

# Cost Management, Benefit Design and Administration Committee

**Meeting – 12<sup>th</sup> April 2021**

**Item 5 Paper B**

## Issue

**To consider whether to recommend to the Board that the methodology and assumptions adopted by SAB in the 2016 cost cap valuation should be retained.**

## Background

1. Under the Board's 2016 cost cap arrangement (separate from the HM Treasury process) the overall scheme cost was calculated to be 19.0% against the target overall scheme cost of 19.5% set out in scheme regulations, resulting in a potential 0.5% improvement in scheme benefits. With a cost saving of between 0% and 1% below the scheme's target cost of 19.5% the Board was permitted to exercise its discretion to recommend scheme improvements worth 0.5% of pensionable payroll to MHCLG Ministers.
2. On the 30<sup>th</sup> January 2019 the Chief Secretary to the Treasury announced in a Written Ministerial Statement that the HM Treasury cost cap arrangement would be suspended in the light of the McCloud judgment. The Board subsequently decided to pause its own cost management process while reserving the right to resubmit the same or a revised package to MHCLG Ministers at a future date.
3. On the 16<sup>th</sup> July 2020 the government published its proposals to rectify age discrimination in the public service pension schemes and confirmed that the HM Treasury cost cap arrangement would be unpause. The Board subsequently decided to unpause its own cost management arrangement but not to take any action until updated HM Treasury Directions were made available, enabling the cost of the McCloud remedy to be calculated.
4. The draft Public Service Pensions (Valuations and Employer Cost Cap) (Amendment) Directions 2021 have now been shared. The Government Actuary's Department has subsequently calculated that the cost of the McCloud remedy under HM Treasury's cost cap arrangement for the LGPS in England and Wales equates to 1.7% of payroll.

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5. A representative from GAD will be attending the committee's meeting on the 12<sup>th</sup> April 2021 to explain the revised HM Treasury directions, and how McCloud costs have been included.
6. The potential impact of McCloud together with the options regarding if and how to take those costs into account will be discussed at the May meeting of the Board. In order to inform those discussions, the methodology and assumptions of the Board process excluding any impact of McCloud must first be revisited to provide the baseline for those considerations.

## Consideration

7. To assist the committee in their deliberations Annex A to this paper includes at Part A a summary of how the scheme specific assumptions recommended by the committee and agreed by the Board were developed; at Part B a summary of GAD's calculation of the scheme's overall scheme cost based on these and other assumptions; and at Part C details of how the package of benefit improvements to bring the scheme's overall target cost back to 19.5% was agreed.
8. Colin Wilson, the Board's actuarial adviser, was also asked to reconsider the recommendations he made on methodology and assumptions to the Board on the 2<sup>nd</sup> October 2018. It should be noted that in revisiting the results of the HMT process to take account of McCloud no changes to assumptions have been made for the passage of time while that process was paused.
9. The GAD representative will present the outcome of the Board's actuarial advisor's consideration of his 2018 advice at the committee.

**Recommendation – that, subject to any contrary advice from the Board's actuarial advisor, the committee agrees a recommendation of no change to the methodology and assumptions (excluding any impact of McCloud).**

## Next Steps

10. As agreed at the Board meeting on the 8<sup>th</sup> February 2021, and subject to the recommendation above, discussions will take place with GAD to assess the options for incorporating McCloud costs into the Board process. These discussions will result in a number of options and outcomes to present to the Board on the 10<sup>th</sup> May.

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## Annex A

### Part A: Road Map of Assumptions

This is a summary of how the seven scheme specific assumptions recommended by the committee and agreed by the Board were developed, with key decision points and dates.

#### 1. Discount rate

##### **7 November 2017 – CMBDA committee**

The majority view of the committee was that the Board process should keep pace with changes in the SCAPE discount rate and for the 2016 scheme cost assessment, assume the rate of 2.8% above CPI as set out in Treasury Directions. A small minority view suggested that probable further increases in interest rate would justify retaining the 3% rate on which the initial scheme cost of 19.5% was based.

**Recommendation – that the Board considers both proposals but bearing in mind the majority view that the current SCAPE rate of 2.8% should apply.**

At the Board meeting on **16 November 2017** the Chair was given delegated authority to decide based on advice from the Board's actuarial adviser. On **17 December 2017**, the Board's actuarial adviser, Colin Wilson (GAD) recommended adopting the lower SCAPE rate of 2.8% above inflation.

##### **29 January 2018 – CMBDA committee**

Following Colin Wilson's advice, committee recommended that the Board arrangement adopt the lower SCAPE rate of 2.8% above inflation and follow any other future changes in the official rate. On 28 February 2018 the Board Chair sent a letter to GAD confirming his agreement to the committee's recommendation.

**6 September 2018 – HM Treasury** published amending Directions announcing a change in the SCAPE discount rate from 2.8% to 2.4%. Following this, on **2 October 2018** the Board's actuarial adviser, Colin Wilson (GAD) again recommended that the rate of 2.8% agreed earlier by the Board should be retained.

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## **2. Post retirement mortality improvements**

### **7 November 2017 – CMBDA committee**

The consensus view of the committee was that the Board process should continue to be based on ONS mortality data (as per HM Treasury directions).

**Recommendation – that the Board agrees that the Board process should be based on ONS data in measuring future improvements in mortality**

**16 November 2017 – Board agreed with the committee's recommendation.**

## **3. Commutation**

### **7 November 2017 – CMBDA committee**

The consensus view of the committee was that the 15% rate prescribed in Treasury Directions was inappropriate for the Board process given the contradictory data on commutation obtained from GAD and local fund actuaries. On balance, it was agreed that the initial assumption adopted by the Board, that is, members commute 65% of the maximum allowable amount of their pension in to lump sum (equivalent to 23.2% of pension commuted) should continue to apply. This equated to a scheme wide rate of 23.9% at the 2016 valuation.

**Recommendation – that the Board agrees to adopt a commutation rate of 23.2%.**

**16 November 2017 – Board agreed with the committee's recommendation.**

## **4. 50/50 option**

### **7 November 2017 – CMBDA committee**

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

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## Option 3 – adopt a Board assumption between 1 & 2

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

The committee rejected options 1 and 2 as being unrealistic and inconsistent with both anecdotal evidence on the 50/50 take up rate or the findings of the recent survey. The consensus was that Option 3 was the only viable way forward, whilst recognising that there is no robust and reliable evidence to confirm what the actual take-up rate is across the scheme as a whole.

**Recommendation – that the Board agreed that Option 3 should be adopted and consider what an appropriate take up rate would be. In reaching a decision the Board should bear in mind advice from their GAD adviser and the committee's related recommendation that work should be undertaken to increase the awareness of the 50/50 option and, in particular, to quantify the number of scheme opt-outs given that this is the main cohort at which the 50/50 option is aimed. The Board may therefore wish to consider whether an increase in the take up rate would follow from this exercise and, in turn, whether the agreed rate should be higher than the anecdotal and survey evidence suggests.**

At the Board meeting on **16 November 2017** the Chair was given delegated authority to decide based on advice from Board's actuarial adviser. On **17 December 2017** the Board's actuarial adviser, Colin Wilson (GAD) recommended an assumption around 4% of new joiners and 4-5% of existing members (=1/3 \* 50% \* 25-30% of existing membership). This would lead to a recommended assumption for the cost management process of 4-5% for overall take-up of the 50/50 option.

## **29 January 2018 – CMBDA committee**

Recommendation to adopt the assumption that 10% of those members earning less than £21k will opt into the 50/50 section given that in real terms this would be equivalent to an increase from 1% to 4%-5% across the scheme as a whole including members earning over £21k.

On **28 February 2018** the Board Chair sent a letter to GAD confirming his agreement to the committee's recommendation.

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## 5. Club transfers

### **7 November 2017 – CMBDA committee**

The committee agreed that the strain cost of belonging to the public sector transfer club should be allowed to proceed in the Board process whilst recognising that if cost savings do need to be found, the option of going back to MHCLG Ministers with the view of leaving the transfer club would be open to the Board.

**Recommendation – that the Board agreed to include the cost of being a member of the transfer club in the Board process.**

**16 November 2017 – Board agreed with the committee's recommendation.**

**At the Board meeting on 10<sup>th</sup> October 2018 the cost of Club Transfers was removed.**

## 6. Revaluation

### **7 November 2017 – CMBDA committee**

The committee agreed that the strain cost associated with first year revaluation should be allowed to proceed in the Board process whilst recognising that if cost savings do need to be found, the option of going back to MHCLG Ministers with the view of reverting back to the preferred methodology would be open to the Board.

**Recommendation – that the Board agreed to include the cost of the current revaluation provisions in the Board process.**

**16 November 2017 – Board agreed with the committee's recommendation.**

**At the Board meeting on 10<sup>th</sup> October 2018 the cost of first year revaluation was removed**

## 7. Pay increase assumption

### **16 November 2017 - Board**

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The question considered by the Board was whether to retain the Board's existing assumption of 1.5% above CPI or adopt the Treasury's rate of 2.75% above CPI for the unfunded schemes. It is worth noting that Treasury's long term assumption for pay increases is closely linked to long term economic forecasts, that is, the SCAPE discount rate.

In local valuations, salary increases net of CPI amounted to 1% with a nominal rate (which included CPI) of 3.1%. Equivalent assumptions used by GAD based on cautious market conditions were 2.1% and 3.9%.

The real and nominal salary increases according to local valuation assumptions and GAD's own research were closer to the earlier assumption of 1.5% above CPI adopted by the Board than the 2.75% above CPI adopted by Treasury under their cost management process.

## **Conclusion - that the general pay increase assumption of 1.5% above inflation will be adopted.**

Chair given delegated authority to decide based on advice from Board's actuarial adviser.

**On 17 December 2017 the Board's actuarial adviser, Colin Wilson (GAD)** recommended continuing with the approach previously adopted rather than introducing changes.

## **29 January 2018 – CMBDA committee**

Recommendation that the general pay increase assumption of 1.5% above inflation should be adopted.

On **28 February 2018** the Board Chair sent a letter to GAD confirming his agreement to the committee's recommendation.

## **Summary of agreed scheme specific assumptions**

Discount Rate	2.8% above inflation
Mortality	Based on ONS data
Commutation	23.2%
50/50	10% of members earning less than £25k
Club transfers	Costs to be included

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Revaluation	Cost of current process to be included
Pay increase	1.5% above inflation

## **Part B – Valuation Calculation**

This is a summary of GAD's calculation of the scheme's overall cost based on the relevant assumptions. In May 2018 a draft letter from GAD was sent to MHCLG setting out the provisional results of the 2016 valuation. The overall cost of the scheme was assessed at 19.8% compared to the target overall cost of 19.5%:-

### **Indicative costings**

Target overall cost	19.5%
<b>Changes due to benefits valued</b>	
Inclusion of additional year's revaluation in CARE accounts	+0.4
Allowance from strain from club transfers	+0.2
Exclusion of transitional protection of the "rule of 85"	-0.1
Cost of accrual greater than contributions	+0.3
<b>Changes due to assumptions</b>	
Change in discount rate from CPI +3.0% to +2.8%	+1.0
Other changes in assumptions	-1.4
<b>Changes due to data/experience</b>	
Change in average age	-0.1
Experience gains/losses	+0.1
Other	-0.1
Overall Cost of the Scheme	19.8%

### **Final costings**

As a result of discussions between the Board and MHCLG, in conjunction with GAD, a revised and final valuation was sent to MHCLG in October 2018 which assessed the overall cost of the scheme at 19.0%. Changes from the provisional assessment in May 2018 are shown in italic text in the table below and result from the following decisions taken by the Board in October 2018.

After MHCLG indicated that a recommendation to remove the additional revaluation applied to the scheme by HMT following the agreement of the scheme design and the setting of the 19.5% target would receive a favourable response the scheme cost was reduced by 0.4%.

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Following discussions with the Board Chair, Vice Chair and Secretary, the Board's Actuarial advisor recommended that the cost of club transfers (0.2%) was removed and the prospective cost of accrual above contributions (0.3%) was not included.

The above elements when rounded account for the total cost difference of 0.8%

Target overall cost	19.5%
<b>Changes due to benefits valued</b>	
<i>Inclusion of additional year's revaluation in CARE accounts</i>	0.0
<i>Allowance from strain from club transfers</i>	0.0
Exclusion of transitional protection of the "rule of 85"	-0.1
<i>Cost of accrual greater than contributions</i>	0.0
<b>Changes due to assumptions</b>	
Change in discount rate from CPI +3.0% to +2.8%	+1.0
Other changes in assumptions	-1.4
<b>Changes due to data/experience</b>	
Change in average age	-0.1
Experience gains/losses	+0.1
<i>Other</i>	0.0
Overall Cost of the Scheme	19.0%

## Part C – Board Cost Cap Proposal

This section details how the package of benefit improvements to bring the scheme's overall target cost back to 19.5% was agreed.

On the 10<sup>th</sup> October 2018 the Board agreed to establish a technical working group from within its membership to agree a package of recommendations to restore the overall cost of the scheme from 19.0% to the target overall scheme cost of 19.5%.

The initial proposal for the working group to consider included:-

- Removal of Tier 3 ill health benefits (with all new events receiving at least Tier 2) plus revisions to some or all of the following;
- Increased lump sum commutation for post 2014 benefits

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- Reduced early retirements factors for 2008 scheme benefits
- Increased lump sum life cover for active members

The recommendations made by the technical working group were considered by the Board when it met on the 21<sup>st</sup> December 2018. The main recommendations to bring the overall scheme cost of 19.0% back to the overall target scheme cost of 19.5% included:-

## **III health**

That the removal of the third tier of ill health (costed on the assumption that tier 2 would be awarded in these cases) should be recommended.

## **Death in service**

That due to the high cost and low perceived benefit a small improvement to the existing lump sum death in service benefit (3 x pay) for all members was not appropriate for recommendation. However, a targeted improvement via the introduction of a minimum payment of £75,000 (per member) was appropriate.

## **Early Retirement**

A number of options on enhanced early retirement factors were considered including limiting the enhancements to various groups of members or sections of the scheme. Following legal opinion on the potential for challenge to a number of options on the grounds of age discrimination two options were put forward to the Board; application of equal enhancement to all members in all sections of the scheme and targeted enhancements to final salary section benefits.

## **Commutation**

Given the potential cost of a membership wide increase together with the potential for confusion and administrative overhead of limiting commutation improvements to a particular group of members or section of the scheme this option was not considered to be a priority and therefore no recommendations were made to the Board in this area.

## **Member Contributions**

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In addition, it was further proposed that the Board considered including targeted reductions to employee contribution rates, in particular to reflect the large number of low paid part time members with earnings near or below the lower tax threshold and therefore not benefiting from tax relief at source.

In a letter to the Local Government Minister dated 16 November 2018 the Chair of the Board sought approval for the following recommendations to achieve the overall target scheme cost of 19.5%:-

- To restore the revaluation of active scheme benefits to that agreed between employers and employees in 2012; that being for revaluation to apply to pension accrued to the end of the previous scheme year
- To remove the third tier within ill health retirement
- To introduce a minimum death in service lump sum amount for each active member of £75,000
- To introduce enhanced early retirement factors for members in service as at 1<sup>st</sup> April 2019 in respect of final salary linked service only
- A package of member contribution changes to reflect changes to the higher rate tax band and the lack of tax relief for low paid members

A further letter to the Minister was sent on the 7<sup>th</sup> December 2018 expressing disappointment that no solution could be found to restore the 2012 revaluation arrangement.

In a further letter to the Minister dated the 12<sup>th</sup> December 2018 the Chair of the Board confirmed that the recommendation on early retirement factors, following receipt of legal advice, would be changed to apply in respect of all service. The Chair also confirmed that the recommendation on changing the revaluation arrangement would be removed for the time being, but that discussions about restoring the previous arrangement should continue.

In light of the Supreme Court judgment in the McCloud case the government announced in a Written Ministerial Statement on the 19<sup>th</sup> January 2019 that the HM Treasury cost cap arrangement would be paused.

In a letter to the Local Government Minister dated the 8<sup>th</sup> February 2019 the Chair of the Board confirmed that the Board's own cost cap arrangement would be similarly paused.