

Briefing

## Public service pension scheme consultations – will the LGPS eSCAPE the consequences?

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The Government has recently published two consultations for public service pension schemes which at first glance for some might seem to impact more on the unfunded schemes rather than the funded LGPS. The impact on the LGPS may be less than the unfunded schemes but they are still relevant.

The two consultations were issued at the same time as they are connected. Both consultations are open until 19 August 2021 and we would encourage all our clients to consider responding to them.

### Recap – the key drivers for the cost of pension scheme benefits

Pensions are long-term arrangements and if we want to know how much to pay today to provide a pension decades from now, we have to make a series of assumptions about how that pension might look when today's workforce comes to retire.

Given a particular pension scheme structure (in other words, the formula for calculating benefits), assumptions are needed to determine the costs:

- How long will that pension be paid for?
- How will the amount of pension change over the course of an individual's life both before and after retiring?
- How much money is needed today to provide that pension in the future?

This calculation can become rather complex, with assumptions covering life expectancies, population demographics, price inflation and salary growth key, but the assumption that converts all of this complexity into a final answer – "what is the cost today?" – is the discount rate.

### Consultation 1: the Cost Control Mechanism<sup>1</sup>

The first consultation looks at proposals for reforming the Cost Control Mechanism. This mechanism was introduced following a review of public sector pension provision carried out in 2011, and its impact was first felt following the 2016 round of scheme valuations carried out by the Government Actuary's Department ("GAD"). As we know, preliminary results revealed the flaws in the current cost control mechanism.

1. [www.gov.uk/government/consultations/public-service-pensions-cost-control-mechanism-consultation](https://www.gov.uk/government/consultations/public-service-pensions-cost-control-mechanism-consultation)

In the unfunded schemes, whilst the calculated cost of benefits to employers had increased, largely as result of changes in financial assumptions, particularly the discount rate, the Cost Control Mechanism determined that the cost of benefits had actually fallen and so required benefits to be improved.

So the message from the 2016 unfunded scheme valuations was – current levels of contributions are not sufficient to support existing pension promises. The Cost Management Mechanism then said – pensions are going to be smaller and paid for a shorter period of time than previously thought so we can afford to improve them. A classic case of the left hand not knowing what the right hand was doing...

This counter-intuitive outcome was a result of a number of factors, the most significant of which were that:

- The two key drivers of the reduction in the projected cost of benefits were lower than expected pay increases and a slowing of future improvements in life expectancy. The mechanism looked at the impact of these key drivers on both the cost of benefits accruing in the future and the impact on members' past service benefits. This meant the projected amount of pensions to be paid in future was now lower than initially assumed. So all else being equal less pension now projected to be paid means lower cost.
- The Cost Control Mechanism ignores changes in the discount rate used in the assessment of the cost of benefits. The 2016 scheme valuations of the unfunded schemes however saw a reduction in discount rate which net of other changes in assumptions and past experience then resulted in an increase in costs and higher employer contributions.

Under the proposals being put forward by the Government, based on recommendations from the Government Actuary, three aspects of the Mechanism would change:

1. It would only consider the impact of assumption changes on benefits earned after 2014, excluding final salary benefits from the calculation.
2. The threshold needed for the mechanism to be triggered would be widened from 2% of pay to 3%.
3. An economic check would be applied using the discount rate, such that the mechanism would only be triggered if it would still have done so after allowing for the economic cost of the change.

### How would these have affected the outcome in 2016?

It's not hard to see why these changes are being proposed – if the Cost Control Mechanism had included these features in 2016, the counter-intuitive outcome we now face would likely have been avoided.

Removing the impact of changes in assumptions on final salary benefits is a sensible proposal in our view. The Cost Control Mechanism was the price to be paid in retaining defined benefits in the public sector albeit there was a move from final salary to career average. If the cost of retaining defined benefits in career average form looked like it might increase more than originally anticipated then a mechanism to cap these costs was required. At a later stage a floor was added to the mechanism and the Cost Cap Mechanism was retitled the Cost Management Mechanism.

In addition, any changes to benefits as a result of the Cost Control Mechanism being triggered can only be to future (career average) benefits.

Based on the average results for the six largest unfunded schemes, the Government actuary reported that a 3% corridor would still have been triggered in 2016 due in part to the impact of pay growth experience on final salary benefits being included. However, removing final salary benefits from the equation would have brought the overall impact down to under 2%. If a discount rate economic 'sense check' had been available within the mechanism in 2016, a change in the level of benefits would not have been required.

While the review of the cost control mechanism did not include any specific results for the LGPS, it is likely that the change in outcome for 2016 would have been similar.

Our view is that the economic sense check makes more sense than widening the trigger corridor. Widening the trigger corridor will reduce the likelihood of having to change benefits and/or member contributions but then bigger changes will be required to get back on track. Thus the proposal, whilst reducing the likelihood of future changes, will increase the magnitude of any required changes.

Clearly, if all these reforms are introduced then it is far less likely that the mechanism will be triggered in future. The economic check in particular will mean that in future, benefits will only be changed if the affordability of the existing benefit package has changed.

### What is being consulted on?

The Government is asking for comments on all three proposals above, as well as the fundamental aim of this review, which is to “achieve the right balance of risk between scheme members and the Exchequer (and by extension the taxpayer)” and to create a more stable mechanism for employers over time.

### What is the impact on the LGPS?

The LGPS is of course quite different to the unfunded schemes in so many ways. We have

- Assets
- Triennial valuations (at least for now)
- Fund specific assumptions including discount rates
- Our own Cost Management Mechanism

So will the LGPS “eScape” the impact of the proposed changes to the Cost Management Mechanism?

In reality no – whilst we have our own mechanism it can’t be too different to the HMT one.

The key issue is that employer contributions in the LGPS are not set using the SCAPE discount rate but Fund specific and in some cases employer specific discount rates.

A slightly different but consistent approach would therefore be required for the LGPS reflecting changes in LGPS discount rates rather than the SCAPE rate. If not the LGPS could still continue to have the same sort of perverse outcomes we have seen under the current mechanism going forward.

So should we use some sort of average LGPS discount rate? This has many challenges not least that the discount rates adopted for the local actuarial valuations include a margin for prudence whereas we would expect that the cost control mechanism should be a best estimate basis. An alternative may be some sort of proxy for a best estimate return for the LGPS, which will reflect how LGPS assets are invested. A review of the overall asset allocation of the LGPS could be carried out in order to set such a best estimate return. Of course the asset allocation of individual funds could vary significantly and therefore it may be difficult to agree the most appropriate return to use.

Although discount rates in the LGPS are not based on the SCAPE rate, they are considered with reference to the SCAPE rate as it is used in carrying out some aspects of the Section 13 LGPS valuations. We also suspect that it is a factor when the Government Actuary sets his best estimate assumptions for other aspects of Section 13 valuations. We would therefore suggest that either the Government Actuary’s best estimate discount rate used for Section 13 purposes, or some LGPS average best estimate discount rate is used in the economic check for the LGPS.

## Consultation 2: the SCAPE discount rate methodology<sup>2</sup>

One of the most important assumptions for the Government's assessment of the cost of public sector pension schemes is the SCAPE discount rate which is used to set the contribution rates for the unfunded public sector schemes. For the LGPS, where contribution rates are set individually for each employer using a discount rate linked to expected long term returns from each Fund's assets, the SCAPE discount rate does not impact contributions directly as these are set by the Fund actuary. However, the SCAPE discount rate, and so the methodology which is the topic of this consultation, still matters:

- It is used in the LGPS Section 13 valuation to some extent.
- It is currently being considered for use in the economic check proposed as part of the changes to the cost control mechanism (see above).
- It is used to determine transfer values and various actuarial factors set by GAD in the LGPS.

In 2016 the SCAPE discount rate was set with reference to long-term projections for UK GDP growth. This is the subject of the second consultation now underway. This discount rate has been steadily falling since 2011. In 2011 it stood at 3.0% above CPI inflation, but was reduced to 2.8% in 2016 and then 2.4% in 2018.

The Government has proposed an alternative methodology and instead use what is known as the Social Time Preference Rate, ('STPR'), a rate used when appraising projects that involve spending money in the short term to deliver future welfare benefit. The SCAPE rate was in fact the STPR prior to the 2011 review.

### Long term GDP growth

In March 2020, the Office for Budget Responsibility published its latest economic outlook forecasts<sup>3</sup>, which the consultation notes could imply a discount rate of just 1.8% above CPI inflation if the same methodology is adopted for the 2020 unfunded scheme valuations.

The consultation makes it clear that this is not currently the case, and that a separate consultation will be carried out in due course to assess the **level** of the discount rate that will be adopted for the 2020 scheme valuations. However, it is worth noting that if the discount rate did reduce from 2.4% to 1.8%, all other things being equal, we expect the liabilities of funds assessed as part of the Section 13 valuation to typically increase by around 11% and for the likes of the Teachers' Pension Scheme, the required employer contribution rate could be getting on for double what it was before the 2016 valuation. It is perhaps no surprise that the Government is keen to carry out a review of the methodology.

### STPR

STPR is currently 3.5% above inflation, and has been since it was first introduced in 2003<sup>4</sup>. At first glance, this suggests that a discount rate based on this methodology could be substantially higher meaning an overall more positive outlook for the 2020 unfunded scheme valuations (and indeed standardised funding levels in the Section 13 valuations). However this may give rise to benefit improvements if used for the cost control mechanism economic check, all else being equal. However, the consultation proposes that if this is the methodology to be used then this rate is adjusted downwards, for two reasons:

- Standard STPR includes an element that represents the riskiness of the endeavour (and the returns generated by taking more risk). Given that public sector pensions are considered lower risk, removing this element would reduce STPR to 2.5% above CPI inflation.

2. <https://www.gov.uk/government/consultations/public-service-pensions-consultation-on-the-discount-rate-methodology>

3. [obr.uk/efo/economic-and-fiscal-outlook-march-2020/](https://obr.uk/efo/economic-and-fiscal-outlook-march-2020/)

4. [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/938046/The\\_Green\\_Book\\_2020.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938046/The_Green_Book_2020.pdf)

- STPR is appropriate for assessing projects over a period of up to 30 years, but a lower rate should be used for very long term projects, with the standard 3.5% reducing to 3.0% after 30 years and then to 2.5% after 75 years. The consultation does not illustrate exactly how this would affect the discount rate used to assess public sector pension costs, but it is reasonable to assume that it would reduce the basic 2.5% rate slightly given the long-term nature of pensions.

### Timing of future reviews

Alongside the methodology consultation, the Government proposes that the discount rate review will move to a new 4-yearly cycle that would coincide with the unfunded public sector pension scheme valuation dates.

This would avoid a repeat of the situation we saw in 2018 when the rate was unexpectedly revised (downwards) during the valuation process for the unfunded schemes, which led to an “unexpected” rise in pension costs – we are pretty sure the Chancellor at the time knew what the impact would be. It is also proposed that the Government would retain the ability to conduct out-of-cycle reviews if and when it suited them / circumstances changed.

### Why does this matter?

This proposal is introducing an option for setting the discount rate that could allow a much more flexible approach. No longer wedded to the OBR’s long-term GDP forecasts, if adopted the STPR appears to offer more room for qualitative arguments to influence the outcome. It could mean the discount rate used for the 2020 scheme valuations would be almost unchanged from the rate used in the 2016 valuations.

Alternatively, the next phase of the consultation process could result in a discount rate that does indeed follow OBR projections which could lead to a substantial impact on the 2020 scheme valuations. What this consultation appears to be offering is the option for flexibility of approach combined with a more predictable outcome.

It would seem a little odd to reverse the decision made just 10 years ago to link the SCAPE rate to GDP forecasts from the STPR approach. Logically the GDP approach does have more merit in that it better reflects what the nation can afford to spend. Perhaps a modified GDP approach is the way forward.

Finally, to link back to the Cost Control Mechanism, if the economic sense check is introduced to this process, as the Government proposes, then the discount rate methodology will be fundamental in determining the cost of benefits and the impact on any future benefit changes.

## Next steps

Following completion of this exercise, we expect to see a further consultation on the level at which the SCAPE discount rate should be set, and more on the Cost Control Mechanism and McCloud remedy. Once these points have been resolved the outcome of the 2020 scheme valuations will be easier to predict.

Both consultations are open until 19 August 2021 and we would encourage all Funds to consider responding to them.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

✉ [info@barnett-waddingham.co.uk](mailto:info@barnett-waddingham.co.uk)

☎ 0333 11 11 222

[www.barnett-waddingham.co.uk](http://www.barnett-waddingham.co.uk)

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