Scheme Advisory Board

Scheme Advisory Board (SAB) Statement on Surpluses

Key points:

- Funding levels across the scheme increased at the 2022 valuation and subsequent market movements have led to some funds experiencing further improvements
- Local Government Pension Scheme (LGPS) regulations emphasise the desirability of stability in primary contributions for employers
- Funds should carefully consider their approach to employer-specific investment and funding strategies and take professional advice as needed
- Clear communication with employers about the impact (or lack of impact) of funding improvements is key – as well as the potential longevity of those improvements
- Funds should have a clear rationale and be able to explain their approach to setting secondary contributions and how employers' covenant positions have been recognised
- Employer flexibilities regulations, statutory guidance and the Board's guide are clear on the circumstances in which mid-cycle reviews of employer contributions are appropriate

As highlighted in the 2022 Scheme Valuation Report, the average funding level of LGPS funds in England and Wales has improved from 98% in 2019 to 107% at 2022 (on local funding bases), with all funds reporting an improvement in their position since 2019. For funds who link their discount rate to gilt yields, more recent market movements are likely to have further increased funding levels for many funds, despite overall asset values being relatively stable. However, with scheme membership continuing to mature, the cash flow position for some funds is becoming as important to manage as their overall funding level.

While being in surplus is clearly a very welcome position for LGPS members and employers, it does raise some novel issues for funds. In line with its statutory function to provide advice on the effective administration and management of the Scheme, the Board has agreed to make this statement.

The Board is already on record emphasising the importance of stability in employer contribution rates but recognises the extremely challenging financial position within local government and for scheme employers generally. Stability of employer contributions helps employers with financial planning and breeds confidence in the sustainability of the scheme.

The Board is aware that there is increased appetite from some employers and their advisers to try to influence funds' investment and funding strategies. Increased employer engagement is welcome, and many funds have been trying to increase this for some time, but expectations may need to be managed. In particular, tailoring of strategies does require additional resource, governance, support from advisers and consistency with the regulations.

Funds should consider how the costs of tailored approaches might be met and how they fit with their overall risk management approach. They are more likely to be appropriate where there is a critical mass of employers targeting a particular strategy (e.g. admitted bodies looking to de-risk a path to exit the fund). Funds will need to consider their own circumstances, those of their employers and their members – and be ready to provide a clear justification for their approach.

Some employers have also proposed "partial termination" (whereby an employer exits the fund for deferred and pensioner members but remains a participating employer for active members). The objective is to lock in current liability values for deferred and pensioner members, but also means that there is no recourse to that employer if those estimates prove too low in future. If that happens, the extra costs become the responsibility of all employers in the fund. Funds should satisfy themselves that such an approach is consistent with the regulations and will need to consider the best way to help an employer manage risk, as well as whether it is consistent with the interests of other employers in the scheme.

Investment and funding strategies are set in line with the LGPS Investment Regulations 2016 and associated guidance. The Board is currently working with the Chartered Institute of Public Finance and Accountancy (CIPFA) to refresh the existing (2016) funding strategy statement guidance. We have already identified that more guidance is needed around risk management, exit credit policy and how to conduct effective consultation with fund employers.

Smoothing of contributions, where fluctuations are caused by market movements, can work both ways – reflecting a fund's deficit or surplus position. The LGPS regulations allow funds to set negative secondary contribution rates where there is a surplus, which can help deliver contribution stability. As secondary contributions are set for employers specifically (not at fund level), funds' funding strategy statements should set out and explain their approach. Funds should also be willing to explain and share their rationale on how their general approach applies to particular employers or cohorts of employers. Parity of treatment is important and means treating like cases alike. That does not necessarily mean treating all employers the same, as different employers have different covenant values and differing circumstances.

Regulation 64A of the LGPS Regulations permits administering authorities to review an employer's contribution rate where there has been a significant change to the liabilities or covenant value of that employer. Examples of appropriate trigger points for such a review should be set out in the fund's funding strategy statement. As advised previously, the Board considers that funds may review the contributions of an employer where there has been a significant change to the liabilities of that employer, for example, if there has been a bulk transfer in, or out. An example of a significant change in covenant would include a material change in an employer's immediate financial strength (evidence should be available to justify such a view).

Generally, local authorities and other tax-backed employers are not subject to change in covenant. They have a statutory obligation to pay employer contributions to the fund in which they participate. Even in the event of a s114 notice being issued, authorities must honour existing contracts and meet statutory duties, including paying employer contributions.

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Changes in funding values due to market movements are not of themselves sufficient to trigger a review and are best managed through the triennial valuation process.

Administering authorities wishing to review their own employer contribution will need to consider very carefully how they manage the conflict of interest between their role as an employer in the scheme and as an administering authority.

Given differing levels of expertise and resources amongst the 18,000+ LGPS employers, funds may find it helpful to have specific communications to explain to employers particularly why their accounting surplus looks different from their funding surplus, and why neither are necessarily ‘realisable’ (even if employer exit is permitted). It may also be advisable for funds to consider how they would respond to enquiries from scheme members about the issues covered in this statement.

In the rare cases where it is proposed to set a negative secondary contribution at a level that puts the overall employer contribution in line with, or below, average employee contributions (generally around 6.5%), funds should consider how best to present this and may wish to seek views from employee representative members on their Local Pension Board, before moving to do so.

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