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Briefing note

# Proposed employer cost cap - latest consultation with response deadline of 2 January 2015

On the face of it, the cost of providing public sector pensions seems to never stop increasing, with arguably the majority of the risk of any additional cost falling on the taxpayer rather than the Scheme member. With Lord Hutton's help, the Government have tried to come up with a way of fairly sharing these risks between public service workers and the taxpayer to ensure public sector pensions remain sustainable and affordable. Their proposal is an employer cost cap.

> GAD published a draft report on 11 December 2014 with the recommended initial level of cap for England and Wales. The initial level of employer cost cap has been set at 14.6% of pensionable pay.

The proposed employer cost cap is fundamentally designed to track the cost of providing benefits and how this changes in between actuarial valuations.

The employer cost cap is calculated by the Government Actuary (GAD) who has collected data from all the LGPS funds in England and Wales to calculate a cost cap as an initial starting point which will be adjusted over time to track how the cost of providing benefits increases (or decreases). The employer cost cap for the LGPS in Scotland will be set using data from the 2014 fund valuations.

Various discussions have taken place over the past couple of years and even though the consultations on the governance regulations and the assumptions underlying the calculation of the employer cost cap have formally closed and been agreed with HM Treasury, the consultation has been reopened for a limited period from 12 December 2014 to 2 January 2015 to hear views on the draft report.

GAD published a draft report on 11 December 2014 with the recommended initial level of cap for England and Wales. The initial level of employer cost cap has been set at 14.6% of pensionable pay.

This report also importantly outlines how the initial overall target future cost of the Scheme has changed from 19.5% to 21.6% of pensionable payroll. 19.5% was the target initially agreed by GAD and influenced the design of LGPS 2014. This gave a notional employer contribution of 13.0% and an average Scheme member contribution of 6.5%. Their most recent assessment however has assessed the target future cost of the Scheme to be nearer 21.6% (with an employer contribution of 14.6%) for reasons explained below.

## What does the employer cost cap cover?

It is very important here to note that the employer cost cap is entirely notional. Initially it is the expected cost of benefits that will accrue between 2013 and 2016 using the agreed assumptions but will be in force over the three year period 2016 to 2019. It is therefore not directly comparable to the future service cost set out in 2013 valuation reports nor does it represent the total contribution rate required to fund benefits. This effectively means that there will be a difference between the actual employer contribution rate paid by employers and the rate that is controlled by the cap.

The recent consultation by GAD is based on the entire membership of the LGPS and they have made a number of assumptions to look at all funds on a single basis. The assumptions used in calculating the cost cap are outlined in GAD's report.

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> It is important to note that, at least initially, the cost cap is in relation to the accrual of future benefits only.

The cap is used for the purpose of measuring relative changes in the cost of the LGPS and will be reconsidered at each triennial actuarial valuation. This rate will be reviewed following the 1 April 2016 triennial valuation when GAD will produce another valuation report.

It is also important to note that, at least initially, the cost cap is in relation to the accrual of future benefits only.

The Scheme is assumed to be 100% funded on 31 March 2013 and assets will be tracked allowing for cashflows in and out the Scheme – employer contributions initially assumed to reflect the cost of new benefits accruing. The notional assets however are assumed to achieve a return equal to the underlying discount rate so essentially any surplus or deficit arising in future will not be down to investment returns – just experience due to inflation, mortality, changes in Scheme membership etc.

When the 31 March 2016 valuation is undertaken by GAD it is probable that it will reveal a surplus or deficit due to experience being different from assumed, i.e. members living longer than assumed, inflation being lower than assumed etc. It is required for this to be recognised in the next valuation report and it will also contribute to the employer cost cap calculation. For more details see below.

## Why has the employer cap changed from 13% to 14.6%?

GAD sets out in detail the reasons for the change in table 7.1 of their report. In short, the initial numbers were based on the 2010 valuation results and set in May 2012. Since then, there have been three main areas of change which have caused this value to increase. These are 1) the assumptions used to calculate the rate have changed as a result of the 2013 valuation, 2) the benefits valued have changed as a result of the way that the CARE benefits were revalued, and 3) the revised figure has also been amended for the new Directions [1] which change what can be included in the cost cap calculation.

The changes due to the Directions are the biggest contributor to the change in the proposed employer cost cap. The Directions require that no allowance should be made in the figures for members to make 50/50 elections and the amount of pension assumed to be commuted for a lump sum was decreased. Both of these changes have caused the employer cost to increase.

### The changes split between Scheme member and employer are as follows:

| | Previous figures | Revised figures |
|---|---|---|
| **Contribution rate required to cover expected cost of benefits accruing over implementation period (A)** | 19.5% | 21.3% |
| **Less average member contribution rate expected over implementation period (B)** | 6.5% | 6.7% |
| **Proposed employer cost cap (A-B)** | 13.0% | 14.6% |

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> Change in the member risks will impact on the headline proposed employer cost cap and therefore if the risk in relation to these issues increases cost, the cap will increase.

**The change in the three areas can be broken down as follows:**

**13.0%** → **1** Changes due to assumptions + 0.2% → **2** Changes due to benefits valued (CARE, Club transfers) + 0.7% → **3** Changes due to Directions + 0.8% = **14.6%**

**Please be aware that the figures in the GAD report have been rounded and therefore do not add up. We have just outlined their figures as reported.*

The average member contribution rate of 6.7% has also been amended for the Directions and removes the allowance for members to make 50/50 elections and therefore is slightly higher than the LGPS target member contribution rate of 6.5% of pensionable pay, which does make some allowance for this option.

## How will the cap change over time?

There have been concerns about how the cap will work in practice, with getting the balance between what risks directly relate to members and risks relating to the employer and what should affect the change in the cap (the cap mechanism). These risks are known as member costs and employer costs with employer costs including those due to technical or financial changes, such as changes to the discount rate or actuarial methodology or long term salary increases. Member costs include life expectancy changes and levels of commutation as well as the average age of new entrants. Only member risks will impact on the cap mechanism and in particular only member risks associated with active members. The report highlights mortality improvements as one of the key risks to an increasing cap.

It is the change in these member risks which will impact on the headline proposed employer cost cap and therefore if the risk in relation to these issues increases cost, the cap will increase.

## What does this mean?

This new process will have no impact until 31 March 2019, but it will depend on the findings of GAD's 2016 valuation. Even then, there will only be an impact if the total required employer contribution rate revealed in the report has changed by a 2% margin from the 14.6% headline rate outlined in the current report. This 2% margin is designed to deal with small cost changes and it will also allow for any deficit arising in the Scheme in the period 2013 to 2016 with the cost of funding any deficit being spread over a 15 year period.

Should the 2% margin be breached then the implication is that the costs to the taxpayer have increased more than is deemed fair and therefore there should be a consultation to allow the responsible authority, employer and members to agree how employer costs should be brought back to the level of the cap.

We would expect the first step to be a detailed analysis by the existing fund actuaries into the assumptions used by GAD in their calculations. These should be updated in line with the Scheme valuation assumptions and can be contested if they are deemed to be inappropriate.

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If you wish to respond to the consultation remember to do so by 2 January 2015 and get in touch with your usual Barnett Waddingham consultant if you have any queries.

If all parties are satisfied with the assumptions used then an adjustment may need to be made in order to bring costs back to the level of the cap. This could be done by a change in future benefit accrual, a change in member contributions or some other adjustment. We can assure you that any proposed changes to the LGPS would need to go through consultation and have to be agreed by the Treasury as well as meeting the requirements of section 22 of the Act [2].

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

[2] The Public Service Pensions Act 2013

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

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