices are centred around gilt yields and the employer advisers on the committee felt that this is a key reference point for an exit valuation.
- Some believe that insurance policies are considered "gold standard" for ensuring member security for trust-based schemes, given the regulation of insurers by the Prudential Regulation Authority and such policies being covered in full by the Financial Services Compensation Scheme. It was noted that there have been at least three insurance transactions within the LGPS in recent years, making this a practical consideration.
- We recognise that there are many detailed points that could and should be considered in relation to insurance pricing and the read across to LGPS exit valuations. However, the employer advisers on the committee were concerned that some of the exit valuations are much higher than could potentially be secured via an insurer (which includes a profit loading for the insurer). The Fund actuaries on the committee are of the view that there are a range of acceptable approaches being taken by funds and there was no correct answer.
- The committee discussed the fact that due to LGPS Regulations there is no readily available competition in relation to LGPS funds and what they offer to employers. Some of the employer advisers on the committee were of the view that if there was competition it could cause funds to move closer to market pricing. Some were of the view that in a situation where there is no competition it is especially important that terms offered are deemed to be acceptable to all employers in the Fund, on the assumption that they are all informed.

Consistency and transparency

- The employer advisers on the committee highlighted the calibration was not always consistent from one fund to the next which can lead to very different outcomes for employers. If you consider a particular sector, for example charities, as some of our committee members advise, it can be seen that employers receive very different treatment which creates a "postcode lottery" and which can have a material impact on the operation of two otherwise similar organisations. As discussed above, this inconsistency can arise from differences in methods (gilts-based versus long-term), or differences in the prudence levels associated with the calibration of the long-term approach.
- The committee is not suggesting as part of this feedback that there should be a single mandated approach/calibration as there is no single correct answer when valuing liabilities. Instead, the concerns about inconsistency relate to the very wide range of outcomes across funds. In particular, in current and recent market conditions, some approaches/calibrations are leading to much higher valuations than gilt or bond-yield based valuations.
- There can be a lack of transparency in relation to the long-term funding valuation approaches used by LGPS funds and these extend to the exit valuations when a long-term valuation approach is used. This can be due to stochastic modelling being used which is difficult to articulate concisely, for example in an FSS. Also, some long-term exit valuations rely on changes to market conditions after the exit date and on long-term asset return assumptions which are set with hindsight some time after the exit valuation date. This makes it difficult for employers to make informed decisions, which risks sub-optimal outcomes for the LGPS (including its members).
- We understand the new Funding Strategy Statement in its current draft form says that the FSS "should also set out in general terms the termination assumptions basis". Taking into account the point above, this may not be sufficient to resolve the current transparency challenges.
- The committee considered whether the SAB, perhaps in conjunction with GAD, could consider disclosure and comparison of exit valuations across all funds. This would help with transparency for all stakeholders and challenge outlying practices. It was considered this in itself could encourage more consistency across funds.
- The committee noted that one of the reasons for the use of long-term valuations relates to how orphan funds are invested. As part of the discussions, it was noted that the uncertainty about the legality of a LGPS fund having different investment strategies for different groups of employers (or the orphan fund) was highlighted. It was agreed that it would be helpful for the legal position to be clarified.

Conclusion

The LGPS is complex with many funds and many employers, and this is a particularly complicated part of it. We encourage SAB to take an LGPS wide perspective on the points we have raised and, in particular, to consider the appropriate distribution of resources between exiting and remaining employers and the need for greater transparency (both in the approaches used and the consultation with employers on those approaches).

In addition, running through the discussion was a desire for a clear set of exit valuation principles which would deal with the issues raised above. We acknowledge that this is not necessarily straightforward, but the significant differences between similar employers in different funds highlights the benefit of doing this.

We would like this to be considered as soon as possible and would note that this is a current challenge and it may not be sufficient to defer this. Short-term guidance akin to the 22 December 2023 note on surpluses might be appropriate, as might an addition to the Funding Strategy Statement guidance.

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