

## **COST MANAGEMENT, BENEFIT DESIGN AND ADMINISTRATION COMMITTEE**

**7<sup>th</sup> November 2017**

### **Item 3 Paper F : SAB Cost Control Mechanism**

There are a number of decisions that the Board will need to make on financial and demographic assumptions to enable GAD to complete work on assessing the employer cost cap for the purposes of the Board's cost management arrangement. To assist in this process and to enable the Investment, Governance and Engagement committee to make recommendations to the Board, the committee's Chair and Secretary met with GAD on the 27<sup>th</sup> October. The following issues were discussed.

#### **SCAPE rate**

The initial employer cost cap of 14.6% was based on the SCAPE rate of 3%. However, a change in March 2016 to 2.8% resulted in the scheme's employer cost cap being revised to 15.3%. This will disturb the scheme's employer/employee 2:1 ratio as prescribed in the scheme's regulations. However, adopting the lower SCAPE rate at this stage does not necessarily imply where any changes in cost may be borne.

The question for the committee is whether the recommendation should be for the Board to retain the former SCAPE rate of 3.0% or follow the change to 2.8% and any future changes in the rate. To assess the extent to which the change to 2.8% was reflected at the 2016 valuation, GAD undertook to provide the committee with the relevant data. GAD have indicated that the local discount rates, net of CPI, fell by an average of just under 0.2% on average between 2013 and 2016. This is broadly in keeping with the change in SCAPE rate.

#### **Post retirement mortality improvements**

HM Treasury's Directions are based on current ONS projections, the most recent published on 26<sup>th</sup> October. According to ONS, actual life expectancy has increased less than expected since mid-2014. The long term assumption that annual rates of improvement will converge to 1.2% for most ages in the 25<sup>th</sup> year of projections remains unchanged.

However, scheme costs are based on the CMI process adopted by local fund actuaries. Assumptions on the long term improvements in mortality adopted by the four actuarial firms at the 2016 valuation are set out below :-

**Aon Hewitt – CMI 2014 model (1.5% pa improvement)**  
**Barnett Waddingham – CMI 2015 model (1.5% pa improvement)**

**Hymans Robertson – CMI 2013 model (1.25% pa improvement)  
 Mercers – CMI 2015 model (1.75% pa improvement (males); 1.5% pa improvement (females)).**

Although the long term improvement rate for ONS (1.2%) is lower than the rates adopted above, that does not imply that the ONS projections will result in lower life expectancies than the CMI projections referred to above, because the short and medium term rates of improvement are also important. GAD is analysing the impact of the latest ONS projections.

Note that the SAB target cost of 19.5% and the initial employer cost cap under the HMT process were both based on ONS mortality projections.

**Commutation**

SAB has been minded in the past to assume that members commute 65% of the maximum allowable amount of their pension in to lump sum (equivalent to 23.2% of pension commuted).

HMT Directions specify the assumption that scheme members will surrender 15% of their pension for a lump sum. This contrast with the data shown below provided by GAD :-

CAT	Gender	Number of members	Initial pension amount	Proportion commuted
Ill Health	F	824	2,468,395	26.1%
Ill Health	M	409	1,724,065	25.6%
Normal Health	F	12,422	13,724,410	22.7%
Normal Health	M	8,404	14,370,133	24.4%
Total / Average		<b>22,059</b>	<b>32,287,003</b>	<b>23.9%</b>

- 1) The data sample is relatively small so may not be representative in itself (approx. 20,000 in the sample, vs 170,000 total retirements in the period).
- 2) It is potentially an atypical group (post-2008 joiners retiring now might not be the same as all post-2008 joiners, in particular they're going to have smaller LGPS pensions at retirement than the general post-2008 group).

The question for the committee is whether the 15% set by Treasury's Directions is out of step with the assumptions adopted by local fund actuaries set out below and on which basis contribution rates were determined.

**Mercers**

It has been assumed that, on average, 50% of retiring members will take the maximum tax-free cash available at retirement and 50% will take a 3/80ths cash sum

(the standard for pre April 2008 service). Members have the option to commute part of their pension at retirement in return for a lump sum at a rate of £12 cash for each £1 per annum of pension given up.

### **Hymans Robertson**

50% of future retirements elect to exchange pension for additional tax free cash up to HMRC limits for service to 1 April 2008 (equivalent 75% for service from 1 April 2008).

### **Barnett Waddingham**

Members will commute pension at retirement to provide a lump sum of 50% of the maximum allowed under HMRC rules and this will be at a rate of £12 lump sum for £1 of pension.

### **Aon Hewitt**

Each member is assumed to surrender pension on payment, such that the total cash received is 80% of the permitted maximum.

### **50/50 option**

There are a number of questions relating to the 50/50 option that are covered in a separate agenda paper (Item 4 Paper B). It is important to note that the scheme's initial costing of 19.5% was based on an assumption imposed by Treasury that 10% of members earning less than £21k would opt into the 50/50 arrangement with a resultant saving of about 0.5% of paybill. However, experience has shown that the actual take up rate has been less than 1% which results on a material cost pressure on the Board's cost management arrangement.

The questions for the committee, as set in Paper B, are as follows :-

**“That the committee considers the findings of the survey summarised above, considers next steps and agrees action points for consideration by SAB on the 16<sup>th</sup> November 2017 in two areas: communication and costing.**

**Firstly, to consider a recommendation to the SAB of a focussed communication exercise to increase awareness of the 50/50 scheme, in particular to those considering opting out of the scheme.**

**To consider a recommendation regarding the treatment of 50/50 for the purpose of the Scheme's cost management process:**

**Option 1 – stick with HMT's assumption**

**Option 2 – follow the 2016 assumption of local fund actuaries**

**Option 3 – adopt a SAB assumption between 1 & 2”**

In addition, the committee will need to consider whether to revise the target initial cost of 19.5% to allow for the cost, that is, the savings that have not accrued due to the lower than assumed take up rate, to be recognised through the Board's cost control mechanism.

### **Club transfers**

In November 2016, the then Chair of the committee wrote to DCLG Ministers requesting that the scheme should leave the club transfer scheme given that it was not part of the initial scheme design on which the initial 19.5% cost was based and was imposed by HM Treasury to achieve consistency across the major public service pensions schemes. This imposition led to an increase in scheme costs of about 0.3% of paybill (now 0.2% based on the latest available data). In his reply, Marcus Jones rejected the committee's proposal and indicated that further consideration should await the impact of the Board's cost control mechanism.

The question for the committee is whether the costs associated with belonging to the transfer club should not feature as part of the Board's assumptions or alternatively, that they are recognised but leaving open the possibility of the Board repeating its request for the scheme to leave the transfer club.

### **Revaluation**

The November 2016 letter to DCLG Ministers also included a request to revert back to the original way in which scheme regulations governed the revaluation of annual pension accounts in the new CARE scheme. As with the transfer club, the more costly arrangement amounting to 0.4% of paybill, was imposed by HM Treasury and therefore outside of the initial target cost of 19.5%.

As above, the question for the committee is whether the cost pressure of 0.4% should form part of the Board's cost control mechanism.

### **Timing**

Regulation 116 of the Local Government Pension Scheme Regulations 2013 was drafted on the basis that any scheme changes agreed following a recommendation made by the Board would be introduced in time for local fund actuaries to reflect the cost savings (or benefits) at the next subsequent triennial valuation. For the current cost control exercise, the expectation is that any necessary changes would be on the statute book by 1<sup>st</sup> April 2019.

Regulation 116(9) requires any report from the Board, including recommendations, to be submitted to DCLG Ministers within 23 months from the date the scheme cost assessment is obtained. On the current timescale and assuming that the Board decides all outstanding questions when it meets on the 16<sup>th</sup> November, it is doubtful whether the scheme cost assessment would be available before March 2018. On that basis it is unlikely that there would be sufficient time for DCLG to consider the Board's report, for a normal 12 week statutory consultation to be undertaken and for the regulations to be in place in time for 2019 valuation.

The committee should therefore be mindful that as an alternative to amending regulations being in place by 1<sup>st</sup> April 2019, steps could be taken to ensure that there is sufficient clarity in the public domain, for example, a statutory consultation or Ministerial Statement, to give local fund actuaries the assurance they need that the agreed changes will become statute at some point in the future.

**Bob Holloway**  
**Pensions Secretary**  
**Scheme Advisory Board**  
**6<sup>th</sup> November 2017**