# Cost Management, Benefit Design and Administration Committee

**Meeting – 13th September 2021**
**Item 6 Paper C**

**HM TREASURY COST CONTROL CONSULTATION RESPONSE**

## Issue

To update the committee on how SAB responded to HM Treasury's consultation on changes to the cost control mechanism which closed on 19th August 2021.

## Background

Details of HM Treasury's consultation and implications for the current SAB cost management process were discussed when the committee last met on the 12th July. The relevant committee paper was circulated "in confidence" to members prior to the meeting.

## Consideration

At the meeting on the 12th July the committee agreed with the recommendation that the Secretariat should prepare a response to HM Treasury's consultation highlighting a preferred option from the three set out in the agenda paper.

A draft response was circulated to members on the 3rd August for comment by the 13th August. No substantive comments were received.

The SAB response (copy at Annex A) cleared by the Chair was submitted to HM Treasury on the 19th August.

**Recommendation – that the committee notes the position as set out above and tasks the Secretariat to update the committee with developments.**

## Next Steps

The Secretariat will continue to liaise with HM Treasury and notify the committee when the consultation response has been published.

Local Government Pension Scheme

# Cost Management, Benefit Design and Administration Committee

**Annex A**

## HM Treasury

## Public Service Pensions: cost control mechanism consultation

Proposal to reform the mechanism

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## Response to consultation

This response is submitted on behalf of the Local Government Pension Scheme Advisory Board (England and Wales) which is a body set up under Section 7 of the Public Service Pensions Act 2013 and The Local Government Pension Scheme Regulations 110-113.

The purpose of the Board is to be both reactive and proactive. It seeks to encourage best practice, increase transparency and coordinate technical and standards issues.

The response was compiled by the Board secretariat in consultation with members of the Board's Cost Management Benefit Design and Administration committee.



Jeff Houston
Secretary to the Board

# Cost Management, Benefit Design and Administration Committee

19th August 2021

## Background to the response

This response is submitted in the context of the Local Government Pension Scheme (LGPS) in England in Wales operating a separate but subordinate cost management process to HMT's cost control mechanism.

The current SAB process operates within and is subject to the HMT mechanism. It is broadly similar but can use different assumptions around employee cost elements. There are however a number of significant differences:

- It has its own target cost of a total of 19.5% employer and employee contribution with a 2/3rd 1/3rd respective split
- It can reflect the impact of take up of the 50/50 section of the scheme
- It operates a may/should/must (make recommendations for benefit/contribution changes) rule for movements against the target cost of less than 1%/between 1% and 2%/over 2% respectively
- It can reflect significant movements in the discount rate in order to provide a 'sense check' of the outcome when compared to the impact of economic elements on employers

The SAB process operates prior to the HMT mechanism and any recommendations made as a result (and accepted by government) are taken into account when calculating the scheme costs for the purpose of the HMT mechanism. In some ways it could be said that the SAB process already operates as a form of 'economic check', even if the current interaction is somewhat complex.

The outcome of the process in 2016 was a good indicator of its greater sensitivity to the costs of the LGPS in that it resulted in a cost movement of minus 0.5% as compared to the indicative HMT mechanism outcome of minus 2.8%.

Despite the result being within the 'may take action' corridor the SAB agreed on a set of benefit design and contribution changes costed by GAD at 0.9%. This meant that had the cost control process not been paused in early 2019, and the outcome of the initial SAB process and resultant design changes been accepted by MHCLG and HMT, the outcome of HMT's 2016 mechanism would have been revised accordingly and not resulted in a breach (-2.8% + 0.9% = -1.9%, within HMT's 2% corridor).

# Cost Management, Benefit Design and Administration Committee

The consultation recognises the differences which exist in both the scheme structure and setting of employer contribution rates for the LGPS. This response includes proposals which seek to address those differences as well as a closer integration of the SAB process within the statutory HMT mechanism.




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# Cost Management, Benefit Design and Administration Committee

## Response to consultation questions

### Preliminary remarks

Before moving onto the consultation questions the Board would wish to make clear its concerns regarding the purpose of the consultation in respect of two points.

- Firstly, the case for change appears to be based on outcomes which both went against expectations and also brought into focus the incompatibility of some of the objectives of the mechanism as listed below:
    - protect the Exchequer (and by extension taxpayers) from unforeseen costs
    - maintain the value of a public service DB pension scheme to its members; and
    - provide stability and certainty on member benefit and contribution levels – the mechanism should only be triggered by 'extraordinary, unpredictable' events.

- Secondly those outcomes were predicated on what, with the benefit of hindsight, appear to be assumptions which overestimated the cost of the schemes when the mechanism was first introduced.

Would it not have been better to revisit those objectives and assumptions rather than revise the mechanism in such a way as would appear to make it far less likely to be triggered?

### Responses

**Question 1: Do you agree that a reformed scheme only design would achieve the right balance of risk between scheme members and the Exchequer (and by extension the taxpayer), and would create a more stable mechanism?**

Although altering the process to include only reformed scheme costs may create a more stable mechanism, it could be difficult to achieve in the LGPS given the effect of the underpin – and would potentially remove a significant (if diminishing) element of cost from the process.
The risk of any future increases in these costs would then fall entirely on LGPS employers, which unlike other public sector schemes cannot be directly borne by the government. It would therefore be important to ensure that other measures to manage that risk are considered alongside these proposals.




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**Question 2: Do you agree with the Government's intention to widen the corridor? If not, why not?**

If the purpose of widening the corridor is solely to reduce the possibility of a breach, then no, as we do not believe this to be a prudent way to identify and manage structural changes to the cost of the scheme.

**Question 3: Do you think that a corridor size of +/-3% of pensionable pay is appropriate? If not, why not?**

Any widening of the corridor, although reducing the potential for a breach, increases the potential for a significant change in benefits should such a breach occur. It would also reduce the possibility for recognising and reflecting structural changes to scheme costs in good time.

For this reason, the SAB process is already designed to operate within the existing 2% corridor to both manage structural changes and avoid cost pressures building up and leading to a cost 'shock' when the corridor is breached.

**Question 4: Do you agree with the proposal to introduce an economic check?**

In principle, provided it is an open, transparent and mechanistic process which appropriately recognises the different cost drivers in the LGPS. The SAB process already contains a similar provision by being able to take into account shifts in the SCAPE discount rate. However, unlike the unfunded schemes, the SCAPE rate does not directly drive employer costs, which are determined by locally set discount rates taking advice from the LGPS fund actuaries as part of the triennial fund valuation process.

**Question 5: Do you think that the SCAPE discount rate, as it currently stands, is an appropriate economic measure for the cost control mechanism?**

No, not for the LGPS as the SCAPE rate is divorced from the drivers of actual employer contributions in the scheme. These contributions, which are determined locally, use discount rates designed to track the returns of each LGPS fund's investment strategy, risk appetite and globally diversified asset allocations.

A discount rate based on the OBR's long-term forecast of UK GDP is entirely appropriate for assessing the future affordability of the unfunded schemes against the projected tax base. The purpose being to ensure the costs of the scheme remain affordable to future taxpayers who will be responsible for meeting those costs.

The LGPS, as a funded scheme, looks to set a discount rate for a different purpose. That purpose being to ensure a minimum call on future local taxpayers by maintaining a pension fund able to meet all future liabilities. As such the rate must be able to reflect changes in global asset values given the global nature of the scheme's investments.

We would therefore propose that – should the economic check be introduced – it would, for the LGPS, use the changes in an 'LGPS discount rate' rather than SCAPE. Such a rate would take into account the factors which influence the actual discount rates in operation across the LGPS (reflecting both future and past investment returns) and would therefore be much more closely aligned with movements in employer contributions.

However, it may not be appropriate to use the discount rates adopted for the local actuarial valuations (even on an average basis) as these include a margin for prudence, whereas we would expect that the rate used for the cost control mechanism would be based upon a 'best estimate' approach.
We would propose that HMT commission GAD to advise on a 'neutral' LGPS-specific discount rate to be included in HMT valuation directions. This rate could be based on a number of starting points for example:

- OBR long-term forecasts for Global GDP growth or
- The standardised best estimate discount rate used for GAD'S Section 13 report, or
- Assumed returns for the overall LGPS asset allocation

We would also propose that whatever basis is used GAD should seek the views of LGPS fund actuaries when determining the advice to be given to HMT in order to assess the potential impact of the variation of the LGPS specific rate from those used in local fund valuations.

Although the proposal would achieve a rate which we believe would better reflect the economic conditions within which LGPS funds operate, we recognise that there would remain some divergence from local rates both due to the 'best estimate' approach and also the variation between local asset allocations and the aggregation. Therefore, the mechanism for setting this rate would need to be clear and transparent and therefore we would recommend that the process is set out in HMT regulations (or HMT Directions).

For information, the shift in average LGPS discount rates (including CPI) between the 2016 and 2019 fund valuations was a decrease from an average of 4.4% to 4.2%. At the same time the average CPI inflation assumption increased from 2.2% to 2.4%. The movement in the average real discount rate was therefore CPI plus 2.2% to CPI plus 1.8% (a decrease of 0.4%) – equivalent to an increase in liabilities of around 8%. Interestingly the SCAPE discount rate, should GDP continue to be used as the methodology, should by now also be CPI plus 1.8% (see page 20 of the separate consultation on SCAPE).

Although this proposal would provide closer alignment with LGPS discount rates it would still leave in place two separate processes with the current 'clunky' timing requirements necessary for the SAB process to influence the HMT mechanism. Furthermore it would not address the other factors and assumptions which act as cost drivers within the LGPS, and which influence employer contributions via the local fund valuations.

**Question 6: If the SCAPE methodology changes, and the Government considers that the SCAPE discount rate is therefore not an appropriate measure for the cost control mechanism, then do you think that a measure of expected long-term GDP should be used instead? If not, please set out any alternative measures that may be appropriate in this scenario. Please consider in the context of the separate review of the SCAPE methodology currently being undertaken by HM Treasury.**

Although the above proposal would provide closer alignment with LGPS discount rates it would, by relying solely on the discount rate, not address the other factors and assumptions (e.g. the 50/50 option) which act as cost drivers within the LGPS and which influence employer contributions via the local fund valuations.

In England and Wales it would also leave in place two separate processes with the current 'clunky' timing requirements necessary for the E&W SAB process to influence the HMT mechanism.

The option set out below seeks to better integrate a revised SAB cost management process within the mechanism in order to perform a similar role to the economic check, but one more closely aligned with the actual costs of the LGPS.

In this proposal the HMT mechanism (up to the consideration of the economic check) would continue to provide a like for like cost of the scheme when compared to others in the public sector.

However, a separate LGPS process would form the basis for the review of corridor breaches, effectively becoming the economic check element of the HMT mechanism. It is proposed that there would be a separate process for each LGPS scheme (E&W, Scotland and NI) however they would all be based on the existing process operated by the current E&W SAB. Each process would include some LGPS specific assumptions but a change from the current E&W process would be required to reflect movements in the same LGPS specific discount rate as proposed above.

The ability to maintain some LGPS specific assumptions, including one for the underpin, would reflect some element of past scheme costs in the check. This would recognise that, unlike in the unfunded schemes, the past scheme risks relating to accrued final salary benefits do not fall on government, but on LGPS employers.

In each LGPS scheme the SAB would (as currently happens in E&W) be free to make recommendations for changes within the corridor in order to address early indications of structural cost changes. Such recommendations would however continue be subject to the approval of and acceptance by the respective departments and HMT.

At this point it is perhaps worth a reminder of the position of the paused 2016 review as set out in the preliminary remarks above to demonstrate how in some ways it could be said that the E&W SAB process already operates as a form of 'economic check', even if the current interaction is somewhat complex. This proposal retains the objective approach preferred by HMT in that it uses the outcome of the SAB process as a mechanistic check on any breach, rather than any form of recommendation from the SAB. It would operate in the same way as the economic check, in that it could not cause or extend a breach – only provide a check on a breach (either way).

In operational terms, a breach of the HMT corridor would only result in mandatory recommendations for a change to benefits/contributions if the LGPS process also resulted in a breach in excess of 3% (should an extended 3% corridor be implemented).

For example, if the HMT process results in scheme costs of plus 4% but the LGPS process results in plus 1% then no mandatory changes would be required. However, if the HMT process results in plus 4% and the LGPS process results in plus 3.5% then changes would be mandatory, to bring costs back to the target cost.




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We believe this proposal provides a separate, appropriate, LGPS 'check' which most closely reflects LGPS costs and which can be justifiably implemented given the fundamental differences between the funded LGPS and unfunded public sector schemes.

**Question 7: Do you envisage any equalities impacts from the proposals to reform the cost control mechanism that the Government should take account of?**

The SAB does not envisage any particular equalities impacts beyond those already known to exist. However, the SAB believes that its proposal above for an LGPS specific process, where the SAB process forms the 'economic check', will more appropriately address any equalities impacts as it will better reflect the composition of the workforce, in particular the significant number of part time workers.




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