BARNETT WADDINGHAM
beyond the expected

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Workforce, Pay and Pensions
HM Treasury
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Sent by email to: CCMConsultation@HMTreasury.gov.uk

Dear HMT

Public service pensions
HMT Cost control mechanism consultation
Consultation Response

We write on behalf of Barnett Waddingham in response to the above consultation which covers, amongst others, the Local Government Pension Scheme (LGPS), the Firefighters' Pension Scheme, the Police Pension Scheme and the Teachers' Pension Scheme. We comment as both actuaries and consultants who operate and provide advice to these schemes and their participating employers.

By way of background, Barnett Waddingham is a pensions and actuarial firm. Our Public Sector Practice Area provides actuarial, benefits and governance consultancy services, and is the Fund Actuary for 25% of the LGPS funds in England and Scotland and provide pensions accounting services to 11 Police and Fire Pension Scheme employers. In addition we have a specialist team who advise many employers who participate in the Teachers' Pension Scheme

We also participate in various industry wide technical, Scheme Advisory Board sub committees and working groups, and in other groups and meetings concerning the LGPS and its operation and development.

We are therefore experienced in the workings of many of the pension schemes in scope for this consultation and we have an insight into difficulties and issues experienced by stakeholders in its operation and administration, including in the aspects covered by this consultation.

Our response to the consultation is set out below and we would be pleased to expand, clarify or discuss any of the comments made. Please note that our response reflects our thoughts, experience and knowledge as actuaries and benefits and governance consultants and should not be taken as legal advice.

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Summary of response

The preliminary results of the 2016 Scheme valuation revealed the flaws in the current cost control mechanism. Although set up with the right intentions, due to the required approach it has led to outcomes which may not have been anticipated or intended.

We welcome changes to the cost control mechanism, and the proposals made are reasonable individually, but we would recommend considering them in their entirety in order to ensure the whole cost control process meets the original objectives of the mechanism.

We agree that the legacy schemes should not be considered as part of a cost control process which informs changes required to benefits in the reformed schemes only. This would make the calculations and the results more consistent.

We also agree the introduction of an economic check. The proposal made appears to be an objective approach which can be easily justified to stakeholders, and will help to avoid perverse outcomes such as those seen in the preliminary 2016 cost cap results.

In terms of widening the corridor, we would suggest considering this in the context of the full reform - is this required if an economic check is in place? What is the ultimate aim of widening the corridor in this way? A wider corridor would mean a larger step change in benefits or member contributions if triggered. Perhaps the frequency of change is not a problem that needs addressed and therefore the corridor could be left unchanged.

We do also have some concerns over the timing of the consultation which is a concern shared by many of our clients. The outcome of this consultation will be significant to the future of the LGPS and other public service schemes and the consultation period is relatively short considering that a lot of public sector services will quieten down over the summer months and therefore there is less resource available to respond to this significant consultation.

We also note that the Government is proposing to consider the recommendations on longevity separately to this review. Due to longevity being a key driver in the breach in 2016, we do not agree that the review of the longevity assumption is excluded in the review of the cost control mechanism. We would prefer that this is reviewed at the same time so that any changes can be incorporated into the mechanism.

Question 1 - Do you agree that a reformed scheme only design would achieve the right balance of risk between scheme members and the Exchequer (and by extension the taxpayer), and would create a more stable mechanism?

As noted in the consultation, one of the main drivers for the breach in 2016 was the low level of salary increases which is not really relevant in the reformed CARE schemes. We therefore strongly agree with the proposal to remove the allowance for legacy schemes in the cost control mechanism. Our opinion is that this is a sensible approach as it will mean the benefits being assessed are consistent with those potentially being reformed.

From the preliminary results of the 2016 Scheme valuations, the change in cost due to past service was a significant portion of the change in cost calculated. This creates some inconsistencies: if there is a change in cost in relation to past service, past service benefits are not reformed; only future benefits are reformed. This is somewhat unintuitive: if the value of benefits to older, longer serving members (who are typically those with significant portions of past service) reduces to breach the cost floor, it is future benefits that are amended which will obviously apply to those older members still in the scheme, but will also apply to younger members who were not impacted by the reduced value of past service benefits. The opposite applies: if the value of past service benefits increases to breach the cost cap, then younger members will lose out through reforms made to reduce the value of future benefits.

As the impact of past service is potentially a significant part of the change in cost (and it was so in the preliminary 2016 results), removal of the legacy schemes' impact from the cost control mechanism should result in a more stable mechanism.

In our view the change in design will achieve a better balance between scheme members and remove the intergenerational unfairness. It should also create a more stable mechanism which should lead to less perverse outcomes. The Exchequer (and by extension the taxpayer) will be taking on additional risk (or arguably risk that it should have retained in the first place) by bearing the cost of the legacy schemes.

An option disregarded in the consultation is to adopt a future service only mechanism, i.e. one which also excludes any past service in the reformed schemes. However, we think that this option has some merit. By including the past service element of the reformed schemes in the cost control mechanism, we agree that this leads to a fairer distribution of the risks compared to if the legacy schemes were still included. However, in a reformed scheme only approach which includes past service, is it fair for new members to bear the risks of costs changing in respect of previously accrued benefits? The cost control mechanism is designed to rectify any future service benefits, and so would an approach that only considers a revised cost of future benefits (and not past service benefits) be more appropriate? It would also remove the need to track a notional fund which is appropriate as all the unfunded schemes have no fund to track and the economic check could replace the aim of this element of the current control mechanism.

Additional costs could occur in the legacy schemes for a number of reasons, and it should be considered whether this is something to be factored into the mechanism once moved to a reformed scheme only approach. 4.28 of the GAD report suggests that a retrospective change that affects just the legacy schemes would not be taken into account. What would happen if a retrospective change applied to the legacy and the reformed schemes, would this be included in the mechanism or not? The reviewed mechanism should be clear on what will happen in these cases.

Question 2 - Do you agree with the Government's intention to widen the corridor? If not, why not?

We do not agree with the proposal to widen the corridor. The intention of this approach appears to be to reduce the frequency with which benefits or member contributions are reviewed, but we don't see how this change would help achieve the objectives of the cost control mechanism.

It is surprising that the Government considers a breach every 20 years to be too frequent when it should be noted that benefits in the LGPS were changed twice in a six year period before the mechanism was even in place. We would not see a breach once every 20 years as unstable. One of the overall aims of the mechanism is to make the schemes sustainable; by delaying any changes in benefits or member contributions, you are building up problems which we don't believe helps to achieve this sustainability aim.

Widening the corridor appears to move away from the aim to protect members' benefits (should a floor not be breached on a widened corridor, but would have been breached on the original corridor). It does of course work in both ways and so protects a member from a reduced value of benefits through the equally higher ceiling.

However, the intention is that a wider corridor will mean less frequent changes. This is positive in terms of ensuring benefits continue to be easy to understand for members and also to reduce any administrative burden of regular benefit changes. What it also brings though is the risk of bigger step changes in benefits due to a bigger margin being required before a breach occurs. In addition, the potential impact of this on members should be considered. Using Table 5.A from the consultation, a breach is expected every 5 valuations (20 years) using a corridor of +/-2%, and every 10 valuations (40 years) using a corridor of +/-3%. The change in cost could potentially hover between 2%-3% for 20 years before breaching a 3% corridor; is a change in value in the range of 2%-3% considered significant and therefore should action be taken when it is consistently within this range? The original corridor was set at 2% so it would seem that this was previously deemed as significant enough to merit a benefit review.

The LGPS Scheme Advisory Board in England and Wales operate an additional cost control mechanism, and that adopts a 'may', 'should' and 'must' approach. Perhaps this approach could be considered for the HMT cost control mechanism. This would involve different ranges in change in cost cap, each triggering actions depending on the significance of the change in cost cap: at the lower end of the range the trigger would be that recommendations may be made to return the cost to the target and at the upper end the trigger would be that recommendations must be made to return to the target. Arguably it may still result in no change until the 3% threshold is breached but if a bracket of 2%-3% was considered a "should" approach, then where the change is consistently falling in the 2%-3% range, action could be taken following review.

Finally, if the proposed additional economic check is accepted, then we would question whether a widened corridor is necessary? As noted in the consultation, the economic check should also help to reduce frequency of change and ensure that any required changes to scheme benefits are considered appropriate.

Question 3 - Do you think that a corridor size of +/-3% of pensionable pay is appropriate? If not, why not?

Please see our answer to Question 2 which disagrees with the proposal to widen the corridor. However, should the corridor be widened then we would suggest a minimal change and believe +/-3% should be the maximum size of any corridor. Any wider and it will become more difficult to achieve the aims of the cost control mechanism and would result in a significant step change to benefits when the corridor is breached.

One of the aims of the mechanism is to provide stability and certainty to benefit levels, and it should only be triggered by 'extraordinary, unpredictable events'. It isn't possible to say what change in cost would be likely from an 'extraordinary, unpredictable event' so the question is whether 2% is more appropriate or 3% (or something else).

One of the options disregarded within the proposal is to have a corridor that varies by scheme to reflect that the costs in each scheme varies. Our view is that this option is reasonable and could be considered. One of the concerns raised in the consultation document for this option is that members may find it more difficult to understand such a corridor design, however, we feel this isn't an issue as members already may need to understand different schemes so an additional difference in corridor would not add significant complexity.

Question 4 - Do you agree with the proposal to introduce an economic check?

Yes, an economic check makes sense and will help avoid perverse results such as those seen in the preliminary 2016 results where no factors linked to the change in economic growth were considered. This would work best as a separate check as currently proposed rather than worked into the current cost control calculations, especially as this could lead to volatile results which the mechanism aims to avoid.

The proposed economic check provides a clear way to assess whether the outcome of the initial cost control calculation is appropriate.

We strongly agree that a more consistent approach should be taken between the assumptions used to set the contribution rates and the assumptions used in the cost control process. Therefore, if the SCAPE rate is used as the main driver in setting employer contributions, it should be used in the economic check. If the SCAPE rate methodology changes as a result of the separate consultation, the changes should also be implemented in the economic check proposed for the cost control mechanism. This is discussed further in our answer to question 5.

Under section 5.29, the consultation proposes for the economic check to also include the impact of any change to the long-term earnings assumption. We think this should be allowed for only to the extent that it is in the cost control mechanism.

For the funded LGPS, the driver of employer contributions is not the SCAPE rate but the discount rates used at triennial actuarial valuations. A slightly different but consistent approach would therefore be required for the LGPS reflecting changes in LGPS discount rates rather than the SCAPE rate. We also mention this in our response to Question 5.

The alternative (or additional) option of having an independent panel to review the initial cost control calculation would introduce a significant level of subjectivity and would be more likely to be challenged by relevant stakeholders, so we would agree not to consider this at this stage. There is merit in such an approach but it would need to be thoroughly considered, for example to ensure that all relevant stakeholders are represented.

Question 5 - Do you think that the SCAPE discount rate, as it currently stands, is an appropriate economic measure for the cost control mechanism?

On the basis that the SCAPE discount rate is used to set employer contributions in the unfunded public service pension schemes, use of the SCAPE discount rate for the cost control mechanism seems appropriate for reasons of consistency – we think it would be appropriate that the discount rate that is used for the unfunded scheme valuations is the same as that used for the unfunded cost control mechanisms. Employer contributions in the LGPS are, however, set as part of local actuarial valuations and are based on Fund-specific discount rates; they are not based on the SCAPE rate. It may therefore be reasonable to consider an alternative approach for the LGPS. It would not be appropriate to use the discount rates adopted for the local actuarial valuations as these include a margin for prudence whereas we would expect that the cost control mechanism should be a best estimate basis. An alternative may be some sort of proxy for a best estimate return for the LGPS, which will reflect that the LGPS has assets which are invested unlike in the unfunded schemes. A review of the overall asset allocation of the LGPS could be carried out in order to set such a best estimate return. Of course the asset allocation of individual funds could range significantly and therefore it may be difficult to agree the most appropriate return to use.

Although discount rates in the LGPS are not based on the SCAPE rate, they are considered with reference to the SCAPE rate as it is used in carrying out some aspects of the Section 13 LGPS valuations. We also suspect that it is a factor when the Government Actuary sets his best estimate assumptions for other aspects of Section 13 valuations. We would therefore suggest that either the Government Actuary's best estimate discount rate used for Section 13 purposes, or some LGPS average best estimate discount rate, is used in the economic check for the LGPS.

Question 6 - If the SCAPE methodology changes, and the Government considers that the SCAPE discount rate is therefore not an appropriate measure for the cost control mechanism, then do you think that a measure of expected long-term GDP should be used instead? If not, please set out any alternative measures that may be appropriate in this scenario. Please consider in the context of the separate review of the SCAPE methodology currently being undertaken by HM Treasury.

Our understanding of the economic check is to reduce the risk of any perverse outcomes. The issue we had with the outcome of the 2016 review was that, as the cost control mechanism did not consider the SCAPE rate, employer contributions were increased as costs were going up whereas the review suggested that member benefits should also be increased as costs were coming down.

Therefore in our view, it is important that the assumption used to set employer contributions is consistent with the assumption used in the economic check to avoid the issue outlined above that we had at the 2016 review.

For the purposes of this consultation, we would suggest that any changes made to the SCAPE methodology are also reflected in the economic check as it is so key to the level of employer contributions paid.

If the SCAPE methodology moves away from a long-term GDP approach, we think it would likely be appropriate to use a discount rate for the cost control mechanism that continues to be consistent with that adopted for the scheme valuations used in setting employer contributions.

If such an approach is not considered appropriate, then an alternative discount rate based on long-term GDP could be an acceptable alternative, however, there would be risk of perverse outcomes in terms of consistency of the cost control mechanism and changes in employer contribution rates due to the underlying discount rate approach for both being different. Therefore we do not agree that such an approach would be appropriate.

For the LGPS, we believe alternatives for the economic check discount rate are potentially required to achieve the same objectives and we elaborate on this in our response to Question 5.

Question 7 - Do you envisage any equalities impacts from the proposals to reform the cost control mechanism that the Government should take account of?

As the proposed reform would apply to all benefits accrued in future, we do not see any obvious equalities impacts. Any future proposed benefit changes should still be reviewed as normal to ensure that they do not cause any inequalities.

Should you have any questions on our response please contact us.

Yours sincerely

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