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Housing briefing, August 2023
LGPS cessation consternation!

LGPS (Local Government Pension Scheme) funding positions are in great shape. As reported by the LGPS Scheme Advisory Board, as at 31 March 2019 the average LGPS funding position was **98%.** Fast forward three years to 31 March 2022, and funding has further improved with around **two-thirds of LGPS funds now in surplus.**

Funding positions aren't the only good news story. Cessation positions – which determine the cost of walking away from the LGPS for good – have been improving too. But recently, due to sharply rising gilt yields, we've been seeing a paradigm shift in the ground rules for exiting some LGPS funds.

This briefing explores what is happening with cessation valuations, why employers in the LGPS might reasonably be concerned, and what you can do about it.

What is a cessation valuation?

Where an employer participates in the LGPS, a cessation valuation is typically undertaken when the last active member of that employer stops earning benefits in the scheme. This may be due to job changes, retirements, or an employer deciding to close the LGPS for all remaining active members.

In this briefing, we won't consider options for employers to postpone settling their cessation position, e.g. through deferred debt agreements. Instead, we'll focus on situations where cessation represents a 'clean break' for both the employer and LGPS fund, via a final payment of a cessation debt by the employer, or potentially by a refund of surplus to the employer, known as an 'exit credit'.

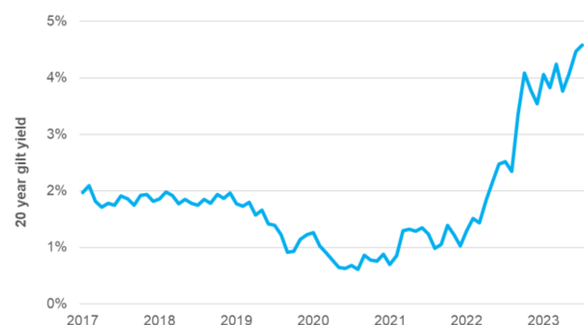
The ground rules for cessation valuations are set out in an LGPS fund's Funding Strategy Statement. Fund officers, usually with guidance from the Fund Actuary, can decide which cessation valuation approach is used in their local LGPS. Fund officers have a duty to ensure all promised pension benefits are eventually paid and also to balance the interests of all fund employers.

Following cessation, the fund has no further recourse to the exiting employer, so it's the 'last chance' for an LGPS fund to receive an employer payment.

How are cessation valuations undertaken?

As a final opportunity to receive payment, common historical practice across LGPS funds has been to adopt a 'least-risk' cessation basis, where the discount rate used to value liabilities is linked to long-dated gilt yields. Until recently, this has generally led to terrifyingly high cessation debts, the risk of which may have kept some employers awake at night.

Long-dated gilt yields over a significant part of the last six years have been less than 2%, as shown in the following chart.



This illustrates how long-dated gilt yields have risen from around 1% to 4.6% between December 2021 and June 2023 – a material rise over a relatively short period. The effect on gilt-based cessation calculations is considered in more detail below.

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How might cessation valuations have improved?

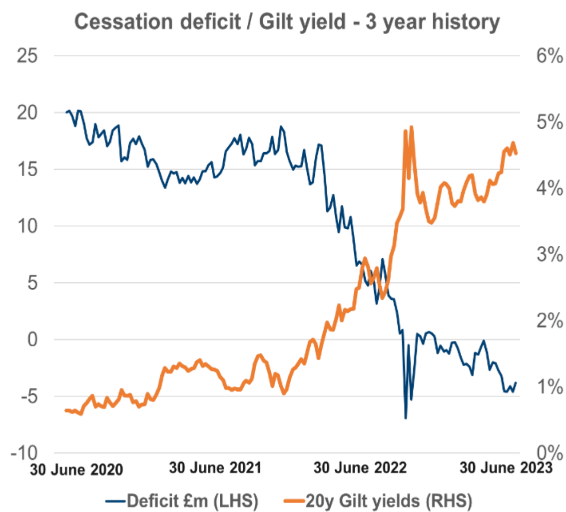
To illustrate the resulting improvement under a gilt-based cessation approach, we've used an assumed LGPS asset mix.

Asset type	Assumed allocation	Assumed representative asset index
Higher risk	80%	MSCI World Equity Index
Lower risk	20%	FTSE > 15 year total return

Let's compare the position three years ago (30 June 2020) to around now (30 June 2023). As at 30 June 2020, 20-year gilt yields were 0.64%. Equities – which represent a significant allocation within a typical LGPS fund – were only just recovering from their March 2020 Covid-19 low ebb.

Let's assume that a hypothetical employer in the above hypothetical LGPS fund has £20m of LGPS assets and was 50% funded on cessation at 30 June 2020.

The following chart shows how financial conditions and the cessation position of this hypothetical employer changed over the previous three years, using a least-risk 'gilts' basis to value the cessation position.



We've made several simplifying assumptions in the above chart, such as new benefits (contributions in and liability accrual) offsetting benefit outgo. Some other key assumptions are shown in the next table, which shows the dramatic change in the employer's cessation funding fortunes.

Cessation valuation	30 June 2020	30 June 2023	Comment
Assets	**£20m**	**£26m**	+20% asset return over period with £2m assumed deficit contributions paid
Liabilities	**(£40m)**	**(£22m)**	Liabilities lower due to higher real gilt yields (adjusted for recent high inflation impact)
(Debt)	**(£20m)**	**£4m**	Cessation debt has now switched to surplus
Funding position	**50%**	**118%**	

Our analysis, while based on a hypothetical scenario, shows how a significant cessation debt could have turned to a cessation surplus for a given employer over recent years, provided a gilt-based cessation debt calculation methodology was maintained.

This is great news… isn't it?

LGPS funds have been waking up to the improvement in cessation positions and no doubt asking themselves (and their Fund Actuary), whether a gilt-based cessation method remains appropriate.

LGPS funds are long-term investors and do not typically hedge the effect of interest rate changes and their inflation risk. In these circumstances (i.e. where the fund has decided not to offer employers the option to hedge), a concern with gilt-based cessation methods might be the future mismatch. In other words, if the cessation position was calculated on gilt yields today (4.6% pa, say), but then next year these rates fall back again, the LGPS fund will have let an employer exit on favourable terms.

This was unlikely to have been a practical concern in the world of sub-1% pa gilt yields. But in light of higher interest rates and gilt yields, we've observed a recent divergence in cessation methods across different LGPS funds. While some LGPS funds have maintained a gilt-based approach (at least for now), we've seen others adopt a completely different *stochastic approach*. This approach assesses the probability of being fully funded in the future by modelling lots of future economic scenarios and counting up the number of scenarios where the employer's asset share is sufficient to pay all its LGPS benefits in future.

Where the modelled success rate is lower than a threshold probability chosen by the LGPS (typically high, e.g. 90%), a cessation debt needs to be paid on exit by the employer.

Where LGPS funds have adopted a stochastic approach to cessation calculations, in all cases we've seen to date, this results in a *materially worse cessation position* than scenarios where a gilt-based method was maintained.

What are our views on the stochastic method?

We recognise LGPS funds have a duty to protect the security of benefits and employers remaining in the fund. We support this.

Assessing the probability of a departing employer leaving enough assets on cessation to pay its share of LGPS benefits in future feels entirely reasonable to us in principle. Therefore, we support the use of a stochastic method where an LGPS fund chooses to use it.

We have **significant concerns**, however, about its implementation. We've seen the stochastic modelling typically applied to an LGPS fund's current asset mix, which includes a significant allocation to long-term, growth-seeking assets (as used in our hypothetical case study). Modelling a high probability (such as 90%) of future success while invested in assets with inherent volatility can result in unusual outcomes.

In our view, the unfairness of this approach is clearly shown in the discount rates we've seen used in cessation valuations that use stochastic approaches. We've seen examples of discount rates equal to **long-dated gilt yields minus 2% pa** as the required discount rate to achieve the probability of success threshold set by the LGPS fund.

While we support the philosophy of stochastic modelling, we would argue that the outcome illustrated above makes the approach worthy of challenge. It's unreasonable to ask employers – who have seen massive improvements in cessation positions on a least-risk gilts basis – to fund cessation debts calculated using discount rates materially lower (e.g. 2% pa lower!) than a risk-free gilt-based discount rate.

While such approaches persist, in our view, employers are effectively being locked into the LGPS through no fault of their own. This is because the only way to exit is to pay an extortionate exit cost, often running into millions, which is clearly unfair if the investment return available on essentially risk-free assets clearly exceeds the cessation discount rate.

What is the solution to this?

We believe there are several practical solutions available. Moving the asset share of a departing employer into long-dated index-linked gilts would allow a near gilt-based discount rate for cessation calculations to be used, mirroring the assets held. The underfunding risk for the remaining employers would be minimal, while allowing an employer to leave on fair terms closer to a least-risk gilts basis.

Indeed, we are aware of some LGPS funds that have already adopted this approach, with a higher-risk asset mix for open employers and a low-risk asset mix for departing employers.

Where a departing employer's asset share is moved to gilts, the stochastic modelling when applied to a 100% gilts asset mix would, in all likelihood, show a high probability of success.

What should we be doing and how can First Actuarial help us?

If you're affected by the issues described in this briefing, you'll need to engage with your LGPS fund. A range of calculation approaches to cessation are coming on stream. LGPS funds and actuaries are starting to understand their impacts on different stakeholders and should be willing to listen.

We can help you write to and engage with your local LGPS fund to explain, clearly and objectively, why new cessation methodologies aren't working as planned, and explain what could be done to achieve more balanced outcomes for all LGPS stakeholders.

Cessation practice is ultimately set by LGPS fund officers, guided by their Fund Actuary. We can't guarantee a change in approach, but we're optimistic that with improved understanding of employer concerns, cessation practice can and will evolve.

This will result in fairer outcomes for LGPS employers, while (of course) protecting the interests of the LGPS employers that remain – a genuine 'win win' for all concerned.

Contact us

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