Meeting:	Pension Committee
Date:	21/01/2019
Title:	Scheme Advisory Board Cost Management
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Purpose:	For information only

1. Introduction

On 21/12/2018 the Scheme Advisory Board (SAB) issued an update on the cost management process. The full update can be seen in Appendix 1, however a summary can be seen below as well as the view of our Actuary, Hymans Robertson.

2. Scheme Advisory Board (SAB) Cost Management

Cost management for the Local Government Pension Scheme (LGPS) in England and Wales is taking place in the contex of a public service pension scheme wide cost cap review under HM Treasuary directions.

As the LGPS is a funded scheme, it has a separate cost management process to all other public service pension schemes.

Based on work undertaken by the Board's actuarial adviser, the total cost of the scheme (employer and employee) under the Board's process is 19% against a target total scheme cost of 19.5%.

The Board agreed to delegate to the Chair and a representative from both the employers and employees' sides, assisted by a small technical group, responsibility for agreeing a package of benefit changes to return the scheme to its total target cost of 19.5% while also looking at employee contributions at the lower end.

In order to achieve this, changes to benefits must be made. Section 3 below gives a summary of the proposed changes.

3. Proposed changes/recommendations

The following package of benefit improvements and employee contribution reductions were submitted to the Secretary of State on 16th November 2018. Since then discussions have taken place with the minister and his team and further legal and equality impact advice has been obtained.

Ill health:

- Removal of the third tier of ill health retirement (amendment required to Regulation 35)

Death in service:

- Introduction of a minimum lump sum death in service benefit of £75,000 per member (amendments required to Regulation 40)

Early retirement:

- Enhanced early retirement factors for all members who are active on 1st April 2019 in respect of their final salary linked membership only. Following further legal advice obtained by Government an amendment to this recommendation was agreed and submitted on 12th December. The recommendation now is that, within the same cost envelope, enhanced early retirement factors should be applied to all service of all members active on 1st April 2019 (new actuarial guidance required).

Employee contributions:

- A new 2.75% band at pay of £0 to £12,850. This new band reflects the lack of any pension tax relief for levels of pay below the new personal allowance.

- An expansion in size but reduction in rate of the current band 2 (5.8%). This would now go from £12,501 to £22,500 and be at a rate of 4.4% benefitting lower paid members.

- An expansion of the top of current 6.8% band from £45,200 to £53,500 to reflect the increases in the higher rate tax allowance since the bands were introduced in 2014.

4. Estimated financial impact of the package

The revision back to revaluation of pension accrued to the start of the scheme year is estimated to be a **reduction** in the future scheme cost of 0.4% of payroll.

This package of recommended benefit improvements is estimated to **increase** the total future service cost of the scheme by 0.5% of payroll.

Within that total it is estimated that the reduction in the employee contribution yield as a result of the new bands will be 0.8% of payroll in 2019-20 with a potentially equivalent **increase** in employer contributions.

All other things being equal the above package would see net increases in average employer future service rates of 0.9% of payroll.

However all other things are not equal and few employers pay the average rate therefore the actual impact for each scheme employer will depend on the outcome of the 2019 valuation process and in particular;

- The view taken by the fund actuaries of the costs of each element of the package
- The membership profile of each employer; with those with higher paid full time staff possibly seeing a smaller upward pressure on contributions and conversely those with a very large proportion of staff earning less than £12,000 potentially seeing a much higher upward pressure possibly in excess of 2%.
- The extent to which the costs are mitigated by other factors such as the falling away of future longevity increases

5. The next step

The SAB is advisory only. The ultimate decision on the final package of amendments rests with MHCLG. It is likely that a consultation is due to be launched in late January/early February, and by necessity will have to be short as the amendments are effective from 1 April 2019 (this date is being driven by HM Treasury and will apply to all public sector pension schemes).

SAB say in their note that they would like MHCLG to issue a letter of comfort to give funds and software providers as much notice as possible of the changes ahead of the effective date.

6. View of the Actuary

The initial thoughts of our Actuary on the announcement are:

- The validity and effectiveness of the whole cost management approach can be discussed at great length. It does seem odd to be awarding benefit improvements at a time when public sector pension costs are the highest they have been for a long time. This has been recognised by HMT who have committed to reviewing, at some point in the future, the cost management approach to see if it meets the current policy intent.

- The presence of the SAB cost management valuation is good news for the LGPS. No other public sector pension scheme has a SAB mechanism in place and as such those schemes are fully exposed to the results of the HMT cost management valuation which has seen cost savings between 3-5% of pay (compared with SAB's saving of 0.5% of pay) and significant proposed improvements to accrual rates. Hopefully, the proposed package of benefit and contribution changes will be sufficient to ensure that the results of the HMT cost management valuation on the LGPS are such that no further and significant benefit improvements are not triggered.

- The estimated cost of the impact of the proposed changes are at scheme level. However, the LGPS is funded at employer level and this is where the changes will be realised. Due to some of the more significant changes (employee contribution rates and death in service) being focussed at the lowest paid members, it follows that those employers with more lower paid staff than the national average will see higher increases. For example, if all of an employer's staff earn less than £12,850 p.a. then the employer contribution rate will increase by 2.75% of pay due to this change alone. It would have been preferable, and more equitable, from an employer's point of view if the proposed changes were consistent across the whole membership.

- The compressed timescale is disappointing and we would question if it allows any real consultation to take place. Given that these changes will have a direct and, in some cases, significant impact on actual benefits, administration and funding, we would have hoped for a longer period to consider the proposals, discuss alternatives and allow time to communicate them to members and employers. Funds will also be under real pressure in an already busy period to update administration systems and routines to cope with the changes to benefits.

Hyman Robertson are currently considering the proposals in more depth and will be providing a more detailed note in the forthcoming weeks.

Appendix A

THIS DOCUMENT DOES NOT IN ANY WAY CONSTITUTE CONFIRMED POLICY NOR DOES IT IN ANY WAY PREJUDGE THE OUTCOME OF ANY FORTHCOMING CONSULTATION PROCESS. IT IS DESIGNED TO GIVE ADMINISTERING AUTHORITIES AND SCHEME EMPLOYERS INFORMATION REGARDING THE PROPOSALS SUBMITTED BY THE LGPS ADVISORY BOARD IN RESPECT OF THE COST MANAGEMENT PROCESS. NO LIABILITY IN ANY FORM CAN BE ACCEPTED BY THE LGPS ADVISORY BOARD OR ANY OF ITS MEMBERS IN RESPECT OF ANY ACTION TAKEN BASED ON THE CONTENTS OF THIS DOCUMENT.

Local Government Pension Scheme Advisory Board
SAB Cost Management

Context

1. Cost management for the LGPS in England and Wales is taking place in the context of a public service pension scheme wide cost cap review under HM Treasury directions. In the other schemes indicative outcomes have seen breaches of the cost cap floor requiring benefit improvements in excess of 3% of payroll.

2. The closest comparable public service scheme undergoing the cost cap process this year is LGPS in Northern Ireland which has recently commenced a consulation on a benefit improvment package costing 3.2% of payroll.

3. LGPS in England and Wales has a separate cost management process which is completed prior to finalisation of the HMT cost cap calculations.

Board cost management outcome

4. At the Board meeting of the 10th October it was noted that, subject to agreement by government to return the scheme design to that agreed in 2013 by the employers and scheme members in relation to the annual revaluation of CARE benefits, the outcome of the Board's cost management process was a total scheme future service cost of 19%. As the target for the process is 19.5% the Board agreed to consider recommendations to return the total cost back to the target.

5. It was further agreed that a Board sub group consisting of the Chair, Vice Chair and an employer representative would consider a package of benefit improvements sufficient to return the total cost back to 19.5% and such further changes to employee contributions within that total cost necessary to obtain the support of both employer and employee representatives of the Board.

6. The Board agreed that options for changes to benefits should be limited to Third Tier Ill Health, Lump sum death grants, Early Retirement and Commutation. These being elements which were both of interest to scheme members and affordable within the 0.5% target cost increase. Any changes to employee contribution rates were to be targeted principally at the lowest bands but also seeking to address existing anomalies with regard to pension tax relief at both the personal and higher rate allowance points.

Consideration of options

7. In order to provide the Board sub group with the information necessary to come to a view a small technical group consisting of representatives of both scheme member and employers as well as the secretariat was formed. This group received actuarial input (in the form of technical advice from MHCLG's GAD adviser and independent actuarial advice from

the Board's actuarial adviser) and legal views from Eversheds (in particular with regard to potential discrimination issues) and considered a number of options around the elements agreed by Board.

8. The secretariat also held discussions with LGPS actuarial firms in order to get a very broad feel of the potential actual impact at fund and employer level of the various options.

9. The following proposals were put to the Board for agreement.

Ill health

10. 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

11. 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.

Early Retirement

12. 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

13. 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.

Employee contributions

14. Based on costing information provided, six options for changes to employee contribution rates were considered. The objective for the options was to find one that most closely met the dual ambition of removing tax relief anomalies (where net contributions are lower after an increase in pay because of the effect of pension tax relief) and providing a real reduction for the lowest paid members.

15. The option that most closely met these ambitions was agreed to be;

- A new 2.75% band at pay of £0 to £12,850. This new band reflects the lack of any pension tax relief for levels of pay below the new personal allowance.
- An expansion in size but reduction in rate of the current band 2 (5.8%). This would now go from £12,501 to £22,500 and be at a rate of 4.4% benefitting lower paid members.

- An expansion of the top of current 6.8% band from £45,200 to £53,500 to reflect the increases in the higher rate tax allowance since the bands were introduced in 2014.

16. It was also proposed to the Board that moving the bands out of regulation and into guidance would in future years enable a more effective tracking of changes to pension tax relief as well as providing a more effective and speedier means to meet the target yield.

17. The Board sub group considered these options and obtained agreement by the employee and employer representatives on the Board.

Recommendations of the Board

18. The following package of benefit improvements and employee contribution reductions were submitted to the Secretary of State on 16th November. Since then discussions of taken place with the minister and his team and further legal and equality impact advice has been obtained.

a) Removal of Tier 3 of Ill Health (amendments required to Regulation 35)

b) A minimum lump sum death in service benefit of £75,000 per member (amendments required to Regulation 40)

c) Enhanced early retirement factors for all members who are active on 1st April 2019 in respect of their final salary linked membership only. Following further legal advice obtained by Government an amendment to this recommendation was agreed and submitted on 12th December. The recommendation now is that, within the same cost envelope, enhanced early retirement factors should be applied to all service of all members active on 1st April 2019 (new actuarial guidance required).

d) Removal of contribution bands from regulations replaced by reference to guidance (amendments required to Regulation 9)

e) Introduction of the bands shown below for 2019-20 (new guidance required)

Band	Pensionable Pay from £	Pensionable Pay to £	Contribution rate
1	0	12,850	2.75%
2	12,851	22,500	4.4%
3	22,501	36,500	6.5%
4	36,501	53,500	6.8%
5	53,501	64,600	8.5%
6	64,601	91,500	9.9%
7	91,501	107,700	10.5%
8	107,701	161,500	11.4%
9	161,501		12.5%

Estimated financial impact of the package

19. The revision back to revaluation of pension accrued to the start of the scheme year is estimated to be a **reduction** in the future scheme cost of 0.4% of payroll.

20. This package of recommended benefit improvements is estimated to **increase** the total future service cost of the scheme by 0.5% of payroll.

21. Within that total it is estimated that the reduction in the employee contribution yield as a result of the new bands will be 0.8% of payroll in 2019-20 with a potentially equivalent **increase** in employer contributions.

22. All other things being equal the above package would see net increases in average employer future service rates of 0.9% of payroll.

23. However all other things are not equal and few employers pay the average rate therefore the actual impact for each scheme employer will depend on the outcome of the 2019 valuation process and in particular;

- The view taken by the fund actuaries of the costs of each element of the package
- The membership profile of each employer; with those with higher paid full time staff possibly seeing a smaller upward pressure on contributions and conversely those with a very large proportion of staff earning less than £12,000 potentially seeing a much higher upward pressure possibly in excess of 2%.
- The extent to which the costs are mitigated by other factors such as the falling away of future longevity increases
- The extent to which the costs are amplified by other factors such as reductions to future service discount rates
- The upward or downward pressure of changes to employer deficits on the total employer rate

Next steps on Board cost management

24. It was hoped that agreement could have been reached with MHCLG on these recommendations and a consultation launched before Christmas. For a number of reasons this has not proved possible, however, it is anticipated that such a consultation will be published in late January/early February for regulations to take effect from 1st April.

25. The Board has made representations to MHCLG and HM Treasury that meeting the implementation date of 1st April 2019, will be significantly challenging for administering authorities and have proposed putting back the implementation date if possible. However, indications are that due to the requirements placed on all public service pension schemes the 1st April implementation date will not be changed

26. The Board has strongly suggested to MHCLG that -

(a) the consultation be as short as is possible and

(b) a letter of comfort is issued as soon as is legally possible to allow administering authorities and software providers to anticipate the changes to regulations and employers to implement new contribution rates.

27. In the meantime, the Board advise that authorities begin preparations for the above changes including taking a view on advising their employers of the proposed contributions rates. Without preempting regulatory changes it may be prudent to put in place the necessary preparations to avoid changing bands on 1st April under current regulations then retrospectively making further changes to bands and rates resulting in contribution overpayments. Doing so could enable employers to take immediate and full advantage of any letter of comfort issued prior to regulations in this area.

28. You may also wish to make employers and members aware of the proposed changes to ill health and early retirement with effect from 1st April so that decisions can be made in light of the proposals.

29. The Board secretariat will contact software suppliers and major payroll providers to assess the changes required to systems to implement these proposals. In particular to determine the most effective way to introduce enhanced early retirement factors with the absolute minimum impact on administrative processes.

30. The secretariat will review the NI database to ensure it can provide the necessary membership information to ensure that minimum death in service lump sums are appropriately limited where multiple active membership records exist across funds.

31. The secretariat will also work with fund actuaries to ensure the proposed changes are able to be appropriately accounted for in the coming valuation.

32. At its last meeting the LGPS Technical Group, consisting of representatives from the regional Pension Officer Groups (POGs), agreed to form a working group early in the New Year to further assess the administrative implications of the proposals and provide information and advice to administering authorities.

Next steps on MHT cost cap

33. The HMT cost cap process will be completed once the outcome of the above proposals and subsequent consultation is known.

34. If the proposals are not accepted by government either prior to or following a consultation then the HMT process will complete without having to take account of any changes to scheme design when determining if the cost floor has been breached.

35. If the proposals are accepted and submitted for legislation, the HMT process will take the changes into account when determining if the cost floor has been breached.

36. In either case if the cost floor is breached changes to benefits will be required under the terms of the Public Service Pension Schemes Act 2013.

Jeff Houston
Secretary to the Local Government Pension Scheme Advisory Board (England and Wales)

If you have any questions please contact the Board Secretariat on any of the following email addresses. Please note you will get an out of office from the team over the Christmas period but your email will be picked up and will be responded to as quickly as possible.

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