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Dealing with the reality of deficits

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Deficits are only part of the agenda

Affordability: are benefits right in the wider context?

Market conditions: how relevant will they be in 2016?

Cash contributions: how will new amounts be set from 2017?

Investments: the balance between ambition and risk?

Covenant: ability of different employers to keep on paying?

Deficits: wider questions

Is the LGPS sustainable for the next 25 years? Benefits too high or too low?

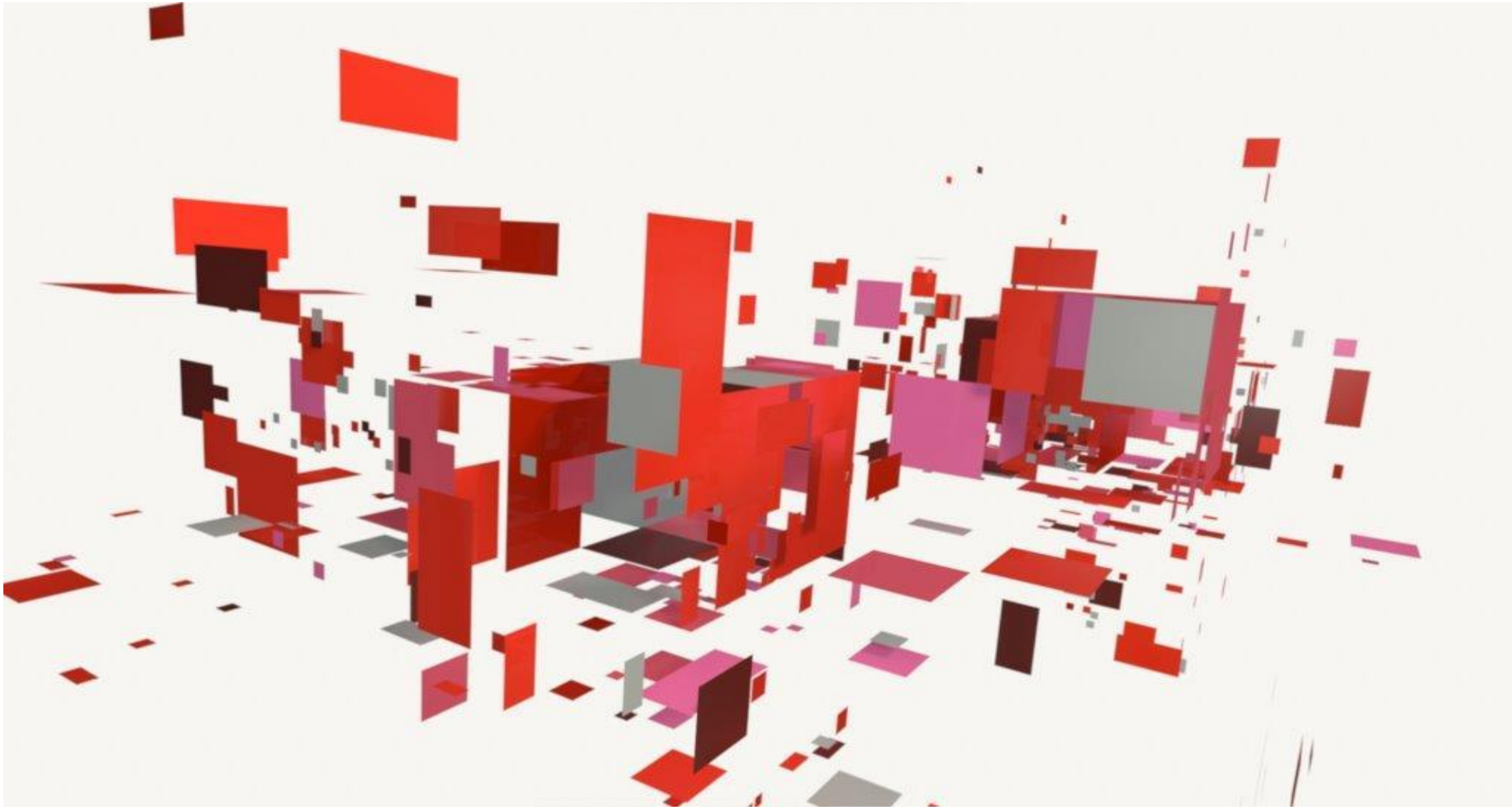
What is are private sector and central government perspectives?

Are recovery plans comprehensive, realistic and affordable?

What impact do deficits have on investment strategy? and vice versa?

How much stress can you put on having taxpayer support?

89 Funds – or one LGPS?



Affordability

Current private sector

- Just 1.5 million workers still earning DB (Defined Benefit pension schemes) benefits.
- Most schemes long ago closed to new members. Closure now means “no more DB accrual”.
- Moving to auto-enrolment, often starting from low contribution rates. But high take up of DC.
- DB pensions are priced from markets.

Current LGPS

- Almost 5 million workers in public sector DB schemes.
- The 2014 CARE benefit structure saved money, with CPI not RPI.
- But the 2016 National Insurance hike will negate savings.
- 50:50 was to be a shared saving. But 1% take up. If in, fully in.
- Pensions are priced as affordable in the public sector. Cashflows seen as percentages of GDP?

Future LGPS

- 2016 move to Single Tier Pension will increase “income replacement ratios” for many workers.
- Is 25 years until next review credible? Can 50:50 help more?
- Outsourcing services – impact?
- Central cost cap mechanism set to work - but it’s not rapid relief.
- Should LGPS pensions be priced the same for all employers?

Premium pricing … … … or … … … a fair deal for workers?

Deficits

Current private sector

- Once, actuaries were optimists!
- But the private sector philosophy is now about risk mitigation.
- Drivers: accounting, regulation, longevity and low interest rates.
- So price of gilts, a "risk free asset", drives the analysis. And gilts have been affected by quantitative easing.
- As schemes move towards closure, more risk comes off the table.

Future LGPS

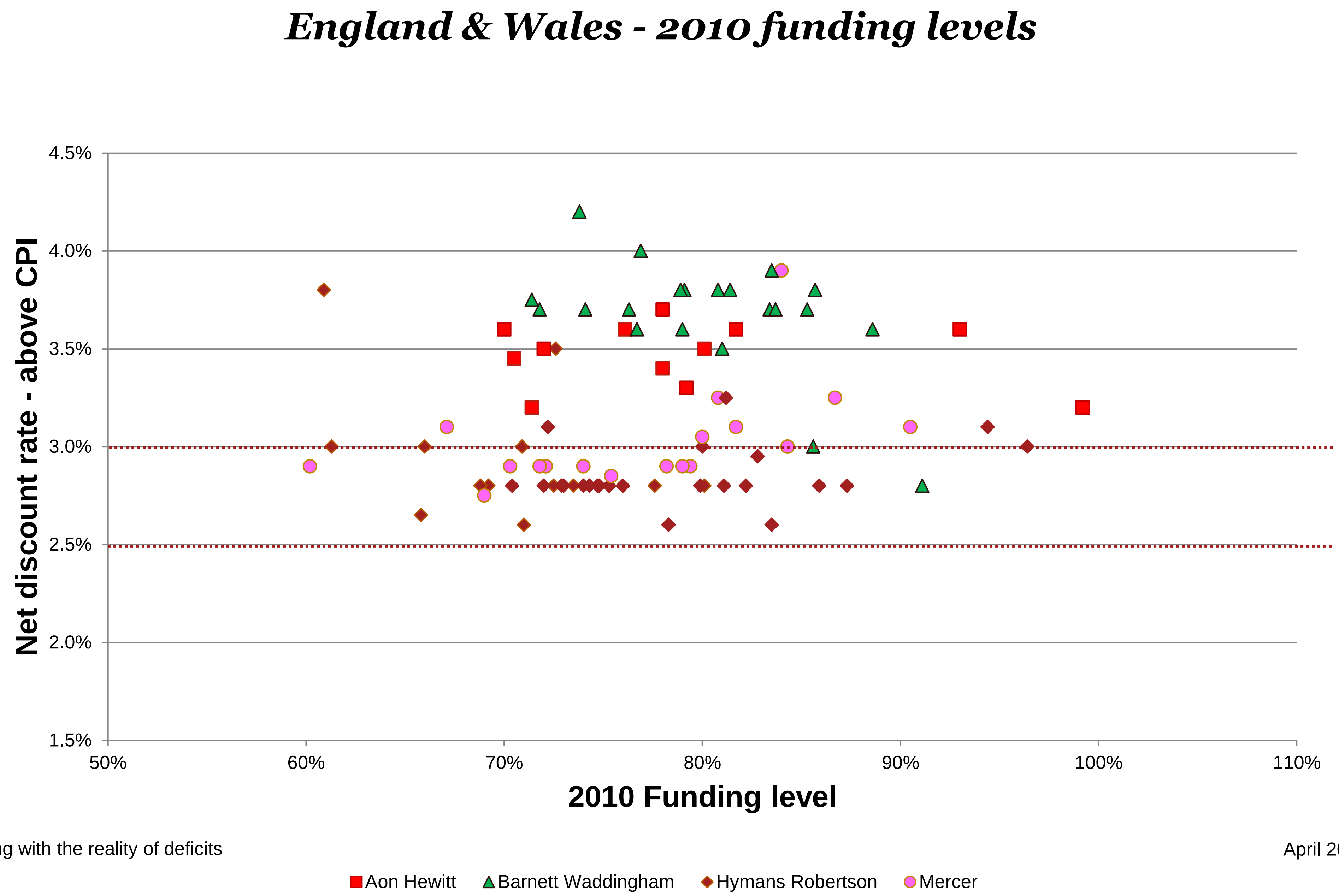
- Will the four actuarial firms move towards consensus in 2016?
- How will tough market conditions affect 2016 outturns?
- An unfunded scheme philosophy would aim to beat CPI inflation by a 3% margin each year.
- Which is "Discount rate = CPI +3%" Or "Net discount rate = 3%"
- Should it be one rate for all?

Current LGPS

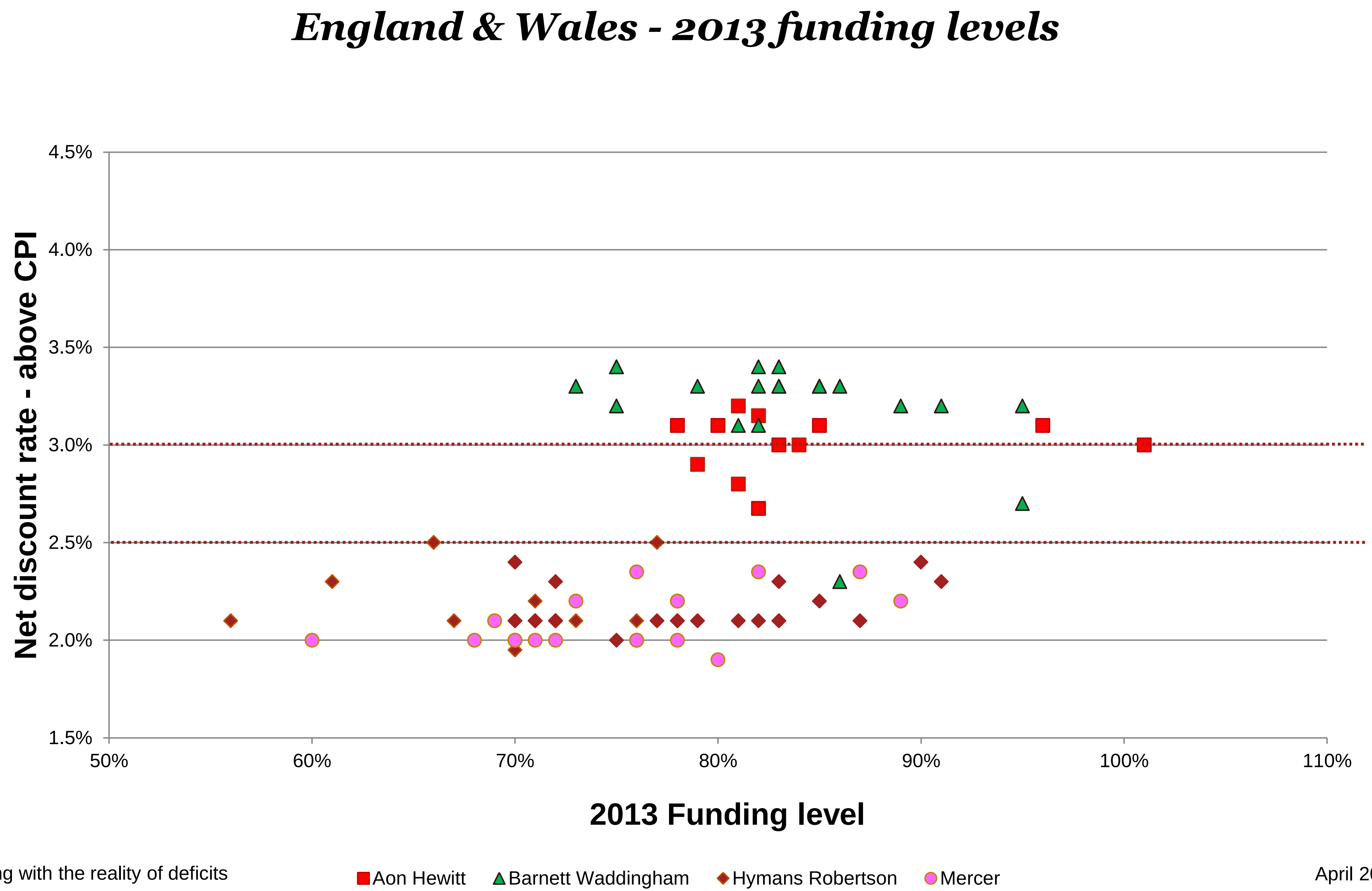
- Total of 2013 deficits in England and Wales was £47 billion.
- The 89 Funds had funding levels between 56% and 101%.
- 90% + of deficit relates to Councils, but others participate.
- Assumptions: different actuaries have different philosophies.
- Funding keeps the LGPS honest. We hold assets ! We call a deficit a deficit !

Mark to market madness … … … or … … … overpromising?

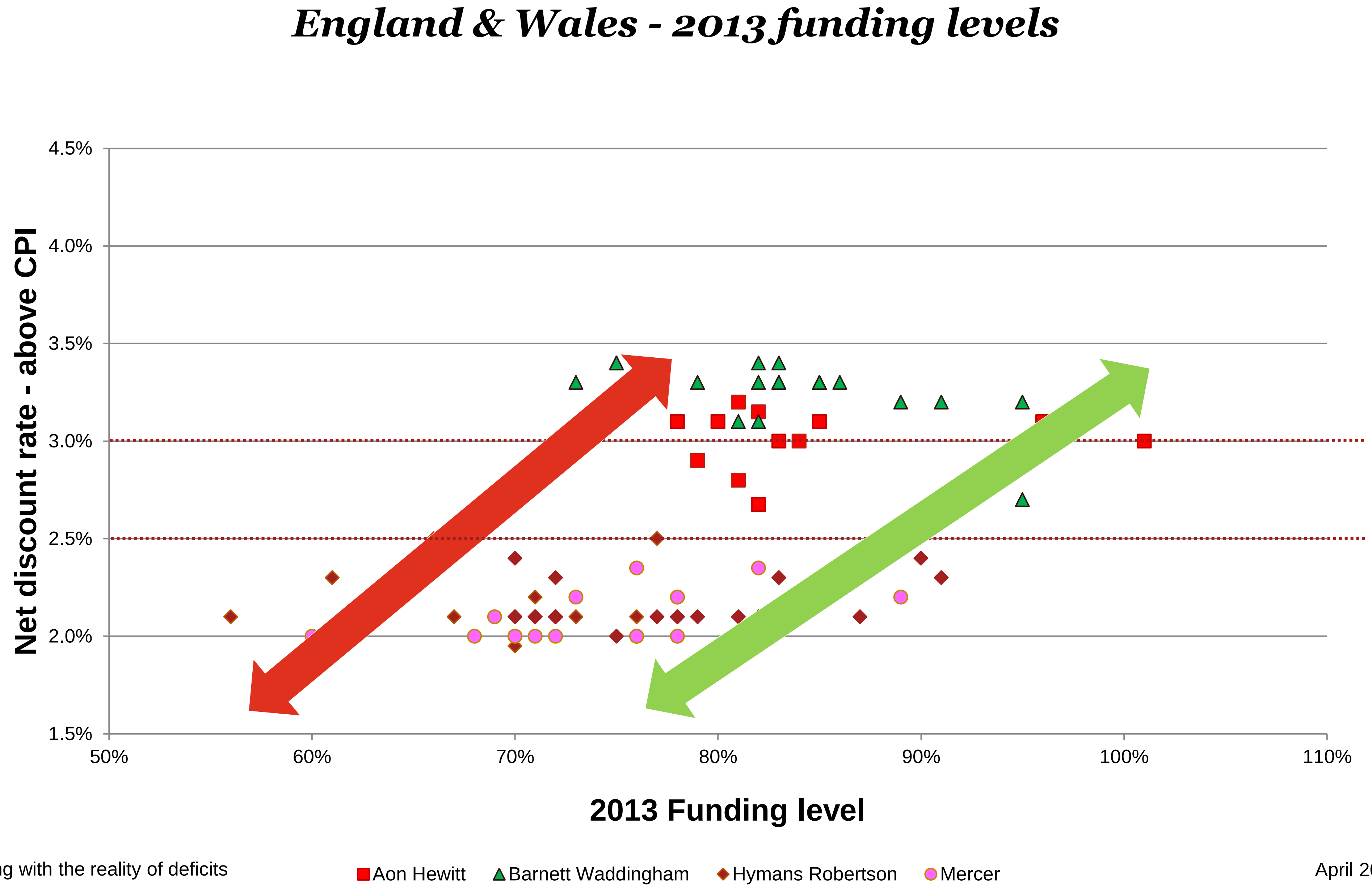
Deficits in 2010, back in the day …. better market conditions



Deficits in 2013, in less favourable market conditions



Deficits in 2013 – sensitivity analyses



Cash contributions: affordable?

Current private sector

- Money is freeing up from the rest of the workforce? Many DC contribution rates are low.
- Which enables deficits in DB schemes to be paid down.
- Despite those strong actuarial assumptions to measure deficits, and the journeys to exit.
- 10 year recovery periods typical
- The Pensions Regulator is required to consider affordability.

Current LGPS

- Different actuarial house styles, so sometimes a challenge to obtain a consistent picture.
- Actuaries with two conflicting objectives:
  - maintain solvency
  - contribution stability
- Contributions had low correlation to “standardised deficits”.
- 20 year recovery periods common.

Future LGPS

- Growing awareness of individual Council needs to negotiate their contributions.
- Deficit payments a higher proportion of pay and of budgets.
- Stability objective should help.
- Be prepared to understand the situation …
- … and make the case early.

Cash is king? **Tight budgets**

Investment

Current private sector

- Decades ago, an asset led approach was common. The equity was king.
- Allocations to growth assets now lower - typically 30% to 60%.
- Risk reduction programmes now common, reflecting employer and trustee requirements.
- Liability Driven Investment (LDI) one example of this.

Current LGPS

- Growth assets are still king! Equities and infrastructure.
- Allocations to growth assets remain high: typically 60% to 80%.
- LGPS Funds are open to accrual and able to seek real returns.
- No evidence that LGPS Funds with low funding levels are taking extra risks.

Future LGPS

- The efficiencies consultation may change investment mechanics within asset classes …
- … but allocation between asset classes is the driver of success.
- Increasing interest in infrastructure and housing.
- LDI: which metric to stabilise?
- Opportunities to tailor investment strategies?

Tune in. Debates on risk, collective investment and infrastructure.

Covenant

Current private sector

- Trustees are totally distinct from employers. Conflicts of interest are managed.
- Covenant is the first leg of "Integrated Risk Management", then funding and investment.
- Good covenant allows lower contributions.
- Trustees will ask "what's new" when there's a deal or transaction.

Current LGPS

- Mix of public and private sector employers. Some employers are higher risk.
- Employers liable for each other's liabilities: last man standing schemes.
- Range of approaches between Funds to assess, monitor guarantee and indemnify.
- Most Funds measure deficit without reference to covenant.

Future LGPS

- Increasing recognition of the value of covenant monitoring.
- Are covenant issues more for the "other employers?"
- So can Councils push back against higher discount rates in 2016?
- And / or argue for longer recovery plans?

Councils should present evidence that their covenant is high quality

Next steps?

Obtain early understanding of likely 2016 deficit and 2017 contributions.

Collaborate with other Councils, especially in the same Fund.

Be prepared for actuarial house styles.

Tune into the investment debate.

Consider infrastructure and other local opportunities.

Communicate strength of taxpayer support, even in tough times.

Questions