

AGENDA ITEM 5

COST MANAGEMENT, BENEFIT DESIGN AND ADMINISTRATION COMMITTEE – 1 NOVEMBER 2016

SCHEME ADVISORY BOARD COST MANAGEMENT PROCESS

- 1.0 Background
- 1.1 At its meeting held on 12 February 2016, the Cost Management and Contributions Sub-Committee discussed, in general terms, the process and timetable regarding the Scheme Advisory Board's cost management process that is due to commence later this year.
- 1.2 The note that follows sets out the background, process and timetable in more detail and, in particular, outlines various questions that the Scheme Advisory Board (SAB) will need to consider and decide regarding methodology and assumptions.
- 1.3 Particular attention is drawn to section 3 of the note which sets out the costs that will fall to be managed under the cost management process and to section 1.6 that lists a number of current known costs. Section 5 of the note then sets out the potential implications for benefit design if the Scheme Advisory Board is required to bring the scheme cost back to the target cost set out at section 1.1 below.
- 1.4 Observers from the Government Actuary Department will be available to respond to any questions from Members.

Contents

1	Executive Summary	13
2	Introduction	16
3	Costs to be managed	17
4	Assumptions for the FSC Process	20
5	Current Known Costs	24
	Appendix A: Legislation	27
	Appendix B: Timeline	29
	Appendix C: Calculation approach	31

1 Executive Summary

The Future Service Cost process is owned by the Scheme Advisory Board

- 1.1 The initial employer FSC was set at 13.0% of pensionable pay (19.5% inclusive of the expected member contribution yield). The SAB cost management process (FSC process) considers the potential for recommendations of action, should scheme costs diverge from this figure, within three bands:

Table 1.1 –FSC Decision Mechanism

		ECC		
		0-1%	1-2%	>2%
FSC	0-1%	SAB May act	SAB May act	SAB May act/ECC takes precedence
	1-2%	SAB Should act	SAB Should act	SAB Should act/ECC takes precedence
	>2%	SAB Must act	SAB Must act	SAB Must act/ECC takes precedence

- 1.2 SAB own the FSC process, and the documentation surrounding this process.

The Employer Cost Cap process runs in parallel, and takes precedence

- 1.3 Under the HMT process, the initial ECC was set as 14.6% of pensionable pay. HMT Directions specify action is required where the divergence from the ECC exceeds 2% of pensionable pay (in either direction). The ECC process, if breached, takes precedence over the FSC process. Regulation 116 (5) states “The Board must not make recommendations under paragraph (2) if steps are required to be taken under regulation 115 (employer cost cap).”

FSC timeline

Table 1.2 – SAB FSC Timeline

	SAB – FSC
October 2016	Data received by GAD
December 2016	Experience analysis by GAD
January 2017	Present analysis
March 2017	SAB confirm agreement of assumptions
April-May 2017	Perform FSC Calculations
June 2017	Discuss initial FSC results
July- August 2017	Discuss & provide costings for possible benefit/contribution impacts
September 2017	Finalise FSC results
October- December 2017	Consultation on proposed benefit/contribution impacts
January 2018	Final recommendations on benefit/contribution changes to Secretary of State
April 2018	SoS confirm revisions to benefits/contributions
October 2018	Draft regulations for benefit/contribution changes
November 2018 – March 2019	Communicate benefit changes to members, employers, administrators
April 2019	New benefit/contributions in force

- 1.4 Many of the steps above (eg validation of/agreement to the data and setting the actuarial assumptions and methodology to be used) are also included in the HMT cost management process, except that in general terms many of the SAB steps are expected to happen before the corresponding HMT steps. It is important that conclusions concerning the data, methodology and assumptions for the FSC process are cognisant of the timeline for and requirements of the ECC process.
- 1.5 SAB need to work closely with DCLG and HMT to enable the process to be carried out efficiently and in an orderly fashion.

Current known cost pressures

- 1.6 There are a number of elements of experience that affect the FSC process but form part of the baseline cost of the ECC process. The current estimated impact of these differences (cost pressures which are known to exist in the SAB process but not in the HMT process) exceed 1% of pensionable pay.

Table 1.3 – Estimated current cost pressures in the FSC process

Cost associated with public sector transfer club	0.3%
Cost of applying an additional year's revaluation	0.4%
Cost associated with lack of take up of the 50/50 option	0.5%

- 1.7 In the absence of any mitigating actions the SAB cost control mechanism is likely to result in a breach of between 1% and 2% of pensionable pay.
- 1.8 In addition, experience and/or assumption changes relating to mortality or salary increases, for example, may materially impact the FSC.

SAB decisions required

- | | |
|------|---|
| D5.1 | SAB needs to determine whether it considers the 50/50 effect to be permanent or temporary. |
| D5.2 | If permanent, SAB needs to decide whether to remove the 50/50 section. |
| D5.3 | If the 50/50 section is retained, SAB will need to set an assumption for proportion of members expected to take up the option. |
| D5.4 | SAB needs to decide whether to revise the target initial cost or allow the cost to be recognised through the cost control mechanism in respect of the 50/50 take up. |
| D5.5 | SAB needs to consider whether to request the transfer club and revaluation items be removed from its cost mechanism by the Secretary of State |
| D5.6 | If the two elements mentioned D5.4 are not removed, SAB needs to decide whether to revise the target initial cost or allow the cost to be recognised through the cost control |
| D4.2 | SAB needs to specify post retirement mortality improvements. |
| D4.3 | SAB needs to specify the salary cut off point for assessing 50/50 impact. |
| D4.4 | SAB needs to specify assumptions for 50/50 take up. |
| D4.5 | SAB needs to specify commutation assumptions |
| D4.6 | SAB needs to confirm other demographic assumptions will be in line with ECC process |
| D4.1 | SAB needs to confirm that it intends to follow the change in SCAPE rate, and any future changes in the SCAPE rate. |

- 1.9 Decisions required to be made by SAB are summarised in chronological order above. Assumptions decisions (D 4.1 to 4.6) are required for both the initial cost cap fund calculation (as at 31 March 2014) and for subsequent valuations to determine the FSC.

2 Introduction

Purpose

- 2.1 The Public Service Pensions Act 2013 and associated HM Treasury Directions introduced a cost control mechanism for public service pension schemes, referred to here as the Employer Cost Cap (ECC). At subsequent valuations the output of the ECC process is known as the “cost cap cost of the scheme”.
- 2.2 Unlike other public sector schemes, the LGPS Scheme Advisory Board has established a second cost control mechanism, implemented through scheme regulations, referred to here as the Future Service Cost (FSC).
- 2.3 This paper documents the definitions, assumptions and decisions required to carry out the FSC process, including interaction with and dependencies on the ECC process. This document sets out the requirements (ownership and scope) and process dependencies associated with the SAB cost management process.
- 2.4 Relevant legislation is referenced in Appendix A.

ECC process

- 2.5 The ECC process is set out in HMT Directions¹.
- 2.6 The initial ECC was set as part of the 2013 valuation of the model fund. The total cost was 21.3% of pensionable pay, employee contributions were assessed as 6.7% led to the ECC of 14.6% of pensionable pay.
- 2.7 If, at a subsequent valuation, the cost cap cost of the scheme falls outside of a range of the initial ECC +/- 2% of pensionable pay, changes to member's contributions or the scheme design must be made to bring the cost cap cost of the scheme back to its initial level of 14.6% of pensionable pay.

FSC process

- 2.8 The FSC process is set out in this document and owned by SAB.
- 2.9 The initial FSC was set at 19.5% of pensionable pay (the target overall cost).
- 2.10 Both the target overall cost (19.5%) and the target proportion (2/3rds employer, 1/3rd member) form the basis of the FSC process.
- 2.11 If, at a subsequent valuation, the FSC does not equal the initial FSC, the Board may make recommendations to the Secretary of State as to the steps to take to bring the overall cost of the Scheme back to the target overall cost and to bring the proportion of the overall cost of the Scheme which is met by contributions by employers and members back to the target proportion.

¹

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/289366/public_service_pensions_actuarial_valuations_130314.pdf

3 Costs to be managed

- 3.1 The costs that need to be managed are for the provision of benefits accrued under the Scheme.
- 3.2 As with the ECC, certain drivers of scheme costs will not affect the cost control mechanism run the by the Scheme Advisory Board. In addition to existing past service effects and changes in financial assumptions, risk associated with investment performance will also be excluded from both the ECC and the FSC. Investment risk is not addressed by the FSC process. Improved governance has been proposed which may assist with this risk.
- 3.3 The costs to be managed by this mechanism are as follows:
- The cost of the future service benefit accrual for active members of the LGPS on 1 April 2014 including increases in the cost of transitional protections.
 - The post 2014 cost of deferred and pensioner members who achieve that status on or after 1 April 2014.
- 3.4 Costs not included in the process are those relating to:-
- Pre 2014 deferred and pensioner members.
 - Pre 2014 service of post 2014 retirees.

2014 Initial Cost Cap fund

- 3.5 As part of the process, GAD will need to calculate the value of the initial cost cap fund. This will establish the notional asset pool as at 31 March 2014.
- 3.6 The process for this calculation will be as per HMT Directions, but using assumptions and adjustments as described in section 4 below.

2016 Initial Future Service Cost

- 3.7 The main output of the exercise will be the Initial FSC.
- 3.8 Data will be provided to GAD by local administration authorities using the universal data specification that has been agreed between GAD, the four actuarial firms and the administration software providers, as part of the valuation process. Additional data will be as specified in Appendix C.
- 3.9 Calculations will be done within valuation process, to avoid any duplication of effort, in line with the timetable specified in Appendix B.

FSC Mechanism

- 3.10 The FSC process results in a revised calculation of the FSC at each triennial valuation. If the FSC differs from the Initial FSC, SAB is responsible to consider a range of actions to bring the FSC back to the initial FSC.

- 3.11 The Board must, before obtaining a Scheme cost assessment prepare and publish a statement setting out its policy concerning recommendations to the Secretary of State.
- 3.12 Recommendations should be made by SAB only if the underlying reasons behind the changes in the FSC are considered to be permanent. **[DN – should there also be a reference to “and/or material?”]**
- 3.13 The Board must not make recommendations if steps are required to be taken under the ECC process.
- 3.14 The responsibility for carrying out the action rests with the DCLG Secretary of State. SAB's responsibility is to recommend the course of action it considers appropriate, within three bands, as set out in the following table:

Table 3.1 – FSC Recommendation mechanism

		ECC		
		0-1%	1-2%	>2%
FSC	0-1%	SAB May act	SAB May act	SAB May act/ECC takes precedence
	1-2%	SAB Should act	SAB Should act	SAB Should act/ECC takes precedence
	>2%	SAB Must act	SAB Must act	SAB Must act/ECC takes precedence

Interaction with ECC process

- 3.15 In order to perform the calculations, as set out in Appendix D, GAD will require accurate data from the local fund administrating authorities. The entire process, including the timeline set out in Appendix B, is dependent on this data being of acceptable quality and timeliness.
- 3.16 The calculations and assumptions required for the FSC process are similar to the ECC process. As such the FSC runs in conjunction with the ECC process.
- 3.17 There are some additional components dealt with in the FSC process that are excluded from the ECC process. Consequently some assumptions and decisions required as part of the FSC process do not affect the ECC process. It is important that conclusions concerning the data, methodology and assumptions for the FSC process are cognisant of the timeline for and requirements of the ECC process.
- 3.18 SAB will work in conjunction with HMT to enable the process to be carried out efficiently and in an orderly fashion. It will be necessary for a method of communication between SAB, HMT and GAD to ensure the processes are coordinated.
- 3.19 In general, as set out in the table below, each FSC process component is undertaken before equivalent ECC process component is undertaken. However, if the ECC process results in a breach, the FSC component effectively stops (although there may still be scope for SAB to make recommendations to the Secretary of State).

Table 3.2 – FSC and ECC process interaction

	SAB – FSC	HMT - ECC
October 2016	Data received by GAD	
December 2016	Experience analysis by GAD	
January 2017	Present analysis	
March 2017	Confirm agreement of assumptions	
April-May 2017	Perform FSC Calculations	
June 2017	Discuss initial FSC results	Indicative ECC results
July- August 2017	Discuss & provide costings for possible benefit/contribution impacts	
September 2017	Finalise FSC results	
October-December 2017	Consultation on proposed benefit/contribution impacts	
January 2018	Final recommendations on benefit/contribution changes to SoS	Initial ECC results, taking into account SAB recommendations
April 2018	SoS confirm revisions to benefits/contributions	If change in ECC $\leq \pm 2\%$, no further action. If $> \pm 2\%$ steps are required FSC process stops.
October 2018	Draft regulations for benefit/contribution changes	
November 2018 – March 2019	Communicate benefit changes to members, employers, administrators	
April 2019	New benefit/contributions in force	

Possible Scenarios

- 3.20 The ECC is breached if, at a valuation, the cost cap cost of the scheme falls outside of a range of the initial ECC $\pm 2\%$ of pensionable pay.
- 3.21 As shown in the table above, the FSC process involves a range of outcomes under which SAB make recommendations to the Secretary of State.
- 3.22 There could be a 2% increase in the FSC without the ECC being breached, due to the elements included within the FSC process that are excluded in the ECC process. In this case, SAB must make recommendations to the secretary of state.
- 3.23 It is conceivable that the 2% threshold in the ECC breaches but the FSC breach is less than 2%. This depends on assumptions adopted in the FSC process relative to the assumptions adopted for the ECC.
- 3.24 It is also possible that both the ECC and the FSC both breach the 2% threshold.
- 3.25 In the event that the 2% threshold in the ECC process is breached, the action required must satisfy the requirements of HMT Directions in relation to the ECC. The ECC process takes precedence and the FSC process stops.
- 3.26 The timeline for the FSC process and how this fits in with the ECC process is set out in Appendix B.

4 Assumptions for the FSC Process

- 4.1 Areas where the SAB mechanism may differ from the HMT mechanism are set out in table 4.1.

Table 4.1 – Main differences in assumptions between the SAB and HMT mechanisms

SAB – FSC	HMT – ECC
<u>Membership driven assumptions</u> Set by SAB using model fund data/experience.	<u>Assumptions</u> Set in accordance with HMT Directions.
50/50: include an assumption for future take up.	50/50: not included.
Transitional rule of 85: no adjustment	Transitional rule of 85: no adjustment
Club transfers: policy to be confirmed	Club transfers: add adjustment
Commutation: policy to be confirmed	Commutation: 15% commuted
Additional Year's Revaluation: policy to be confirmed	Additional Year's Revaluation: adjustment

Financial Assumptions

- 4.2 Financial assumptions will required to assess the FSC.
- 4.3 The annex to item 6 of the February 2015 Cost Management and Contributions meeting agenda contained the following assumptions, which at that time represented SAB's expectations for both the ECC and the FSC. Assumptions adopted for the 2016 ECC valuation will be contained within HM Treasury Directions.

Table 4.2 – Financial Assumptions

	Scheme valuation - Employer Cost Cap (ECC)	Scheme Advisory Board Future Service Cost (FSC) process
Relevant rate of increase	PI Act where set or (i) 2.9% on 7th April 2014; (ii) 2.3% on 6th April 2015; (iii) 2.1% on 11th April 2016; and (iv) 2% on the first Monday in each tax year subsequently; 2% pa used for ECC	Use actual PI where known. Where not known assume 2% pa.
Public service earnings growth	(a) 2.2% over the year to 31st March 2014; (b) 2.5% over the year to 31st March 2015; (c) 3% over the year to 31st March 2016; (d) 3% over the year to 31st March 2017; (e) 3% over the year to 31st March 2018; and (f) 4.75% each year from 1st April 2018. 4.75% pa used for ECC	Use actual public service earnings growth where known. Where not known, assume CPI +1.5%.
Discount Rate	SCAPE discount rate over each year ending on the 31 March (the assumed rate of increases awarded in line with the Pension (Increase) Act 1971 in the April immediately following each year,	As ECC

	compounded with 3%;) - 5.06% pa nominal used for ECC	
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- 4.4 SAB will need to consider if any of these assumptions need to change. For example in May 2016, the SCAPE discount rate changed from 3% to 2.8% above the expected rate of pension increases. It is understood that Treasury will be amending their direction before this year's autumn statement to reflect this change.

D4.1	SAB needs to confirm its financial assumptions. In particular, SAB needs to determine whether it intends to follow, and if so how it intends to allow for, the change in SCAPE rate, and any future changes in the SCAPE rate.
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Demographic Assumptions

- 4.5 The annex to the February 2015 Cost Management and Contributions meeting agenda contained the following assumptions, which at that time represented GAD's expectations for both the ECC and the FSC. GAD will perform an analysis of experience since the 2013 valuation, which may lead to changes to some of these assumptions. Assumptions are required for both the initial cost cap fund (as at 31 March 2014) and assessing the FSC as at 31 March 2016 and at subsequent valuation dates.

Table 4.3 – Demographic Assumptions

	Scheme valuation - Employer Cost Cap (ECC)	Scheme Advisory Board Future Service Cost (FSC) process
post-retirement mortality improvement rates	Mortality rates published by the Office for National Statistics as part of the most recent principal population projections for the United Kingdom	FSC process will check ONS against LGPS index and scheme experience
Changes to SPA	These assumptions are in line with the proposed increases in State Pension age to 67, to be phased in between 2026 and 2028.	As ECC
50/50	No members of a scheme providing benefits to local government workers in England and Wales ever have, or ever will, make an election under regulation 10 of the Local Government Pension Scheme Regulations 2013	As per reform process 10% of those earning less than £x
Pensioner baseline mortality Normal health Dependants Ill Health (current) Ill health (future)	Set as standard SAPS tables adjusted by the percentages shown below M: +0.1% +0.1% 99% x S1NMA; F: 93% x S1NFA M: 120% x S1NMA; F: 101% x S1DFA M: 104% x S1IMA; F: 106% x S1IFA	As ECC
Age retirement All members joining on or after 1 Oct 2006, and all members not entitled to unreduced benefits before age 65 under the 'Rule of 85'	0.3% (M) or 0.2% (F) retire each year from 55 up to 5 years before NPA, then 9% (M and F) a year prior to NPA: 100% at NPA	As ECC

Members entitled to unreduced benefits at age 65 under the 'Rule of 85'	Members with NPA or 65 or 66 (born before 6 Apr 1960): typically 31% (M) or 30% (F) retire at 60, with 2% (M and F) a year prior to CRA: 17% (M) or 23% (F) a year between CRA and NPA; 100% at NPA. Members with higher NPA (born after 6 Apr 1960): Rates intermediate between the above and those applying to members joining on or after 1 Oct 2006	As ECC
Members entitled to unreduced benefits at ages between 60 and 65 under the 'Rule of 85'	Consistent with rates above, but based around unreduced benefits being payable at 62 rather than 60	As ECC
Ill-health retirement - Incidence Tier 1 / 2 / 3 split	Increasing by age: male rates are around 0.01% at age 30, 0.1% at age 45, 0.8% at age 60; female rates lower 77% / 11% / 12% (male and female)	As ECC
Withdrawal	Reducing with age: female rates are around 7% at age 30, 4% at age 45, 2% at age 60, net of 20% re-entry within 5 years; male rates lower; no duration-based assumptions for males or females	As ECC
Death before retirement	Increasing by age: male rates are around 0.03% at age 30, 0.09% at age 45, 0.32% at age 60; female rates lower	As ECC
Promotional salary scale	Steeper at younger ages: male rates are around 1.1% at age 30, 0.5% at age 45, 0.0% at age 60; female rates lower	As ECC
Commutation Pre-2008 service 2008-14 service 2014 Scheme service	10% of pension commuted 15% of pension commuted* 15% of pension commuted* *Specified in HMT Directions	At the meeting of 3rd July 2014 the committee agreed that the FSC process should continue using the assumption that members commute 65% of the maximum allowable amount of their pension in to lump sum - (equivalent to 23.2% of pension commuted)
Family statistics Proportion married/partnered Age difference	80% (M), 75% (F) at ages up to 70, with consistent assumptions for existing pensioners and other ages Male member 3 years older than partner Female member 2 years younger than partner	As ECC

- 4.6 There remains a degree of flexibility in relation to what is included, and SAB needs to make a number of decisions to clarify its approach following GAD's analysis of experience. SAB needs to confirm where it will follow HMT methodology/process, other than for explicit deviations/variations of assumptions.

D4.2	SAB needs to specify mortality improvements.
D4.3	SAB needs to specify the salary cut off point for assessing 50/50 impact.
D4.4	SAB needs to specify assumptions for 50/50 take up.
D4.5	SAB needs to specify commutation assumptions
D4.6	SAB needs to confirm other demographic assumptions will be in line with ECC process

- 4.7 SAB may wish to consider seeking specific actuarial advice about the possible impact of these variations in assumptions.

5 Current Known Costs

- 5.1 A number of aspects are known to impact the SAB's FSC cost cap mechanism that are either already included within, or outside the scope of, and therefore do affect HM Treasury's ECC baseline cost. These are:

Table 5.1 – Impact of current known cost pressures

Cost Item	Source of cost	Potential impact on FSC* % pensionable pay (based on 2013 data)	Approximate Cumulative impact on accrual rate
50/50	Fewer people opting for 50/50 benefits than expected (current actual take –up possibly less than 1%)	0.5	1/50 th
Public sector transfer club	Cost associated with providing benefits worth more than incoming transfer value	0.3	1/51 st
Revaluation	Additional year's revaluation imposed on scheme after	0.4	1/52 nd

* There is also a past service effect, due to accumulation of contributions between 2014 and 2016 not recognising these items. We expect this to emerge as an experience item when we calculate the cost cap fund as at 31 March 2016, which will lead to a small increase to the FSC, when spread over 15 years.

- 5.2 Due to these known aspects alone, and in the absence of other possible courses of action, the SAB cost control mechanism is likely to breach by around 1-1.2% plus or minus any other cost pressures that are identified in the valuation process - eg actual demographic experience and/or assumption changes relating to mortality or salary increases.

Source of Cost

- 5.3 The first cost (ie that arising from 50/50) is a function of the initial assumption, of a take-up of the option by 10% of the membership earnings less than £21,000, not being borne out in practice. As noted in paragraph 3.12 SAB's stated approach is to only take action if it considers the effect to be permanent.
- 5.4 The remaining two items above were identified as impacting on the target cost of 19.5% after the target cost was established and agreed.

Possible courses of action (50/50)

- 5.5 One possible course of action could be to continue to assume a proportion of members take 50/50 benefits. If the low take-up of 50/50 is not considered to be permanent (that is, SAB expects future take up to be materially higher), this may be an appropriate course of action.

As part of the decision-making process, SAB may wish to conduct a survey of members, administrators and employers to understand why the take up of this option has been so much lower than expected, to enable SAB to determine whether it believes the effect to be permanent, and thereby determine the appropriate course of action.

- Table 5.1 above indicates that if the future take-up of 50/50 is assumed to be zero, that would be equivalent to reducing accrual from 1/49th to just over 1/50th. Evidence may lead to a reduction in the proportion of members with salary below £21,000 assumed to take up the 50/50 option to a figure between 0% and 10%. In this case, the assumption made could, all other things being equal, lead to a non-integer accrual. Some other public sector schemes do offer non-integer rates of accrual; in some cases expressing them as a percentage (eg $1/49.5 = 2.02\%$).
 - Alternatively, it could be that the accrual rate is recognised as an experience item flowing through the cost cap mechanism. In this case, there may not need to be an immediate change to scheme design, but over time the effect would accumulate if there is no offsetting change in experience. This may be appropriate if SAB wish to gather more information and monitor experience over time.
- 5.6 Alternatively, SAB may consider that the low take up is permanent feature. In this case, options available to SAB are:
- That the 50/50 section is retained, and an assessment based on experience to date is allowed for; or
 - That the 50/50 section is removed altogether

- 5.7 Under both of these scenarios, the cost could be recognised, as part of the target cost (that is the target cost be restated to be approx. 20%), shared between employers and members according to the 2:1 target proportion. Members would meet their share of the additional cost by an increase in their contributions.

- 5.8 Alternatively, the cost could be recognised through the cost control mechanism, and is therefore effectively borne by members, by means of a reduction in accrual rate to 1/50th, or by some other benefit change.

Possible courses of action (public sector transfer club, revaluation)

- 5.9 One possible course of action would be for SAB to approach the Secretary of State with a case for removing these two items from the SAB cost control mechanism.
- 5.10 A second possible course of action would be to adjust initial target costs to allow for these effects. This would lead to a sharing of the impact between employers and members, similar to the paragraph 5.7.

- 5.11 A third possible course would be to allow the cost management process to play through, (effectively meaning the members could bear the cost of these items when they are recognised) by means of a reduction in accrual rate, or some other benefit change.

D5.1	SAB needs to determine whether it considers the 50/50 effect to be permanent or temporary.
D5.2	If permanent, SAB needs to decide whether to remove the 50/50 section.
D5.3	If the 50/50 section is retained, SAB will need to set an assumption for proportion of members expected to take up the option.
D5.4	SAB needs to decide whether to revise the target initial cost or allow the cost to be recognised through the cost control mechanism in respect of the 50/50 take up.
D5.5	SAB needs to consider whether to request the transfer club and revaluation items be removed from its cost mechanism by the Secretary of State
D5.6	If the two elements mentioned D5.4 are not removed, SAB needs to decide whether to revise the target initial cost or allow the cost to be recognised through the cost control mechanism in respect of the transfer club and the revaluation.

Appendix A: Legislation

- A.1 Under the Public Service Pensions Act 2013, Public Service Pension Schemes including the Local Government Pension Scheme (LGPS) are subject to an employer cost control regime². The detail of this cost-control (“cost-capping”) process is set out in Directions issued by HM Treasury³.
- A.2 The LGPS has a second, complimentary, cost control process – the LGPS Scheme Advisory Board (SAB) cost management process. The SAB cost management process is set out in regulation 116⁴ of the Local Government Pension Scheme Regulations 2013 and results in a Future Service Cost (FSC) assessment. We refer to it as the “FSC process”. The FSC process is similar, but not identical, to the HM Treasury process which results in an employer cost cap (ECC). We refer to this as the “ECC process”.
- A.3 Where the two different cost management processes conflict/coincide, the Treasury cost management process overrides the SAB process. In this event, any actions proposed as part of the SAB may or may not be considered as part of the resolution of the HMT process.
- A.4 The purpose of this paper, which is owned by SAB, is to bring together various sources of information describing the FSC process into a single summary document. This document does not however replace the other documentation, or the underlying regulations, both of which take precedence and should be read in conjunction with this paper.
- A.5 Regulation 116 states that:
- (1) The Local Government Pension Scheme Advisory Board (“the Board”) must obtain a Scheme cost assessment from the Scheme actuary detailing the overall cost of the Scheme and the proportions of that cost being met by Scheme employers and members on the dates specified in regulation 62(1)(a) (actuarial valuations of pension funds).
- (2) Subject to paragraphs (5) and (6), where the overall cost of the Scheme is above or below the target overall cost, the Board may make recommendations to the Secretary of State as to the steps to take to bring the overall cost of the Scheme back to the target overall cost.
- (3) Where the proportion of the overall cost of the Scheme which is met by contributions by employers is above or below the target proportion, the Board may make recommendations to the Secretary of State as to the steps to take to bring the proportion of the overall cost of the Scheme which is met by contributions by employers and members back to the target proportion.

² <http://www.legislation.gov.uk/ukpga/2013/25/crossheading/cost-control/enacted>

³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/289366/public_service_pensions_actuarial_valuations_130314.pdf

⁴ <http://lgpsregs.org/index.php/regs-legislation/timeline-regulations-2014?showall=&start=16#reg116>

(4) The Board must, before obtaining a Scheme cost assessment under paragraph (1), prepare and publish a statement setting out its policy concerning recommendations to the Secretary of State about the steps to be taken to bring the overall cost of the Scheme back to the target overall cost and the proportions of that cost met by Scheme employers and members, back to the target proportion.

(5) The Board must not make recommendations under paragraph (2) if steps are required to be taken under regulation 115 (employer cost cap).

(6) Subject to paragraph (5) the Board must make recommendations under paragraph (2) if the overall cost of the Scheme is above or below the target overall cost by 2% or more of pensionable earnings of members.

Existing Documentation

- A.6 A number of existing documents have been prepared previously in relation to the FSC process, some of which remain in draft form. This paper brings together those previously prepared documents.

<http://www.lgpsboard.org/images/PDF/CMCApril2014/DraftCostMgmtPaper>
<http://www.lgpsboard.org/images/PDF/CMCFeb2015/Item6-CCAssumptions.pdf>
<http://www.lgpsboard.org/images/PDF/CMCFeb2015/Item6-Annex1.pdf>
<http://www.lgpsboard.org/images/PDF/CMCJan2016/Item5aCostManagementProcessMap.pdf>
<http://www.lgpsboard.org/images/PDF/CMCJan2016/Item5aCostManagementTimetable.pdf>

- A.7 In addition to bringing these strands together into one place and formalising them, this paper clarifies where decisions have been made and where decisions need to be made and advice may be required. In the appendix we set out a methodology for performing the calculations.

Appendix B: Timeline

- B.1 The timeline for the SAB FSC and HMT ECC processes is set out below. The FSC/SAB cost cap mechanism may result in proposed benefit/member contribution changes. If these are insufficient to meet the needs of the ECC, they will be adjusted to do so, with no additional requirements from the ECC process.

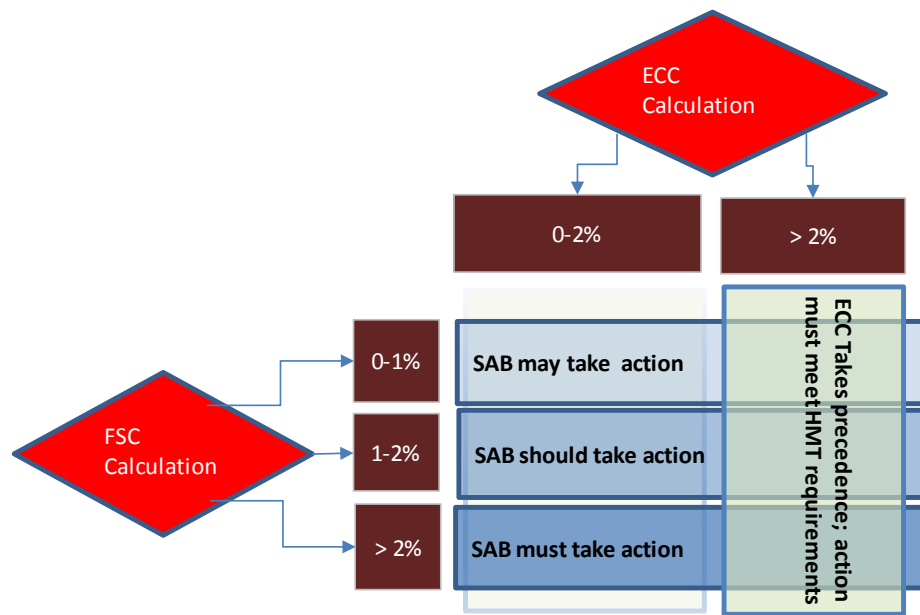
Table 6.1 – Timeline Comparison with HMT ECC

	SAB – FSC	HMT - ECC
October 2016	Data received by GAD	
December 2016	Experience analysis by GAD	
January 2017	Present analysis	
March 2017	Confirm agreement of assumptions	
April-May 2017	Perform FSC Calculations	
June 2017	Discuss initial FSC results	Indicative ECC results
July- August 2017	Discuss & provide costings for possible benefit/contribution impacts	
September 2017	Finalise FSC results	
October-December 2017	Consultation on proposed benefit/contribution impacts	
January 2018	Final recommendations on benefit/contribution changes to SoS	Initial ECC results, taking into account SAB recommendations
April 2018	SoS confirm revisions to benefits/contributions	If change in ECC $\leq \pm 2\%$, no further action. If $> \pm 2\%$, then feed back into FSC process with revised proposals.
October 2018	Draft regulations for benefit/contribution changes	
November 2018 – March 2019	Communicate benefit changes to members, employers, administrators	
April 2019	New benefit/contributions in force	

Interaction with HMT Process

- B.2 A key aspect of this process is how changes to benefits or contributions are implemented. This is described in the following table.

		ECC		
		0-1%	1-2%	>2%
FSC	0-1%	SAB May act	SAB May act	SAB May act/ECC takes precedence
	1-2%	SAB Should act	SAB Should act	SAB Should act/ECC takes precedence
	>2%	SAB Must act	SAB Must act	SAB Must act/ECC takes precedence



Appendix C: Calculation approach

- C.1 **Data collection.** Data is provided as at 31 March 2014 (the date of the inception of the reformed scheme) and 31 March 2016 (the effective date of the valuation).
- C.1.1 We collect membership and movement data from each of the funds in the LGPS. Data is tested for accuracy compared with previous valuation and other sources such as fund accounts.
- C.1.2 We report on the data quality, for both membership and movement data. This will deal with any steps we have taken to adjust or “rate up” the data for missing elements, or where information provided is clearly incorrect.
- C.1.3 The data required for the SAB and HMT mechanisms are broadly similar. However, the SAB cost control mechanism requires additional data compared with the HMT cost cap process, due to the additional items it covers.
- C.1.4 Additional data GAD will require data including
- take up of the 50/50 option,
 - numbers and amounts of club transfers received, and benefits offered in respect of those transfers, in order to assess the impact of this item
 - members’ commutation of pension for cash.
- C.2 **Estimation of Member Contribution Yield**
- C.2.1 Following receipt of data, we will be able to estimate the member contribution yield, and if necessary recommend changes to contribution rate bands to bring this back to maintain the target proportion in relation to the target cost.
- C.3 **Experience analysis and assumptions**
- C.3.1 Financial assumptions set by SAB in line with the process set out in this document.
- C.3.2 GAD analyse experience.
- C.3.3 GAD report on this analysis to SAB. SAB will then consider the results of the analysis, take advice as appropriate, and decide what assumptions should be adopted.
- C.4 **Programming scheme benefits**
- C.4.1 GAD set up valuation programs to assess the cost of providing scheme benefits for the overall membership of the scheme.
- C.5 **Actuarial calculations**
- C.5.1 GAD run the valuation programs to determine the initial cost cap fund using and updated cost of benefits already built up to 31 March 2014) and the cost of providing benefits under the assumptions set by SAB (the FSC).

C.5.2 Updated cost of new benefits being built up assuming all active members are in the new scheme. Allowing for:

Updated data at 2016
Updated demographic assumptions
Experience since the old scheme closed (2014)

C.6 What could cause a cost cap breach?

C.6.1 The following table of possible contributing factors was provided in the 2013 valuation report. Items expected to impact the Cost Cap of the scheme are also expected to impact the FSC.

Item		Employer contribution rate ⁵	Cost cap cost of the scheme ⁴
Expected:	Short-term mortality improvements & increases in members' average SPA	o	o
	Run-off of short-term financials up to the next valuation date (final salary benefits only)	N/A	N/A
Likely:	Short-term experience effects:		
	- demographic	N/A	✓
	- financial	N/A	✓
	Assumption changes:		
	- short-term financials after the next valuation date	N/A	✓✓
	- mortality improvements	✓	✓✓
Possible:	Errors found in data sets from previous valuations	✓	✓
	Unanticipated membership changes	✓	✓
	Assumption changes:		
	- demographics set by the Secretary of State subject to HMT approval	✓	✓
Key ⁶ 7:	N/A = not applicable o = impact is likely to be less than 0.5% of pensionable pay ✓ = impact may well be more than 0.5% of pensionable pay but, although possible, is quite unlikely to be more than 2% of pensionable pay, ✓✓ = impact may well be more than 2% of pensionable pay		

C.7 Reporting

⁵ Each item is considered separately; a combination of these items could have a larger impact than is considered likely for any of those items individually.

⁶ Showing relative importance of items in the table in our judgment at the time of signing.

⁷ Shown in increasing order.

- C.7.1 GAD prepare a draft report on the results of the actuarial calculations to be shared with SAB and DCLG. This report will indicate to what extent the FSC exceeds or falls short of the initial target cost.

C.8 SAB Consideration

- C.8.1 Discussions will cover possible courses of action that SAB wishes to consider.

- C.8.2 We will assess and report on the costs of these respective courses of action, following which SAB will determine the most appropriate and consult on the proposal, leading to a recommendation to the Secretary of State.

- C.8.3 Potential options for adjustment

Change to member benefits

- > Default: Accrual Rate (currently 1/49)
- > Other benefits? (Spouse's benefits, Early Retirement Terms)

Change to member contributions

- > Target proportion equates to 6.5% on average (member contribution yield).

C.9 Reconciliation between ECC and FSC

- C.9.1 The following reconciliation between the employer FSC and the ECC disclosed as at 31 March 2013 was provided for the February 2015 Cost Management and Contributions sub-committee of the SAB. It is an extract from the Scheme actuarial valuation report as at 31 March 2013.

Table 3.2 - Reconciliation of proposed employer cost cap with target overall cost (% of pensionable pay)

Target overall cost met by employers	13.0
Changes due to Directions	
Exclusion of allowance for 50/50 elections	+0.3
Exclusion of transitional protection of the 'Rule of 85'	-0.1
Change in commutation assumption	+0.6
Changes due to assumptions (other than changes above required by the Directions)	+0.2
Changes due to benefits valued	
Inclusion of additional year's revaluation in CARE accounts	+0.4
Allowance for strain from Club transfers	+0.3
Proposed employer cost cap	14.6