

**DERBYSHIRE COUNTY COUNCIL**

**PENSIONS AND INVESTMENTS COMMITTEE**

**23 January 2019**

**Report of the Director of Finance & ICT**

**LOCAL GOVERNMENT PENSION SCHEME COST MANAGEMENT**

**1 Purpose of the Report**

To inform Members of anticipated changes to the Local Government Pension Scheme (LGPS) Regulations further to a review of the costs of public sector pension schemes by Her Majesty's Treasury (HMT).

**2 Information and Analysis**

**2.1 Public Service Pensions Cost Cap Mechanism**

A cost cap mechanism was introduced as part of the Public Service Pensions Act 2013 which is aimed at ensuring that public service pension schemes remain affordable and sustainable.

Under the mechanism, a fixed floor and fixed ceiling of contribution levels is set. If the costs of the scheme breach the floor or exceed the ceiling, action is taken to bring costs back in line with a target cost via a review of benefits and/or member contribution changes.

Cost management for the public service pension schemes is currently taking place under HMT directions. In September 2018, HMT announced that early indications in some schemes showed that the cost cap floor had been breached with the following information helping to explain the fall:

- A reduction by the Office for Budget Responsibility in its forecasts of short term pay growth and a change in the period over which these forecasts apply, meaning that accrued final salary pensions are now expected to be less costly; and
- The latest population projections from the Office for National Statistics show forecasts of future life expectancy have reduced, meaning that pensions will typically be paid for a shorter period than previously expected.

In some of the unfunded public service schemes, including the Police, Fire, Teachers' and NHS schemes, indicative outcomes have seen breaches of the cost cap floor requiring benefit improvements in excess of 3% of payroll.

## **2.2 LGPS Cost Cap Mechanism**

The LGPS in England and Wales has two mechanisms to assess the costs of the scheme:

- An Employer Cost Cap mechanism (ECC), operated by HM Treasury on advice from the Government Actuary's Department (GAD), which is the mechanism formally required by the Public Service Pensions Act 2013 in common with the other public service schemes; and
- A Future Service Cost mechanism (FSC), operated by the Local Government Pension Scheme Advisory Board (SAB), on advice from (GAD) and to the satisfaction of the Ministry of Housing, Communities and Local Government (MHCLG).

The cost cap process is designed to control changes in "member costs" which are those costs relating to the profile of scheme members such as expectations about life expectancy, growth in salaries or career paths. Changes to financial or technical assumptions such as the discount rate or actuarial methodology are defined as "employer costs" and are not captured by the cost cap process.

The FSC mechanism was introduced to reflect the specifics of the LGPS scheme (e.g. the LGPS 50/50 option which is unique in the public service pension schemes). There are a number of differences between the two processes, which will mean that the figures calculated through the ECC process are unlikely to match the figures calculated through the FSC process.

## **2.3 Target Costs**

The SAB's FSC cost control mechanism is based on a target future cost of the scheme set at 19.5% of pensionable payroll (total of employer and member contributions at a 2:1 ratio, 13% relating to employers' contributions and 6.5% relating to members' contributions). The target cost for the HMT ECC process is 14.6% of employer contributions alone.

The cost cap mechanisms are both concerned with calculating the cost of providing benefits that have been accrued since the career average reforms took effect in April 2014. The total employer contributions targeted of 13% for the FSC and 14.6% for the ECC are therefore notional figures, and most employers' individual contribution rates are likely to be different to these notional rates.

The SAB cost management process is completed prior to finalisation of the HMT cost cap calculation. The statutory HMT employer cost cap takes precedence over the cost controls overseen by the SAB, however, if the government accepts the SAB's recommendations for changes to the scheme,

the statutory ECC will be adjusted to take the new scheme designs into account.

Any changes to the scheme agreed under the cost cap process will be determined nationally and implemented locally by individual funds.

## **2.4 Triggers**

There are some differences between the mechanisms in how the changes to the scheme are triggered, but under both processes a movement of 2% or more in either direction from the target requires action to bring costs back to the target cost by either:

- Changes to scheme benefits for future accruals; or
- Changes to the level of member contributions.

Changes to the scheme under the ECC process are only triggered on a movement of 2% or more from the target but the FSC process is designed to take a more gradual approach to the trend in costs and adheres to the following triggers:

- A movement of between 0% and 1% from the target in either direction *may* result in agreed recommendations for action to move back to the target.
- A movement of between 1% and 2% from the target in either direction *should* result in agreed recommendations for action to move back to the target.
- A movement of 2% or more from the target in either direction *must* result in agreed recommendations for actions to move back to the target.

## **2.5 The SAB Review**

The SAB has determined a total scheme future service cost of 19% of pensionable payroll under the FSC cost management process. As the target for the process is 19.5%, SAB agreed to consider recommendations to return the total cost back to the target.

To identify how this might be achieved, a SAB sub group was asked to consider a package of benefit improvements sufficient to return the total cost back to 19.5%. The SAB agreed that options for changes to benefits should be limited to: Third Tier Ill Health; Lump Sum Death Grants; Early Retirement and Commutation.

Further to the sub-group's deliberations, the following package of benefit improvements and employee contribution reductions were submitted by the SAB to the Secretary of State on 16th November:

- a) Removal of Tier 3 of Ill Health;
- b) A minimum lump sum death in service benefit of £75,000 per member;

c) Enhanced early retirement factors for all members who are active on 1st April 2019 (initially this was restricted to final salary membership only but following legal advice the recommendation was changed to include all service of active members on 1<sup>st</sup> April 2019, “within the same cost envelope”;

d) Removal of contribution bands from regulations, to be replaced by reference to guidance; and

e) Introduction of the employee contribution bands shown below for 2019-20.

Band	Pensionable Pay from £	Pensionable Pay to £	Contribution rate
1	0	12,850	2.75%
2	12,851	22,500	4.4%
3	22,501	36,500	6.5%
4	36,501	53,500	6.8%
5	53,501	64,600	8.5%
6	64,601	91,500	9.9%
7	91,501	107,700	10.5%
8	107,701	161,500	11.4%
9	161,501		12.5%

## 2.6 Cost Cap Next Steps

It is anticipated that consultation on these proposals will be published in late January/early February 2019 with a view to the new regulations taking effect from 1st April 2019.

The SAB has identified that implementation of revised regulations from 1 April 2019 will provide a significant challenge for Administering Authorities and has proposed to HMT and MHCLG that implementation of any changes is delayed, however, indications are that the implementation date is unlikely to be changed. The SAB has, therefore, “strongly suggested” to MHCLG that:

- The consultation be as short as possible; and
- A letter of comfort is issued as soon as is legally possible to allow administering authorities and software providers to anticipate the changes to regulations and employers to implement new contribution rates.

The Pension Fund Team will ensure that the Fund’s employing authorities are made aware of and kept up to date with the potential changes, particularly those relating to ill-health and early retirement so that any decisions for processes under consideration may be made with awareness of the potential changes. The Team will also work with employers to seek their assistance in cascading information to their scheme members.

The HMT ECC process will be completed once the outcome of the SAB proposals and subsequent consultation is known.

## **2.7 Timing of Scheme Valuations**

LGPS fund valuations, used to determine local employer contributions, currently take place on a triennial basis and the LGPS national scheme valuation, used to test the employer cost cap mechanism, was originally aligned with the LGPS local valuation cycle. However, the other major public service schemes undertake quadrennial valuations, with the next one due in 2020. HMT wants to bring the LGPS national scheme valuation onto the same quadrennial cycle as the other public service schemes. Discussions are ongoing regarding the implications of such a move for local fund valuations.

The Government Actuary is going to review the cost cap mechanism to check whether it is working as intended and delivering the government's objectives before the next round of quadrennial valuations.

## **3 Financial Considerations**

The combined package of recommended benefit improvements and proposed reductions in employee contributions is estimated to increase average employer future service rates by **0.9%** of payroll, all other things being equal. However, all other things are not equal and individual employer rates from 1<sup>st</sup> April 2020 will be determined by the 31<sup>st</sup> March 2019 local funding valuations which are based on individual fund and employer experience. Local funding valuations also take into consideration benefits payable in respect of pre-April 2014 service.

## **4 Other Considerations**

In preparing this report the relevance of the following further factors have been considered: legal and human rights, human resources, equality and diversity, health, environmental, transport, property, and prevention of crime and disorder.

## **5 Officer's Recommendation**

That Members note the contents of the report.

PETER HANDFORD

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