HYMANS ROBERTSON

LGPS- A success story

The LGPS continues to evolve and adapt to the ever changing pensions environment, including the increased scrutiny it is under to ensure its sustainability and affordability.

However, unlike the unfunded public service pension schemes it often receives unfair criticism and negative press coverage from ill-informed commentators. This is because the LGPS is funded, holding assets to meet benefits accrued, but not quite enough as yet. There are of course no assets at all held to pay benefits for the unfunded schemes so there is no tangible deficit – something that appears difficult to comprehend.

We have carried out analysis which evidences why the LGPS is a success story due to the hard work and innovation of administering authorities, officers and its advisors and why although there remains many challenges ahead, the LGPS is now better placed to deal with these than it has been for many years.

Who CARES?

The LGPS is largely made up of part time employees. In fact, 70% of the active membership is part time and 60% are part time females. So, commentators that attack the LGPS are targeting the pension provision of females on low incomes – probably not a headline politicians would want to be associated with.

Given this demographic the move to a career average revalued earning scheme (CAREs) is appropriate. This is a much fairer, consistent scheme design for the LGPS membership where benefits earned correspond directly to the contributions paid by employees and employers.

The increased accrual rate and inflation-linked revaluation rate implemented at the same time favours members closer to retirement, and during this period of very low salary increases for public sector workers has resulted in extra accrual of benefit and cost for the LGPS. However, this has been offset by the lower than expected salary revaluation on the remaining final salary benefit - one of the reasons for the improved funding position of the LGPS at the 2016 valuation.

Over the long term , the expectation is that employees will receive real salary increases and so both the CARE design and inflation-linked revaluation should help the LGPS to be sustainable and affordable. The increase in normal retirement age and the cost control mechanism will also help – not so much the largely ignored 50/50 option!

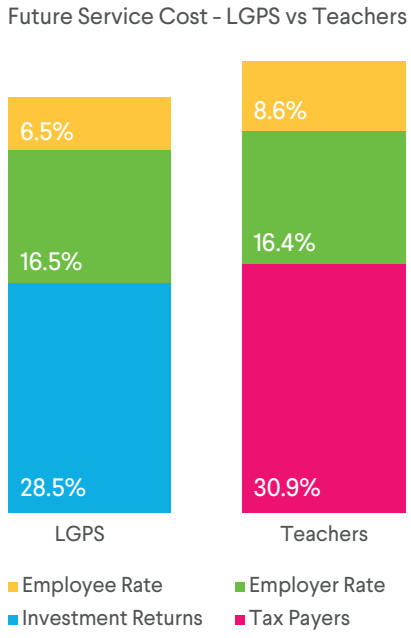


Costs of public service pension provision

The demographic of the LGPS makes it worth thinking about what the LGPS costs in pounds and pence, rather than a percentage of pay. Although many employers are paying in a significant percentage of payroll, which is materially higher than the unfunded schemes, when we analyse this in more detail the results are interesting!

Scheme	Total Membership	Total Pension	Average pension at retirement
LGPS	1.5m	£9.0bn	£6000 p.a.
Civil Service	0.64m	£5.5bn	£8500 p.a.
NHS	0.8m	£6.9bn	£8500 p.a.
TPS	0.67m	£8.7bn	£13000 p.a.

The table above shows the average pension in payment for public service schemes. It doesn't take a rocket scientist (or even an actuary) to work out that paying the average Teacher's pension of £13,000 p.a. costs more than twice as much as the average LGPS pension of £6,000 per annum. The cost of these schemes, ignoring investment returns, is north of 50% of pay, as shown in the chart below. Employer contributions for the cost of future benefits in the TPS and the LGPS are around 16.4% of pay if we adopt similar assumptions. The only way the LGPS can be sustainable is by generating strong investment returns to pay for the future accrual of benefits. The chart below shows that investment returns have typically paid for more than half of the cost. And how can the teacher's pension scheme afford it? Ultimately, the tax-payer has to foot the bill!



The benefit of funding

There are two principle elements to funding a pension scheme (once the scheme design has been determined) – the investment returns achieved on the assets and the contributions paid in. Our analysis shows that around 60% of the cost of the LGPS has been met by investment returns, with the remainder coming from employer and employee contributions.

Over the long term, the average LGPS fund return has been around 7% p.a. as shown in the chart below in the WM Local Authority column, based on data collected and analysed by State Street. The average LGPS fund has therefore outstripped both the Treasury target of CPI plus 3% and UK economic growth over the last 20 years. As we can see the average LGPS investment return has outstripped both CPI plus 3% and UK economic growth. If we consider the unfunded public service pension schemes to be "funded" by the growth in the UK economy then we can see why there would be a significant notional deficit for these schemes and why the funded approach that the LGPS adopts has been such a success.

	WM LA	CPI +3%	UK GDP
1 year	17.1	4.2	1.8
3 years	9.6	3.8	2.4
5 years	10.7	4.4	2.1
10 years	6.5	5.3	1.1
20 years	7.1	5.0	2.0

Value for money

There have been many discussions in the public forum about the investment fees paid by LGPS funds to access these investment returns. In fact, research carried out suggests that the LGPS are paying fees that are consistent or even lower than private sector pension schemes of a similar size and pooling will provide the scope to reduce fees further – a worthy objective. Further analysis shows that the LGPS provides excellent benefits for members at a cost that is very good value for money. If the LGPS funds had paid the same contributions to a DC private sector scheme and achieved the same investment returns, the pension available for a member from an annuity provider would be materially lower than the LGPS pension accrued as shown in the table below. The LGPS is delivering pensions to its membership at much better value than the private sector.

Term	Contributions	Investment returns	DC pension	LGPS pension
5	23.5%	10.6%	£1200 p.a.	£1900 p.a.
10	23.1%	7.0%	£2500 p.a.	£4000 p.a.
20	19.7%	7.3%	£6900 p.a.	£10600 p.a.

Onwards and upwards

The LGPS is in a strong position. Based on the published funding levels of the 2016 valuations, the LGPS as a whole was 85% funded against funds' own targets and on the HMT treasury basis was in fact 96% funded. This means that, even if the LGPS collected no further contributions, with reasonable investment returns on the assets already invested, the vast majority of pension earned up to the 2016 valuations could be paid with no future reliance on the tax-payer. In fact, the LGPS is now holding more assets per pound of pension to be paid than possibly ever before. The return required to meet the future pension payments is lower than it has ever been and due to having much more data and analysis the life expectancy of the membership is now captured in funding targets appropriately.

There are challenges ahead, not least in generating long term consistent strong investment returns – the Holy Grail for sustainability and affordability for the LGPS. However, now that the LGPS is in this strong position it is important that we build on and protect this position, possibly looking to lock in some of the gains that have been made over the last 10 years.

Some funds may be in a position to de-risk. Considering rebalancing the portfolio would be an organic way to do this. Some funds will want to consider more significant changes to investment strategy. However, the question is whether de-risking is appropriate for all employers in the fund. Although the overall position has improved materially there will be some large employers whose funding position does not afford them the opportunity to de-risk. In short, a one size investment strategy does not fit all any longer and it is important to consider investment, funding and contribution strategy in a joined up way. The impact of changing investment strategy for the whole fund may have a detrimental effect on contribution strategy for some of those less well funded employers in the fund and Administering Authorities and Pension Committees need to bear this in mind.

We will be looking at this in more detail in a forthcoming Briefing Note.



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