

Briefing

Cost management in the LGPS and the 2019 valuation outlook

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The 2019 formal valuations for the English and Welsh funds in the Local Government Pension Scheme (LGPS) are fast approaching and preparation is key. As if there wasn't enough to do already, the cost control mechanism has been triggered.

This mechanism was introduced following the Hutton review, with the aim of providing protection to taxpayers and employees against unexpected changes (expected to be increases) in pension costs.

Lord Hutton's recommendation was:

.....
"The Government, on behalf of the taxpayer, should set out a fixed cost ceiling: the proportion of pensionable pay that they will contribute, on average, to employees' pensions over the long term. If this is exceeded then there should be a consultation process to bring costs back within the ceiling, with an automatic default change if agreement cannot be reached."
.....

This would ensure that the anticipated risks of the rising cost of pensions would be shared fairly between employers and employees. What we ended up with though was not just a cost ceiling but also a floor so that if costs reduced then changes would be required to increase costs back to the fixed cost.

So 2016 was the first time the mechanism was utilised. Contrary to what was anticipated when these mechanisms were being built – at least by their architects – it was the floor that was breached rather than the ceiling.

As a result, changes will be needed to the design of the LGPS to actually improve benefits. This will return the total cost of the LGPS to the target rate of 19.5% p.a. of pay (split 13% employer and 6.5% employee contributions). So, the outcome of the cost management process has shown the cost of the Scheme has actually decreased since implementation in 2014. So how has this happened and what does it mean?

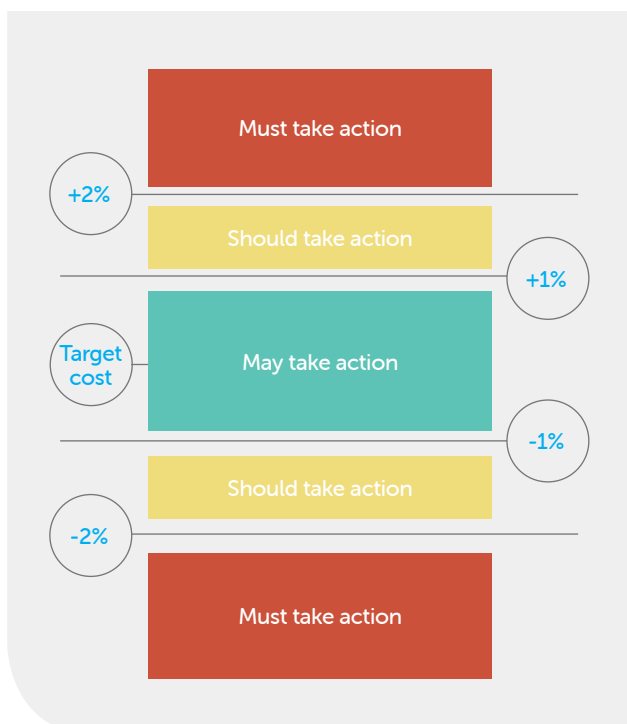
In this briefing note we explain the key reasons for the outcome of the cost management process and cover the likely changes to the LGPS set out in the consultation soon to be underway as we understand it. We discuss how this might affect administering authorities, employers and members. We also consider what administering authorities can do to prepare for the 2019 valuation as a result.

Cost management process outcome

As a reminder there are two cost control mechanisms in place for the LGPS. One is calculated by the Treasury (HMT) and the other is calculated by the Scheme Advisory Board (SAB). Below is a summary of the key differences:

- The SAB mechanism is tested first and gives an early warning. The HMT mechanism is then tested allowing for any changes proposed by SAB. HMT, however, has the final say!
- The HMT mechanism is the same across the public sector schemes but the SAB mechanism takes into account the additional features of the LGPS as a funded scheme.
- So, the SAB mechanism considers total future cost only whereas the HMT mechanism uses a model LGPS fund and considers both past and future service cost that fall to the employer.

In both cases, the mechanism is triggered if the absolute change in the cost of the Scheme is more than a pre-specified level. Under the SAB mechanism, the Scheme design may, or must, be changed to bring the total future service cost back to the target of 19.5% p.a. of pay. Under the HMT mechanism it is to bring the total employer cost back to 14.6% as follows:



The SAB have carried out their calculations as part of their 2016 Scheme valuation and assess the future service cost to be 19% p.a. of pay, so the cost has decreased by 0.5% p.a. since inception. GAD has suggested that the key reason for this decrease is a result of the latest projections of future life expectancy. Available evidence suggests that longevity improvements have slowed down since 2014 and so although future life expectancy continues to increase, it is increasing at a slower rate than previously assumed. This reduces the length of time that pensions will typically be paid for and lowers the expected cost by around 0.4% p.a.

There are other factors which have also resulted in a decrease in cost relating to early retirement assumptions and withdrawal assumptions, but these have a smaller effect.

The cost control mechanism only considers "member costs". These are the costs relating to changes in assumptions made to carry out valuations relating to the profile of the Scheme members; e.g. costs relating to how long members are expected to live for and draw their pension. Therefore, assumptions such as future expected levels of investment returns and levels of inflation are not included in the calculation, so have no impact on the cost management outcome.

So, after the reviews, the cost of the LGPS is now estimated to be lower than it was previously on both mechanisms, based on the assumptions used. This means benefit improvements are required to bring the total cost back to target. The SAB get to go first and the upcoming SAB consultation will consult on these proposed benefit changes as follows.

Recommendations

The following benefit changes have been proposed by the SAB so that, hopefully, the LGPS cost falls within the 2% corridor and does not then trigger the HMT cost cap mechanism:

- Removal of Tier 3 ill-health benefit with any eligible member receiving Tier 2 instead;
- Introduction of a minimum death in service benefit of £75,000 – this is per member, not per employment; and
- Enhanced early retirement factors for members active on 1 April 2019, applied to all service.

⋮ The net additional cost of these benefits is
⋮ estimated to be an increase of 0.5% p.a. of pay.

The review also includes some recommendations around changes to employee contribution rates. This involves a proposal to reduce employee contributions at the lowest salary bands to remove tax relief anomalies. The expected reduction to contribution yields, and therefore potential increases in employer contributions, is 0.8% p.a. of pay. This will vary by employer, depending on their employee profile, with employers where there are mainly lower paid workers being more significantly affected.

The communications from the LGA suggest that employer contributions could increase by up to 2% p.a. but, as mentioned above, this will vary by employer. The actual change in employer contributions will be more heavily driven by the assumptions used in the 2019 actuarial valuation by the local Fund actuary.

The SAB process must be carried out before the HMT cost management process can be completed. However, we understand that HMT will take into account these proposals by SAB, if they are accepted by the Government, when determining whether the cost floor has been breached in the HMT cost cap review.

It is important to note that if these changes are agreed the employee contribution rates would change with effect from 1 April 2019. Any changes to the employer rates would start from 1 April 2020 when new rates will be certified by the local Fund actuary as part of the 2019 formal valuation. Discussions are being held with software providers but it is important that payroll providers are ready to implement any changes as soon as they are confirmed.

We also understand that there could be some changes proposed to the revaluation of CARE benefits but we will cover this in a separate blog once we know more.

A further potential complication could however impact on this process. The recent McCloud judgement recently ruled that the transitional protections for older members built into the Judges' Pension Scheme when the scheme changed breached age discrimination rules (there was also a similar case in the Firefighters' Scheme). Whilst the transitional protections in the LGPS and the other public service schemes were slightly different, there is the possibility that they too could be deemed to have breached age discrimination rules. This would then mean that all the public service schemes would need to be amended and would most likely mean an improvement in benefits. Therefore, there is the possibility that the outcome of the cost management reviews of all public service schemes could be put on hold until this is resolved. This will clearly take some time and will not be resolved before 1 April 2019. We understand that ministers are considering the position and will make a decision very soon.

Perhaps, not unsurprisingly, a further recommendation is that the cost cap mechanism process is reviewed prior to the next review.

⋮ We will provide a further update, if
⋮ required, as the cost management
⋮ process progresses and any
⋮ proposed changes are agreed.

2019 valuation outlook

The 2019 valuation gives us the opportunity to review and monitor the assumptions we agreed with funds as part of the 2016 valuation. The key assumptions impacting the valuation are the assumed future investment return (or in actuarial terms, the discount rate), price inflation, longevity and, to a lesser extent, the levels of future salary increases (as this assumption only effects the ever diminishing proportion of pre-CARE benefits).

The Section 13 valuation commissioned by MHCLG resulted in an independent review of the 2016 local fund actuarial valuations for compliance, consistency, long term cost efficiency and solvency. Increased consistency of assumptions across funds was one of the recommendations made by GAD in their final report. However we still believe that they have misinterpreted their obligation to comment on inconsistencies or outliers, rather than lack of consistency.

However, although the Section 13 valuation considers consistency, there are good reasons why assumptions vary across funds. For example, different investment strategies lead to different assumed future returns and a fund's geographical region and membership profile has a significant impact on longevity assumptions. In addition, a fund's attitude to risk is factored into our discount rate model through a transparent and bespoke level of prudence.

Changes in assumptions will only be made if considered appropriate in light of experience and factors emerging since the 2016 valuation. There are no hard and fast rules. Although some of our assumptions are consistent across the funds we advise, we do not have a house view on assumptions. Instead, we discuss and agree appropriate assumptions with each fund so that they understand the level of risk being taken.

Having said that, typically we might expect the following changes for 2019:

- A reduction in the discount rate - markets have outperformed expectations over the last three years and future investment return expectations are likely to be lower, therefore placing a higher value on liabilities / future cost - as prices go up yields come down;

- Low salary growth to continue for longer, placing a lower value on liabilities (no impact on future cost);
- A small increase in the gap between the Retail Prices Index (RPI) and the Consumer Prices Index (CPI) placing a lower value on liabilities / future cost, as this reduces the future assumed inflationary increases applied to all benefits in the Scheme linked to CPI; and
- A reduction in longevity improvements placing a lower value on liabilities / future cost.

Even after allowing for recent market falls, assets have still outperformed expectations since 2016 and so funding levels have typically increased, assuming liabilities are valued on current market conditions and assumptions are set consistent with the 2016 approach.

With all else being equal, the proposed changes in benefits and potentially updated assumptions will increase primary contributions. Any improvement in funding level should reduce secondary (deficit) contributions, hopefully resulting in overall stability of total contribution rates. However, this will vary by employer depending on their membership profile and actual experience since 2016. Therefore, it may be useful to carry out approximate calculations for some employers to help engagement and avoid any nasty surprises. This will provide an early indication of any likely changes in contribution rates from 1 April 2020.

New employers commencing post 31 March 2019

There is a second reason why carrying out some indicative calculations is beneficial. As a result of any formal valuation review, there will always be a “cliff edge” as a result of a review and potential changes in assumptions at each valuation date. This will be a particular issue for employers who join a fund after 31 March 2019, but before the valuation assumptions and approach have been finalised.

The size of the problem will be different for different funds based on:

- The amount of employer work in each fund, particularly in terms of the number of new employers that are likely to join in this period and the related administrative work; and
- How much employer contributions will change by, and the need to budget for future costs. This will depend on how the assumptions may change relative to 2016.

It is therefore difficult to recommend a single approach that will be the optimal solution for all funds. The options are likely to be:

1. Don't change the approach until the assumptions have been agreed following the initial discussions meeting (around September 2019). For employers between 31 March 2019 and this time, calculations are carried out on the 2016 assumptions. This would mean either:
 - a. providing a contribution rate on the 2016 assumptions and apply this to 31 March 2020 and recalculate the contribution rate, assets and liabilities for consistency with the other employers on the 2019 assumptions once agreed;
 - b. setting contributions at a notional level, using the current level of the local authority/guarantor for outsourced employers and recalculating once the assumptions are known. However, this may not be appropriate for some employers where a bidder needs a good indication of the contribution rate to complete the tender.
2. Carry out calculations from a current date but consider a review of the assumptions used to be based on any likely changes to the 2019 valuation assumptions. This will provide an assessment that will be close to the 2019 valuation results for such employers, once the assumptions are finalised.

Option 1 results in less work and fees.

However, it may be less satisfactory from the new employer's view point. Option 2 requires some work to determine the assumptions ahead of the valuation (although this has other benefits through an early indication of results to help budgeting). But it will be more helpful in contract negotiations/assessing bids.

In both scenarios a bulk exercise can be done once the 2019 assumptions are agreed to calculate the accurate starting positions and appropriate contribution rates for each employer.

The agreed approach should be consistent across all employer work. Therefore, administering authorities should consider how any changes in approach would affect employers leaving a fund and the basis to apply for their cessation valuation.

This is an important issue and we strongly recommend that you give this consideration before 31 March 2019.

We will get in touch with you to discuss and agree an approach or please speak to your actuary if you have any concerns. We would also be happy to help administering authorities to communicate these changes to employers, members and committees in the form of bulletins, training sessions or one-to-one discussions.

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:

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