Government Actuary's Department

Local Government Pension Scheme (LGPS)

Actuarial valuation as at 31 March 2024 Initial advice on assumptions for the SAB cost management process

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Navigating risk | Cutting through complexity

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Background

Public service pensions cost control

The Public Service Pensions Act 2013 and associated HM Treasury Directions introduced a cost control mechanism for public service pension schemes, referred to here as the Employer Cost Cap (ECC).

Unlike other public sector schemes, the LGPS Scheme Advisory Board (LGPS SAB) has established a second cost control mechanism, implemented through scheme regulations, referred to here as the SAB cost management process (SAB process). The aim of this process is to provide greater control over employer contribution rates within the LGPS, recognising the different mechanism for setting employer contribution rates compared to the unfunded public service pension arrangements.

The Public Service Pensions (Valuations and Employer Cost Cap) Directions 2023 (the Directions) require an ECC calculation for the LGPS as at 31 March 2024. Therefore, the SAB process is also required as at 31 March 2024.

Since the 2016 valuation, the cost management process has been updated in a number of respects. The ECC mechanism now applies to the reformed scheme only, incorporates a wider corridor, and allows for changes in the SCAPE discount rate before confirming any cost breach. which must be satisfied before any cost cap breach is confirmed. Consequently, the SAB agreed to update the SAB process, to allow for the reformed scheme only (but retaining allowance for the underpin), to widen the corridor, and to adopt a discount rate reflecting changes in conditions. These updates first introduced in 2020 will apply for the purposes of the 2024 valuation.

This report has been commissioned by the LGPS SAB and provides advice on the assumptions required for the SAB process as at 31 March 2024. It is intended to aide discussion on the assumptions to adopt and refers to the approach adopted for the SAB process as at 31 March 2020.

Assumption requirements

The Directions specify numerous assumptions for the ECC process and require others to be determined by the responsible authority as best estimates. The SAB process is less prescriptive and provides the LGPS SAB with greater flexibility about the assumptions to adopt. However, the approach has been to maintain consistency with the ECC process where appropriate and only deviate where there are legitimate LGPS specific reasons. The SAB process at the previous valuations adopted the ECC process assumptions, unless there was good reason not to. At the 2020 scheme valuation, SAB adopted different assumptions to the ECC process in the following areas:

- Discount rate
- pay growth
- 50:50 option take-up

In addition to these assumption differences, the SAB process also adopted a different methodology to the ECC process in the following areas:

- cost of revaluation in first year of retirement
- cost of club transfers assumptions

These latter differences relate to policy positions rather than actuarial judgement and I do not consider them further in this paper.

Financial assumptions

There are a variety of financial assumptions required to calculate costs for the ECC and SAB process. Table 1 below summarises the ECC assumptions (where known) and indicates whether they are LGPS specific or set in Directions. Where assumptions for the ECC are LGPS specific, there is less likely to be a reason for the SAB process to adopt a different assumption.

Table 1: Summary of financial assumptions for the LGPS England & Wales 31 March 2024 valuation

Assumption	% per annum		LGPS specific / Directed
Discount rate	CPI + 1.7% to 31 March 2026, CPI + 2.0% thereafter		Directed
Pay increases	Year to 31 March 2025	4.0	Directed
	Year to 31 March 2026	6.1	
	Year to 31 March 2027	3.2	
	Year to 31 March 2028	2.1	
	Year to 31 March 2029	2.1	
	Year to 31 March 2030	2.2	
	Year to 31 March 2031	2.3	
	Thereafter	3.8	
Promotional pay scale	Separate male and female scale between ages 20 and 50 (the same as for 2020)		LGPS specific
Pension increases	Official pension orders where known, then		Directed
	8 April 2024	6.7	
	7 April 2025	1.7	
	6 April 2026	3.8	
	12 April 2027	2.3	
	10 April 2028	2.0	
	9 April 2029	2.1	
	Thereafter	2.0	

Discount rate

The discount rate for the ECC is a Directed assumption and uses up-to-date SCAPE rates. The effect of changes in the SCAPE rate, since the employer cost cap was set, are then excluded from the ECC check but considered as part of the new economic check.

The 2020 SAB process adopted a discount rate that maintained the SCAPE rate applicable at 1 April 2016 (CPI + 2.8%), this resulted in a stable cost relative to the previous, 2016, process. This decision was based on the following considerations:

- between the 2016 and 2020 valuation dates, both the SCAPE discount rate and Fund valuation discount rates had reduced
- subsequent to the 2020 valuation date gilt market yields had increased significantly and expected Fund valuation discount rates would likely be increasing
- adoption of a rate consistent with 2016 would result in an estimated cost close to the target, which was considered appropriate recognising the divergence of indicators on LGPS costs

Tables 2 and 3 below show the change in the applicable SCAPE rate and the average Fund real discount rate over the period since the 2016 valuations.

Table 2: SCAPE rate changes since 31 March 2016

Date	SCAPE Rate
1 April 2016	CPI + 2.8%
1 April 2019	CPI + 2.4%
1 April 2023	CPI + 1.7%
1 April 2026	CPI +2.0%

Table 3: Average LGPS Fund real discount rate since 31 March 2016

Date	Fund real discount rate
31 March 2016	2.2%
31 March 2019	1.8%
31 March 2022	1.5%
31 March 2025	3.0%*

* This is an indicative figure from initial work that GAD has carried out in relation to Section 13.

The above tables show the SCAPE discount rate has reduced since the 2016 valuation, reflecting OBR's reduction in expected GDP growth, whereas average LGPS Fund discount rates have increased reflecting changing market conditions and higher yields available on gilts and bonds. The SAB could consider maintaining the SCAPE rate adopted for the 2016 and 2020 process.

This would result in a stable cost and be consistent with the 2020 valuation decision which was taken at a point where the available information indicated a divergence of possible approaches.

Alternative approaches could be:

- allowing for the change to the SCAPE rate which has decreased from CPI +2.8% adopted for the 2020 SAB process to CPI +1.7% as at 2024, subsequently increasing CPI +2.0% as at 1 April 2026. This would increase assessed costs by around 8-9% of pensionable pay.

- aligning to the average real Fund discount rate, either 1.5% pa (latest known at the valuation effective date) or 3.0% pa (latest available). Adopting 1.5% pa would increase the assessed cost by around 13% of pensionable pay, whereas adopting 3.0% pa would decrease the assessed cost by around 2% of pensionable pay.

As illustrated, the discount rate has a material influence on the results of the SAB process, and there are a variety of reasonable options that could be adopted. The options listed above should not be considered as exhaustive, and it is important to remember the purpose of the SAB process to provide greater control around employer contribution rates given the funded nature of the LGPS and potential for the ECC to deliver inconsistent outcomes as a result.

Pay increases

The pay increase assumption has a relatively small impact on the cost of providing ongoing benefits, since these are provided on a Career Average Revalued Earnings basis, and are revalued in line with CPI. However, the LGPS statutory underpin means that pay increases can influence the SAB process outcomes. However, the recent period of high inflation compared to salary growth will reduce the cost of the statutory underpin. Assumptions need to reflect long term impact up to the point of retirement for members accruing benefits in 2014-22, which covers a long period that is difficult to anticipate. However, SAB should consider whether the Directed short-term assumptions and the long-term assumption of 3.8% pa are reasonable for the membership of the LGPS.

For comparison the 2020 SAB process adopted a single assumption for both the short and long term of CPI + 3.5% pa, which was chosen to be consistent with the choice of discount rate and maintained the gap between the discount rate and pay increases used in the 2016 valuation. Therefore, I would recommend considering the approach to pay increases in tandem with the discount rate decision.

Promotional pay increases

A scheme specific assumption is adopted for the ECC. This assumption will be based upon experience in the LGPS and expectations for future promotional progression. Therefore, this should reflect a reasonable best estimate and there should be no reason to adopt anything different for the SAB process.

Pension increases

The LGPS provides pension increases in the same way as other public service pension schemes, predominantly providing increases in line with the change in CPI. The Directed pension increase assumptions are intended to reflect changes in CPI and there is nothing unusual about the LGPS which would suggest any reason for deviating from these. However, it will be important to check the overall consistency of all the financial assumptions when settling on a basis for the SAB process.

Overall effect of financial assumptions

The overall effect of financial changes to the SAB process assumptions relative to 2020 will be largely dependent on the choice of discount rate. Therefore, this could be anything from close to no change in the assessed cost to a material increase in the assessed cost.

Demographic assumptions

Table 4 below sets out the key demographic assumptions required to carry out the valuation calculations.

Table 4: Summary of recommended demographic assumptions for the LGPS England and Wales 31 March 2024 valuation (**subject to change until formally agreed by Secretary of State**)

Assumption			LGPS specific / Directed
Post-retirement base mortality rates (males / females)	Normal health	99% S4NMA_M / 103% S4NFA	LGPS specific
	Ill health	113% S4IMA / 121% S4IFA	
	Dependants	97% S4DMA / 102% S4DFA	
Post-retirement mortality improvement rates	ONS_2022 population projections		Directed
Retirement decrements (years) (member with SPA 67)	CRA 60 CRA 65	63.7 64.1	LGPS specific
Withdrawal (likelihood of leaving service before 65 for member now 45) (males / females)	Males 58.4% Females 68.3%		LGPS specific
Proportion married/partnered (at retirement)	Males 80% Females 75%		LGPS specific
Age difference (years)	Males less females 3 Females less males -2		LGPS specific
Commutation (of pension)	Pre-2008 service: 10% Post-2008 service: 20%		LGPS specific
50:50 option	Cost cap past service - reflect actual cost Cost cap future service - ignore		Directed
Club transfer allowance	Approach still to be determined		LGPS specific

LGPS specific assumptions

The LGPS specific assumptions above expected to be used in the 31 March 2024 ECC valuation reflect a best-estimate approach (do not include margins for prudence or optimism) and are based on analysis of LGPS scheme experience and other information, where relevant. There is no specific reason to adopt an alternative approach for the SAB process.

Directed assumptions

HMT directs the mortality improvement assumption for the ECC valuation process and has directed the use of the ONS-2022 population projections. This was the latest ONS model at the time the directions were issued. It includes an estimated adjustments in respect of the impact of Covid-19 on mortality rates in the short term. There is no specific reason to adopt an alternative approach for the SAB process and the 2020 process adopted the latest ONS population projections (the ONS-2020 population projections) in line with the ECC approach. The differences in life expectancy for the different mortality improvement assumptions are shown below:

Table 5: Change in life expectancy moving from ONS-2020 to ONS-2022 mortality improvement assumption as adopted between 2020 and 2024 valuations:

	ONS 2020 imp (adopted for 2020)		ONS 2022 imp (adopted for 2024)
Males:			
Current pensioners, age 65	87.1		86.9
Future pensioners, age 45	88.8		88.4
Females:			
Current pensioners, age 65	89.4		89.5
Future pensioners, age 45	90.9		90.9

The 50:50 benefit option is also directed by HMT. For the 2024 ECC valuation process the cost cap future service cost continues to be calculated as if no member has or ever will opt for 50:50 benefits to ensure that the take up has no impact on the cost cap future service cost. For the past service cost, there is a slight change in the technical implementation of the 50:50 policy in that the cost cap liabilities and assets will now reflect the actual take up of the 50:50 option, so that 50:50 take up does not lead to cost cap surpluses or deficits, and ensure that the take up of 50:50 has no impact on the cost cap past service cost.

For the 2020 SAB process a small (1%) allowance was made for the 50:50 option, reflecting information at the time showing very few members had taken up the option. There are three possible approaches for the 2024 SAB process:

- Maintain the 2020 assumption, regardless of experience
- Follow the ECC process to ignore the impact of 50:50
- Update the analysis of take-up of the option to support an updated assumption

The impact of the 50:50 assumption will be relatively small as regardless of which approach is adopted it only applies to a small proportion of the membership.

Overall effect of demographic assumptions

The impact of adopting the demographic assumptions in table above would be to slightly reduce the cost cap cost relative to the 2020 SAB process. This is because the mortality improvement rates are lower than for the 2020 process and hence future life expectancy is reduced, the other minor changes to the rate of withdrawal and the proportion married at death are broadly cost neutral when considered together. It is estimated at this stage that the impact on the cost cap cost would be a reduction of the order of 0.1% pa of pensionable pay.

Conclusion

The majority of assumptions required for the SAB process are LGPS specific when used in the ECC and therefore it seems appropriate to maintain these assumptions. For the assumptions that HMT directs for the ECC, the most significant is the discount rate. There are multiple possible options to set the discount rate, which would lead to a wide range of SAB process cost cap costs.

The financial assumption options set out above are likely to result in a SAB cost estimate broadly in line with the 2020 SAB process or an increased cost. The demographic assumptions are likely to lead to a very small reduction in the SAB cost estimate relative to 2020 but the impact is largely immaterial. The overall outcome will ultimately depend upon the choice made for the discount rate. It is therefore important to consider the achievable objectives from the SAB process and its interaction with the ECC before settling on the assumptions to adopt