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A SIMPLE WAY TO COMPARE PENSION FUND DEFICITS

CASE STUDY: LOCAL GOVERNMENT PENSION SCHEMES

LGPS RANKINGS INCLUDED
88 LOCAL AUTHORITIES

FEBRUARY 2016

"Local authority actuarial valuation methods are from 'Gaga Land'."

Edmund Truell (LPFA) 2014[1]

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This report is based upon the best efforts of the publisher and the named authors to provide a fair and unbiased description based upon the public information available to them. Every effort has been made to ensure that the analysis and assumptions used are consistent and representative across all pension schemes included in the report. However, the accuracy of our estimates and calculations cannot be guaranteed. Furthermore, while every care has been taken in the preparation of this publication, it may contain errors for which the publisher and authors cannot be held responsible.

It is important to note that we have not discussed our assumptions and valuation estimates with any of the LGPS listed in this report and would welcome the opportunity to discuss individual observations in order to adjust our conclusions if appropiate.

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SUMMARY

This report sets out a methodology for comparing LGPS on a council-by-council basis using public data and transparent calculations.

The use of a standard approach allows stakeholders, including taxpayers, to identify schemes that are being transparent and prudent in their approach to valuation.

With the 2016 valuations due in March, setting out a transparent methodology allows all stakeholders to make a considered judgement about the assumptions used in the upcoming valuations and whether they are prudent.

In tandem with upcoming valuations, the forthcoming pooling of LGPS needs clear and comparable data to ensure that potential mergers are going to be effective and deliver value for the taxpayer.

Overall, we find that the aggregate deficit for LGPS does not change materially if the long-run equity risk premium is set at 3% across the board. However, if our analysis is representative for individual schemes, we find that the funding levels of a number of authorities could change, and in some cases significantly.

The Recommendations are:

1. LGPS valuations should be made comparable and shown for a range of similar performance assumptions so that stakeholders can assess the funding risk for different scenarios including the ‘risk-free funding level’ if all assets were to be invested in Gilts.
2. A transparent portfolio-based valuation approach should be used where the discount rate is a function of the riskiness of the portfolio.
3. Excess performance assumptions over and above standard long-run risk-reward trade-offs should not be allowed. There is no free lunch in financial markets over the long time horizons used in actuarial calculations.
4. A government actuary should decide what performance assumption criteria should be used for all LGPS and how to estimate this for each asset class. We suggest that the values for excess expected return on equities over Gilts be based on 0%, 1%, 2%, and 3%.
5. That the £ and % impact of recovery period extensions should be specified in the valuation report so that stakeholders can evaluate the extent to which each council has sought to improve the funding position of the scheme from these kind of paper gains.

CONTENTS

Introduction

In this report, CLERUS, in collaboration with Dr Iain Clacher from Leeds University Business School, makes the first attempt to analyse what would happen to individual LGPS valuations if performance assumption and calculations were carried out by a single credible government actuary.

A government actuary would be expected to value liabilities and calculate funding levels and deficits using a pre-specified range of consistent and uniform investment assumptions across all schemes. Such an approach would circumvent much of the opacity around the current myriad of approaches, thereby, providing taxpayers with the clarity necessary to assess the risk that these funds represent to local communities who may see their services reduced to fund future shortfalls.

In ‘Opportunity Knocks’, the Centre for Policy Study (CPS) suggested that a uniform range of discount rates should be used across schemes when determining liabilities.[2] We agree on the objective. However, we argue that this method would not provide comparable valuations, since the asset allocation across schemes are not the same. The discount rate for a LGPS with 40% allocation to equities should not be the same as a scheme with a 90% allocation to equities as the expected return for the latter is higher.

As an improvement to the CPS proposal, we argue that in order for LGPS valuations to be comparable, the discount rate must reflect the asset allocation of each individual scheme. The expected excess return over Gilts must come from somewhere and this is through exposure to equities or other riskier asset classes held within individual LPGS portfolios. It is our proposition, therefore, that it is the Equity Risk Premium (ERP) which should be the same, and shown for a range of outcomes (See Table 1 and Appendices 2-4).

Such a portfolio-based approach to valuations is aligned with current regulation and enables us to compute realistic discount rates for each scheme based on the riskiness (equity beta) of their portfolios. This achieves two things; first we can compare all schemes on a consistent basis, allowing us to make a value-for-money assessment for taxpayers; and second, we can assess the investment strategy of an individual fund and the risks being run, as well as the possible shortfalls that may occur.