

Cost Management and Contributions Sub-Committee

Item 6 - Assumptions for use in cost management process and consistent funding level calculations

Introduction

1. This paper has been drafted in order for the sub-committee to consider and make recommendations to the Shadow Scheme Advisory Board in respect of the assumptions which should be adopted for:
 - a. the SAB Future Service Cost (FSC) process, and
 - b. the calculation of a consistent measure of funding for LGPS pensions funds.
2. As part of the implementation of the new benefits structure in most public service pension schemes, the Government has mandated for periodic reviews of the costs of the reformed schemes in order to establish how the costs have moved from the agreed targets, and possibly change benefits structures/ employee contribution rates depending on movements from the targets. This mechanism is known as the 'Employer Cost Cap' (ECC).
3. In the LGPS in England & Wales, these periodic reviews will take place on a triennial basis in line with local funding valuations from 2016 onwards. An LGPS specific approach will also be operated by the Scheme Advisory Board in order that a process exists which more closely aligns with the experience of the LGPS. This mechanism is known as the 'Future Service Cost' (FSC).

Summary of assumptions

4. The summary table in **ANNEX 1** attached to this paper summarises the assumptions detailed in the 3rd November 2014 version of the GAD papers LGPS (E&W): Actuarial valuation as at 31 March 2013: advice on assumptions and report on methodology. These assumptions, shown in column 2, cover both those determined by Treasury Directions and those set as 'best estimates' from scheme experience.
5. The summary table also includes in column 3 the assumptions to be used for the FSC where they differ from those above and in column 4 the recommendations made by PWC for use in a *standardised liability and deficit calculation*.

SAB Future Service Cost assumptions and dry run of FSC

6. **Decision:** The committee are asked to agree the differences in assumptions in column two for use in the FSC process.
7. At the meeting of 7th November the committee agreed to await the GAD valuation report on the employer cost cap before deciding if the Board should commission from GAD a dry run of the Board future service cost process

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based on the 2013 valuation data. The table below reconciles the valuation result with the original basis for the 19.5% FSC target cost:

Reconciliation of proposed employer cost cap with target overall cost % of pensionable pay

| | |
|---|-------------|
| Target overall cost met by employers | 13.0 |
| Changes due to Directions | |
| Exclusion of allowance for 50/50 elections | +0.3 |
| Exclusion of transitional protection of the 'Rule of 85' | -0.1 |
| Change in commutation assumption | +0.6 |
| Changes due to assumptions (other than changes above required by the Directions) | +0.2 |
| Changes due to benefits valued | |
| Inclusion of additional year's revaluation in CARE accounts | +0.4 |
| Allowance for strain from Club transfers | +0.3 |
| Proposed employer cost cap | 14.6 |

8. Two of the cost elements above (50/50 and commutation) have different assumptions in the FSC process which if used would bring the employer cost back to 13.7%. Another (Club transfers) is currently being debated with HMT and may change.
9. **Decision:** Taking into account the above reconciliation the committee are asked to consider if GAD should be asked to dry-run the FSC on 2013 data.

Standardised liability and deficit calculation

10. In commencing its deficit management project, the Shadow Board commissioned PwC to make recommendations as to how fund and employer deficits could be better managed within the LGPS.
11. One of the recommendations made to the Shadow Board by PwC was that every three years in line with local funding valuations, calculations of individual funds' funding levels be commissioned by the SAB on a standardised basis in order to make through-time and cross-fund comparisons.
12. PwC stated:
"After consultation with the four actuarial firms that advise the 89 LGPS Funds, we set out below one possible basis for standardised liability and deficit calculation. GAD preferred not to comment, since it advises DCLG.

Consultation suggests agreement that the major financial assumptions should be prescribed. The most significant of these, other than the discount rate, is earnings growth. Simplicity is important here, to keep costs down. In the 2013 valuations, the typical long term assumption made by LGPS actuaries was that earnings would increase by 1.5% more than CPI. Different assumptions were used elsewhere in the public sector, notably by GAD for the unfunded schemes, where pay restraint was reflected in lower rates in the next few years, higher rates

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later. More accurate, perhaps, but such sophistication would add to the costs of the 89 Funds. So 1.5% is noted below, subject to Scheme Advisory Board review in 2016. There are then two approaches for the main demographic assumptions, as shaded in the table below.

- One approach would have them decided by the Fund Actuary, with a requirement to reflect Fund experience, in consultation with the relevant pension committees. This would allow for the use of local/Fund specific demographic information. It would, for example, typically require LGPS Funds in more affluent areas of the country to reflect greater longevity.
- The other approach would have the Scheme Advisory Board set them centrally before each valuation. This would emphasise that the standardised basis is not the funding basis. It might underestimate longevity in more affluent areas, tending to overstate their relative funding.

Either way, the rate of future mortality improvement should be set centrally. It is intrinsically a matter of hypothesis, and evidence can be interpreted in different ways. Regional and socio-economic differences in mortality improvement are modest at the moment. An annual rate of improvement of 1.5% was commonly used by LGPS actuaries in 2013.

| Assumption | Definition/ example approach |
|--|--|
| Financial | |
| Net discount rate above price inflation. This is stated as a rate above CPI. | 3% pa (equivalent to a gross monetary discount rate of CPI+3.0% pa). CPI would itself be assumed to increase at 2.0% pa |
| Earnings increases – general | 1.5% pa above CPI. This differs from unfunded schemes, for which GAD used 2.75%pa above CPI in respect of period from 2019 and lower rates before that, reflecting short term pay restraint. |
| Future changes in financial basis | To be adjusted in line with any changes in the SCAPE rate/HMT direction, in accordance with reviews by the Scheme Advisory Board. |
| Demographic | |
| Earnings increases - promotional | None |
| Mortality – base table | Set locally by Actuary based on Fund experience, or centrally by SAB |
| Mortality – base table adjustment to valuation year | Set locally by Actuary based on Fund experience, or centrally by SAB |
| Mortality – future projection from valuation year | Long term 1.5% per annum reduction in mortality rates, to be set centrally by the Scheme Advisory Board |
| Commutation | Set locally by Actuary based on Fund experience, or centrally by SAB |
| 50:50 uptake | Not relevant to deficit calculations: rate only required for any future service calculation |
| Other demographic assumptions | Set locally by Actuary based on Fund experience, or centrally by SAB |

- The assumptions above have been included in ANNEX 1 in order to provide a direct comparison to those to be used in the ECC and FSC processes.
- Decision:** In view of the above the sub-committee are asked to determine a recommendation to the Board that:

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- Either the assumptions to be set centrally should be as recommended by PWC or the same as set for the FSC process (note CPI and discount rate assumptions are the same in both).
- The other assumptions are either set centrally to be the same as those used for the FSC or set locally (i.e. to be the same as those used for the fund valuation).

15. In determining the setting of the other assumptions the committee should also consider who will be performing the calculation and the prospective costs. For example if it is determined that assumptions should be set locally and calculated by the fund actuaries then a recommendation to DCLG that regulations will need to require such calculations may be necessary. In that case the cost will fall on each fund directly.

5th February 2015