LGPS Spotlight: Cost Management Process (England & Wales)

January 2019

There are two Cost Management processes for the LGPS – the HM Treasury (HMT) (as set out in the Public Service Pensions Act 2013) and the Scheme Advisory Board (SAB) processes. The SAB process in relation to the 2016 valuation of the LGPS shows that the cost based on assumptions set by the Government Actuary's Department (GAD) has declined and consequently benefit improvements / employee contribution reductions are anticipated. The SAB has set out some recommendations under the SAB process and these were sent to Administering Authorities on 21 December in advance of any consultation which will take place in late January / early February. These have also been documented on the SAB website as part of the 16 January 2019 meeting here.

Introduction

All public service schemes have a cost management process governed by the Public Service Pensions Act 2013 (PSPA). If the employer cost ceiling or floor is breached by more than a specified margin, (currently 2% of pay[1]) due to member-related experience, (financial experience and changes in financial assumptions are excluded) public service schemes **must** implement changes in benefits or member contributions to return the cost to the employer cost cap. Many public service schemes are seeing cost reductions in excess of 3% of pay overall, and we understand that HMT has indicated that the unfunded schemes should not reduce member contributions to bring the employer cost back down to the employer cost cap, so benefit improvements will be required.

The LGPS in England and Wales has a further cost management mechanism agreed by stakeholder representatives when the 2014 scheme design was agreed - the so-called SAB process. There are some key differences between the two processes but each aim to amend benefits or contributions if member-related experience leads to cost pressures or reductions. For the LGPS this is of course at scheme rather than local level.

Whilst the PSPA / HMT mechanism takes precedence, we believe HMT has agreed to honour the gentleman's agreement that the PSPA process will be run *after* any changes required by the SAB process have been agreed. Discussions on the SAB process are now quite advanced as evidenced by the 16 January 2019 meeting papers and, given results which have been announced to date in relation to the unfunded schemes, it is no surprise that some change to the LGPS in England & Wales will be required under the SAB process.

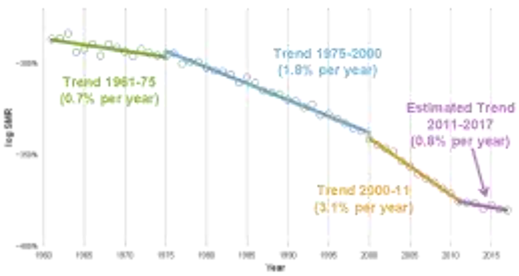
In this Spotlight we provide some comments on the SAB proposals and set out our understanding of some of the figures set out in SAB's document.

Why are the Cost Management processes showing a decrease in cost?

A major reason for the decline in the cost is the slowdown in mortality improvements (see graph of our analysis illustrating how mortality improvements have slowed for males aged 50-89).

The Cost Management processes for the LGPS do not take account of investment returns or any change in expected returns. The calculations in both processes are undertaken using financial assumptions adopted by GAD.

[1] The Public Service Pensions (Employer Cost Cap) Regulations 2014



Benefit Changes to meet a 0.5% shortfall

The SAB process shows that the total cost of the LGPS has reduced from 19.5% to 19.0% of pay. SAB's recommended changes, which are assessed to have a cost of 0.5% of pay under the assumptions used by GAD, are as follows:

Removal of the Tier 3 Ill health benefit

This has been costed by GAD on the basis that those who would have received this benefit will instead be granted benefits under Tier 2. Tier 3 ill health relates to members who are initially deemed to be capable of undertaking gainful employment in the next three years. The Tier 3 pension is payable for a maximum of three years with the position being reviewed after 18 months with a decision to discontinue the pension (and for the member to receive a deferred pension), continue for a further 18 months, or upgrade the pension to Tier 2. The number of Tier 3 ill health cases is currently relatively small and SAB has been reviewing the ill-health provisions for some time so this proposal is perhaps unsurprising.

Death in Service Lump Sum

It has been recommended that there should be a minimum lump sum of £75,000 payable on a member's death in service. The current rules set out that the benefit is 3 times pay, so this will benefit the beneficiaries of those earning less than £25,000. The average cost of providing the death in service lump sum is relatively low (around 0.3% of pay in total across the scheme) so we would not expect this to have a large cost but this will vary between employers. The devil will of course be in the detail and we are not sure how any new provisions will affect those with multiple jobs in the LGPS and casual workers, noting that different employers and different administering authorities appear to have different approaches to the treatment of casual workers. Perhaps the changes will be a catalyst to more consistency of approach?

Early Retirement Enhancement

An improvement in the early retirement factors for members on 1 April 2019 has been recommended but no detail has been provided, other than that the improvement will apply to Final Salary benefits as well as CARE benefits. This may encourage more members to retire earlier and we may need to reconsider our retirement assumptions for valuations once we have detail of the recommended factors.

Change to Annual Revaluation of CARE benefits

Whilst not a headline change, paragraph 19 of the document sent on behalf of SAB to Administering Authorities on 21 December[2] states that there is a proposal to change the revaluation of CARE benefits to be based on the balance of the account at the start of the year, instead of the balance at the end of the year. It is stated that this change is estimated to **reduce** the future cost of the scheme by 0.4% of payroll. Please note that this change is opposite to the other changes proposed which result in an increase in the cost of the scheme.

We understand that the proposed change in benefits would move the scheme back into line with the scheme that was originally costed under the SAB Cost management process. The revaluation that was allowed for in these processes was based on the pension accrued at the start of the year i.e. excluding pension accrued in the year. However, this was different to the actual benefits of the scheme. What was set out in Regulations (and we understand reflected in the HMT employer cost cap of 14.6% of pay) was to award revaluation based on the pension accrued at the end of the year including pension earned in

[2] If any administering authorities have not seen this, please let us/LGA know.

the year. This is best explained by way of an example.

Current method as set out in the Regulations

	£ per annum
CARE pension earned after revaluation at 1 April 2019	2,000
CARE pension earned in 2019/20	400
Revaluation (say 2%) applied to sum of the above (£2,400)	48
CARE pension at 1 April 2020	2,448

Proposed method

	£ per annum
CARE pension earned after revaluation at 1 April 2019	2,000
CARE pension earned in 2019/20	400
Revaluation (say 2%) applied to CARE pension at start of year (£2,000)	40
CARE pension at 1 April 2020	2,440

The document states that the proposal to change this benefit back to that originally costed will (in isolation) reduce the cost of the LGPS by 0.4% of pay. If confirmed, this would also mean that the operation of revaluation in the LGPS in England and Wales would be out of line with the other reformed public service schemes and we understand that confirmation is being sought that the proposals meet the PSPA requirements (specifically Section 8(4)(b), i.e. that benefits are "revalued each year".)

Reduction to Employee Contribution Rates

The SAB document states that in addition to the changes set out above to return the total cost of the scheme back to 19.5%, further changes to employee contributions were proposed to obtain the support of both employer and employee representatives of the Board.

The main recommended changes to employee rates are:

- 2.75% band for those earning less than £12,850 per annum to reflect lack of pension tax relief for those earning below the new personal allowance. Currently these members are paying 5.5% of pay.
- Band 2 rates to be reduced from 5.8% to 4.4% and expanded so would apply to those earning between £12,851 to £22,500.
- The top of the Band 4 rate (the 6.8% band) to be increased from £45,200 to £53,500, to reflect increases in the higher rate tax band.

If the employee contributions reduce, the employer contributions calculated at local funding valuations can be expected to increase by a corresponding amount as a result of this change. The cost to employers has been assessed by GAD as 0.8% of pay on average across the LGPS but clearly will be significantly higher for those employers with a high proportion of lower paid workers. For those employers where all employees earn less than £12,850 the cost as a result of this change will be 2.75% of pay.

Summary of Costs

A summary of the costs of the proposed changes for the LGPS as a whole set out in the SAB document, split between those relevant to the Cost Management (CM) process and those which will affect the actual contributions payable by employers, is set out on the next page.

It should be noted that based on these proposals the split of costs (as assessed for SAB Cost Management purposes) between employer and member will be 13.8% and 5.7% of pay respectively compared to the previous 13.0% and 6.5% of pay.

Change	Total Cost (for SAB CM purposes) % of pay	Employer Average Cost (actual) % of pay
Reval'n of CARE pension	CM costings already based on start year reval'n	-0.4%
Other Benefit Changes	+0.5%	+0.5%
Change in employee rates	Nil as does not affect total cost	+0.8%
Total	+0.5%	+0.9%

If all this happens, what's the actual impact on employer contribution rates?

The cost summary in the table above is just an average across the LGPS in England and Wales, based on GAD's assumptions. In practice the valuation assumptions for early retirement made by local fund actuaries, and between individual LGPS funds, may vary.

So, while an increase in employer rates of 0.9% may not be unreasonable as a "best current indication", we will only be able to provide further advice for our own funds and their employers once more detail is available, in particular, on the early retirement factor changes. We could, however, provide details of the impact of the change to employee contributions which is a large proportion of the total cost.

Whether or not 0.9% turns out to be a reliable indicator of the actual average increase for your fund, it is clear that there will be big variances at valuations for individual employers, depending on the profile of their membership, particularly given the employee contribution changes, It looks as though employers with a high proportion of lower-paid employees can be expect to be harder hit – with increases of 2 to 3% of pay (or even more) being possible in some situations.

Are there further changes ahead?

Possibly. Government consideration of the SAB proposals will need to be concluded, and the formal MHCLG consultation process on the changes is then required – expected to be later this month or next. It is not impossible that this will result in refinements to the proposals.

Just to make the outlook even more uncertain, the HMT Cost Management calculations for LGPS E&W will only be finalised after allowing for the outcome of the SAB process. If the HMT process were to show a cost reduction of more than 2% of pay, further changes to the benefits and/or employee contributions may be triggered. Administering Authorities are not in a position to provide employers with any certainty on this point but given HMT Directions under the PSPA requires changes to be effective on 1 April 2019 we would encourage you to raise the changes with employers sooner rather than later, although as ever you will need to take care in managing expectations.

In any event, we had already been strongly advising that Administering Authorities caution employers against budgeting for employer contribution reductions from 1 April 2020. Much may still change in the run-up to the 2019 valuation date and one thing that is clear is that the Cost Management changes will carry a net cost – and this will at least partly offset any downward cost pressures elsewhere, such as those that may arise from the slowing of life expectancy improvements.

In addition, whilst the cost management process is itself under review, thought should be given as to whether any positive effects of demographic experience since 2016 should be allowed for in employer contributions given that this could feed through into cost reductions in the next cost management cycle. There is therefore much for Fund Actuaries and administering authorities to discuss and consider!

When's this coming in and what are the administration implications?

We understand that the implementation date for any changes is 1 April 2019[3] and will not be changed. This is clearly extremely short notice for Administering Authorities, their software providers, and employers to implement these changes. Even if the new regulations are laid before 1 April 2019, there is likely to be a period where manual calculations are required while Administering Authorities wait for updates in their software packages. However, given the short timescales (and other Government priorities in the next few months) it is possible that the regulations could be laid after 1 April 2019 and backdated. If this scenario occurs this will leave Administering Authorities and employers with the headache of going back and reviewing cases. We understand that SAB is hoping that MHCLG may issue a letter of comfort in consideration of the forthcoming regulations, once any consultation has ended but Administering Authorities and employers will still need to consider the legal ramifications of paying benefits and deducting contributions that are not covered by regulations. Administering Authorities need to communicate the proposed contribution rate changes to their employers as soon as possible so they can liaise with their payroll providers. Administering Authorities themselves will need to liaise with their software providers and consider any warnings they should give members e.g. those going through the ill health retirement process or those considering early retirement. We will be supporting Administering Authorities we advise in communicating with their employers. If any other Administering Authorities would like our assistance, please do let us know.

Isn't this daft? Why are benefits being improved but costs to employers going up?

We can well understand that employers, in particular, will be asking these questions, and hard-pressed administration and payroll teams are unlikely to be welcoming change either! If it is any comfort for LGPS employers in England and Wales, the expected employer contribution impacts for the unfunded schemes such as NHS and Teachers are far bigger – a double whammy arising from the benefit improvements and a reduction in the discount rate being used for valuations of the unfunded schemes. The Cost Management processes could have resulted in changes in either direction, and with a "symmetrical" process with an agreed cap and floor, this sort of outcome was always a possibility. The processes were designed at a time when life expectancy improvements had been significant, and these improvements have slowed dramatically in a way that most experts had not expected.

The introduction of the Cost Management framework was an integral part of the reforms to the public service schemes, although Lord Hutton's IPSPC recommended a "cost ceiling" rather than a symmetrical process. We can see why Government was very keen to introduce a cost cap mechanism to limit the risks of ever-increasing DB scheme costs. But with all the attention and controversy that's arisen, and the announcement that the process itself is under review, don't be surprised to see a bit of "re-engineering" of the framework in place for the next Cost Management process in a few years' time!

And finally, at the LGPS Governance Conference in Bristol on 17th January all the actuarial firms were asked what changes they would make to the cost management process. We have two key suggestions: amend to an asymmetrical process as recommended by the IPSPC and remove the past service element of the calculation – this has the effect of materially magnifying the changes as a % of pay. Martin Clarke, the Government Actuary was in the audience although whether GAD will take account of our or others' views remains to be seen! If any Administering Authorities feel strongly about the process and how it should operate in future, we would be delighted to support you in making representations to SAB or direct to GAD/MHCLG.

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[3] PSPA and The Public Service Pensions (Valuations and Employer Cost Cap) Directions 2014

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