Briefing note

Getting Cost Control under control

Key messages

- The Government has launched a consultation on proposals to reform the national cost control mechanism (alongside a consultation on its discount rate methodology). These proposals will not affect the results of the 2016 cost control valuations, which are due for publication after being adjusted to allow for the McCloud remedy.
- The reforms are designed to bring greater stability to the cost control process and avoid 'perverse' outcomes that fly in the face of common sense. The Government has chosen three Government Actuary recommendations – 'reformed scheme only', 'widened corridor' and an 'economic check' - to achieve this.
- The LGPS is unusual amongst the largely unfunded public sector schemes; it holds assets, and employer contribution rates are heavily reliant on past and future investment returns. In addition, the Scheme Advisory Board in England and Wales runs its own cost control mechanism alongside the Government's mechanism. These differences can cause the outcomes of cost control valuations on the LGPS to be significantly different to those in other public sector schemes.

With recent headlines focussing on the travel 'traffic light' list, the publication of the Government Actuary's review of the cost control mechanism and subsequent Government consultation may have slipped under people's radars. Whilst the review and consultation will not affect everyone to the extent of influencing which country they may travel to this summer, it will have a significant impact on the long-term sustainability of public sector pensions across the UK. And possibly whether Danny Alexander's famous 'a pension scheme to last a generation' claim can be met.

Why is Cost Control out of control?

The review into the mechanism was ordered because of the perverse result that came out of the 2016 unfunded public sector pension valuations. Costs and employer contribution rates were going up, but at the same time the cost control mechanism said that scheme benefits should be improved. There was a lot of head-scratching up and down the country as people wondered why a mechanism that was introduced to limit increases in costs to employers and taxpayers had the total opposite effect. Thankfully, for the LGPS in England & Wales, this situation was not extreme due to the presence of the Scheme Advisory Board's separate cost control mechanism.

What does the review say?

At 56 pages in length, the Government Actuary's review is thorough, a lot of the key issues have been considered and most of the recommendations would probably improve the current mechanism to differing degrees.

It was especially pleasing to see acknowledgement that it is impossible to design a cost control mechanism that can achieve all the Government's desired objectives **and** be flexible enough to work as intended in all future outcomes. Such a view seemed to have been missed when designing the current cost control mechanism. Its strict and rigid algorithm essentially operates under a “computer says no” approach, where the outcome must be acted upon, no matter how sensible or otherwise it seems. Hence the paradoxical situation at the 2016 unfunded public sector pension valuations.

The Government Actuary made five recommendations for changes to the current cost control mechanism.

1 “Reformed scheme only”: essentially, remove from the mechanism any cost variations associated with service accrued before the reformed schemes were introduced in 2014 (in LGPS England & Wales) or 2015 (LGPS Scotland and other public sector schemes).

2 “Future service only”: going one step further, only consider changes in the cost of future accrual of benefits. Any changes in costs of accrued benefits would be ignored from the mechanism.

3 “Widened corridor”: at the moment, costs can vary +/-2% of pay from the benchmark cost before any action is taken. The proposal is to widen this corridor to +/-3% of pay.

4 “Affordability offset assessment”: currently, cost control operates in a parallel universe to the actual funding valuations and does not include allowance for changes in long-term economic assumptions such as the discount rate. This proposal is seeking to partially align the cost control and funding valuations to avoid the situation where benefit improvements are being offered at the same time that employer contribution rates are increasing.

5 “Review of breach”: the current mechanism is set up in such a way that any result must be acted upon and implemented. This proposal would put in place a safety valve which would allow qualitative “reasoned judgement” to be used to determine whether or not to apply the results of the cost cap valuation.

The first three proposals are technical in nature and seeking to provide greater stability to the mechanism, as well as addressing intergenerational fairness issues. The quid pro quo for having increased stability in the mechanism is that it loses some of its “bite”. Effectively, the Government and taxpayers will be underwriting (or benefitting from) more of any future cost variations.

The fourth proposal, the “affordability offset assessment”, would be a change to one of the fundamental ‘rules’ of the mechanism; members do not suffer or gain from benefit changes as a result of a change in the discount rate or other long-term economic assumptions. This rule is the main culprit for why the initial outcome of the 2016 cost control valuations was benefit improvements at the same time as the outcome of the 2016 formal funding valuations was contribution rate increases.

The final proposal to add in an additional layer of qualitative review after a breach is identified is seeking to resolve the “computer says no” weakness in the current mechanism. It would allow the mechanism to incorporate wider economic, social and political issues when reviewing if the benefits offered are affordable and fair to members. The governance arrangements around this proposal would need to be carefully considered to avoid disputes between interested parties during any such review. Avoiding such disputes was probably one of the main reasons why the current mechanism was designed with such rigidity.

What has the Government decided to do?

In another welcome turn of events, the Government has taken the Government Actuary’s review and decided to quickly run with some of the recommendations.

Of the first three proposals, two have been taken forward – “Reformed scheme only” and “Widened corridor”. It is not surprising that the ‘future service only’ recommendation has not been taken forward for consultation as this proposal gave away the most “bite”.

The “reformed scheme only” proposal seems sensible whilst the “corridor widening” is also understandable given the desire for stability. However, the assessment and justification for moving to 3% of pay is reliant on the results of some modelling to be certain about sources of future cost variations. This modelling, by its very nature, is very uncertain.

Given the Government only wants a breach of the corridor due to “extraordinary, unpredictable events”, a neater solution may be to hold the corridor at 2%, to keep the bite for taxpayers, and have some form of review to ascertain if the causes for a breach fall into the category of extraordinary and unpredictable.

This leads us onto to the most disappointing aspect of the consultation – the decision not to take forward the “Review of breach” recommendation. We think such a feature is desirable as it would have provided the opportunity to do a ‘common sense check’ on what will otherwise still be an objective and formulaic mechanism with no wriggle room. Whilst the governance arrangements may be complicated to implement to avoid disputes between interested parties during any such review, we think this element of pain would have been worth it for the long-term gain.

The most striking aspect of the consultation is the decision to take forward the "affordability offset assessment" (called the "economic check" in the Government's consultation). Removing the potential for the type of disconnect witnessed at 2016 seems an obvious and easy win. However, by doing so, the choice around the formal valuation's long-term economic assumptions will take on a new meaning due to the potential impact on the cost control mechanism (something alluded to in the Government's SCAPE discount rate consultation launched on the same day – see later for more details).

How does this affect the LGPS?

The cost control mechanism applies to all public sector pension schemes, including the LGPS. Therefore, the consultation proposals, if implemented, will apply to future LGPS cost cap valuations. The "Reformed scheme only" and "Widened corridor" proposals can be relatively easily applied to the LGPS. However, the "economic check" proposal is slightly more complicated.

In the LGPS, employer contribution rates are set locally and are significantly influenced by the level of asset returns achieved to date and the future level of expected investment returns, both of which vary by investment strategy. However, it is proposed that the "economic check" is based on the same discount rate used to value the unfunded schemes – future expectations of growth in UK Gross Domestic Product (GDP). Whilst the consultation acknowledges this difference, the Government Actuary and Government believe that the difference is not significant enough to warrant any different treatment. This is an opinion we would disagree with, mainly because LGPS funds invest globally so we do not believe UK GDP is a suitable proxy for future expected LGPS investment returns.

The LGPS in England & Wales is also slightly different to other public sector schemes as there exists a Scheme Advisory Board cost control mechanism which runs alongside the Treasury mechanism (further detail can be found on the SAB's website). The existence of this additional mechanism seeks to recognise the unique nature of the LGPS in the world of public sector pension schemes (having assets to pay the liabilities). At the time of writing there is no detail on whether the SAB mechanism will be amended in line with any of the consultation's proposals.

Two buses at once

On the same day as the cost control consultation, the Government also launched a second consultation on the SCAPE discount rate methodology that is used for the formal valuations of all unfunded public sector pension schemes e.g. NHS, Teachers, Civil Service etc.. The timing of the consultation is in line with a pre-agreed frequency – it is to be reviewed every 10 years, with the last review occurring in 2011.

The consultation will not have any impact on the funding of LGPS schemes; LGPS funds set their own funding assumptions, including discount rates, based on advice from their own Fund Actuary and their own views on the future. However, the SCAPE discount rate is used by the Government Actuary's Department to set factors relating to the likes of transfer values, or early and late retirement, that apply to the LGPS. Whilst likely to be second order (or even third) compared to investment returns and changes in the fund's own funding assumptions, if there is a substantial change to the SCAPE rate, this may affect employer costs in the LGPS.

Summary

The job of designing a cost control mechanism is a hard one which involves making trade-offs in every aspect of its design. The Government Actuary's review covered all the pertinent points in seeking to improve the mechanism for the future, and the justification behind the proposals taken forward to consultation are all sound.

However, the lack of some sort of qualitative sense check does seem to be an own goal (no current article is complete without some nod to Euro 2020). Hopefully the Government will not rue the decision to turn down the pensions equivalent of the Video Assistant Referee. The cost control mechanism consultation is open until 19 August 2021.

We will be preparing our own response to the consultation and will share it publicly when available (end of July).

In the meantime, if you wish to discuss any of the topics covered in this briefing further, please contact your usual Hymans Robertson consultant.

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