

Scheme Advisory Board

Board 10th May 2021 11am
Item 4 Paper B

Scheme Advisory Board Cost Management and McCloud

Background

1. This paper provides a summary of the cost management processes in place for the Local Government Pension Scheme (LGPS) in England and Wales together with options for the 2016 Scheme Advisory Board (SAB) process in taking account of McCloud costs.

Cost management in the Public Service Pension Schemes (PSPS)

2. The Public Service Pensions Act 2013 (the 2013 Act) sets out the obligations and duties of schemes in respect of cost control and in particular, makes provision for the HM Treasury (HMT) Employer Cost Cap process in section 12 of the 2013 Act.
3. The process runs every 4 years and checks the costs of the scheme (as a percentage of total pensionable pay) against a pre-set target cost. The process includes only those elements attributable to members, for example, pay increases and longevity, in the calculations of scheme costs. The 2016 process was paused in January 2019, and “unpaused” in July 2020. Future cost cap processes are subject to an ongoing review by the Government Actuary’s Department (GAD).
4. There is a 2% each way ‘corridor’ for cost changes. Results outside of the corridor must be rectified back to the target cost not just to the corridor. For example, if the result is 4% above the target cost then changes to benefits and/or contributions must be made to bring the cost down by the full 4%.
5. Although consultations would take place if changes to benefits and/or contributions cannot be agreed then they would be automatically implemented (via an adjustment to the scheme’s accrual rate) under section 12 of the 2013 Act.
6. As only member attributed costs are assigned to the process, with changes in financial costs (e.g. inflation, discount rates) met by employers through the scheme valuation process, it is possible for the costs to diverge. For example, the HMT process may show an increase

Scheme Advisory Board Secretariat

18 Smith Square, London SW1P 3HZ

Jeff Houston *Head of Pensions* **email:** jeff.houston@local.gov.uk **tel:** 020 7187 7346

Joanne Donnelly *Senior Pensions Secretary* **email:** joanne.donnelly@local.gov.uk **tel:** 074 6453 2613

Bob Holloway *Pensions Secretary* **email:** robert.holloway@local.gov.uk **tel:** 078 6719 2448

in costs due to improvements in longevity while in the scheme valuation employer costs are falling because of increases in the discount rate, or vice versa.

The SAB cost management process

7. The LGPS in England and Wales is the only public service scheme with an additional process. This is run by the SAB prior to the completion of the HMT process. This extra process is primarily to reflect the fact that employer contributions are not driven by the scheme valuation, but by individual fund valuations, using a variety of assumptions.
8. The SAB process can affect the outcome of the HMT process but cannot overrule it. The process must also be completed before the HMT process in order to have any effect on its outcome. The SAB can only recommend changes to benefits with any final decision taken by the Ministry of Housing Communities and Local Government (MHCLG) and approved by HMT.
9. For example, if the HMT process would have resulted in a plus 3% outcome an SAB process which recommended benefit reductions of 1.2% would, if accepted by MHCLG and HMT, change that result to plus 1.8%, bringing it back inside the 2% corridor.
10. The SAB target cost is 19.5%. This is the figure agreed by employers and trade unions when negotiating the 2014 CARE scheme although not the cost of the scheme delivered by regulations, which included further costs such as first year revaluation of CARE which all PSPS had to adopt. This figure is fixed, it is not designed to track the actual cost of the scheme as calculated by fund actuaries but rather the movement in those costs assigned to members.
11. The SAB process can use different member assumptions (e.g. pay increases) from the HMT process and in a significant shift from that process can recognise material changes in discount rates.
12. The corridor of the SAB process is also different as it recognises smaller changes in cost. For example, although changes in cost of 2% or more 'must' result in recommendations for changes to benefits/contributions, changes between 1% and 2% or even below 1% 'should' or 'may' result in such recommendations.

Scheme Advisory Board Secretariat

18 Smith Square, London SW1P 3HZ

Jeff Houston *Head of Pensions* **email:** jeff.houston@local.gov.uk **tel:** 020 7187 7346

Joanne Donnelly *Senior Pensions Secretary* **email:** joanne.donnelly@local.gov.uk **tel:** 074 6453 2613

Bob Holloway *Pensions Secretary* **email:** robert.holloway@local.gov.uk **tel:** 078 6719 2448

The 2016 cost management process

13. The 2016 cost management process ran from April 2016, when data was first collected, to January 2019 when the process was paused by HMT.
14. Up to that point early calculations had pointed to a possible breach of the corridor in excess of minus 2%. This was driven mainly by a flattening of longevity improvements and lower than assumed earnings growth and could have required increases in benefits and/or reductions in employee contributions in excess of 2% to take effect from April 2019.
15. The SAB process, following agreement of assumptions, had an indicative outcome of 19% against the 19.5% target. This difference was primarily due to a different pay increase assumption and the recognition of a reduction in the SCAPE (Superannuation Contributions Adjusted for Past Experience) discount rate.
16. A package of benefit improvements and contribution reductions equivalent to a total average cost of 0.9% was agreed. These changes if accepted would have brought the HMT process back within the 2% corridor, however, before these could be actioned HMT paused their process in January 2019 due to the uncertainty around the 'McCloud/Sergeant' age discrimination case. In February 2019 the SAB reluctantly agreed to follow suit.

Cost management 'unpaused'

17. In July 2020 HMT announced that their process would be restarted but would include the additional costs of McCloud within member attributed costs. This move would increase the costs of the schemes as measured by the HMT process, potentially nullifying the downward cost pressures previously identified.
18. In recognition that this move could result in corridor breaches above 2% the Chief Secretary to the Treasury announced that no benefit reductions would be made in that circumstance. This will however require changes to the 2013 Act in order to prevent the automatic application of section 12 changes to benefits.
19. GAD have indicated that the inclusion of McCloud costs for the LGPS in England and Wales, although still showing an overall reduction in scheme costs, is likely to bring the result back within the 2% corridor.

Scheme Advisory Board Secretariat

18 Smith Square, London SW1P 3HZ

Jeff Houston *Head of Pensions* email: jeff.houston@local.gov.uk tel: 020 7187 7346

Joanne Donnelly *Senior Pensions Secretary* email: joanne.donnelly@local.gov.uk tel: 074 6453 2613

Bob Holloway *Pensions Secretary* email: robert.holloway@local.gov.uk tel: 078 6719 2448

20. The Board must now decide how to proceed with the SAB process and how McCloud costs should be treated. This is not a straightforward process of adding GAD's estimate of McCloud costs (under the HMT process) to the previous SAB outcome of 19%, as different assumptions are used for each process. The HMT process also spreads McCloud costs over 4 years which the Board may wish to change when deciding if and how to include McCloud costs.
21. In order to provide a base level for the Board's deliberations the Cost Management, Benefit Design and Administration (CMBDA) committee met on 12th April and agreed to recommend no change in SAB process assumptions due to the passage of time, This recommendation concurs with the opinion of the Board's actuarial advisor as stated in ANNEX A to this report.

Potential Judicial Review

22. We understand that an application for a Judicial Review (JR) has been given permission to proceed Originally the grounds for the JR were around the pausing of the HMT process but we further understand there is agreement to amend the grounds to the inclusion of McCloud costs in the HMT process as member attributed costs.
23. As the Directions required for the HMT process to complete are currently in draft the JR will not proceed until these are published as a final version. However, their publication will also finalise the outcomes of the HMT processes in all PSPS.
24. If the JR is successful, one outcome could be the re-running of the HMT process without McCloud costs which would presumably revert to an outcome breaching the corridor in excess of minus 2%.

Options for the Board

25. A series of briefings took place for Board members representing employers and scheme members during the week of 4th to 7th May 2021. At these briefings a summary of the cost management processes was presented and the following options were outlined:-
 1. Run the SAB process as previously but including McCloud costs using the same 4 year spread period as the HMT process
 2. As above but use a different spread period which takes into account how such costs will actually be spread as part of the fund valuations, and/or when the majority of McCloud costs will have been met
 3. Ignore McCloud costs and stick with the previous 19% outcome

Scheme Advisory Board Secretariat

18 Smith Square, London SW1P 3HZ

Jeff Houston *Head of Pensions* email: jeff.houston@local.gov.uk tel: 020 7187 7346

Joanne Donnelly *Senior Pensions Secretary* email: joanne.donnelly@local.gov.uk tel: 074 6453 2613

Bob Holloway *Pensions Secretary* email: robert.holloway@local.gov.uk tel: 078 6719 2448

4. Agree to not agree
 5. Continue pause while JR is unresolved
26. Broad estimates of the potential impact of using a different spread period under option 2 have been provided to Board members separately as ANNEX B to this report.
27. Given that the Board can only make recommendations on the back of the SAB process, the role of MHCLG and HMT will be pivotal in whether the option chosen has any actual impact on the benefits of the scheme.
28. In its considerations the Board should also be aware that any changes made, as a result of the 2016 cost management process, would have to be backdated to April 2019. Any such changes would therefore add to the already considerable administrative burden faced by LGPS authorities.

Action for the Board

Board are asked to consider the options 1-5 set out above and instruct the secretariat how to proceed with the SAB process.

Scheme Advisory Board Secretariat

18 Smith Square, London SW1P 3HZ

Jeff Houston *Head of Pensions* **email:** jeff.houston@local.gov.uk **tel:** 020 7187 7346

Joanne Donnelly *Senior Pensions Secretary* **email:** joanne.donnelly@local.gov.uk **tel:** 074 6453 2613

Bob Holloway *Pensions Secretary* **email:** robert.holloway@local.gov.uk **tel:** 078 6719 2448