‘Hot topics’ in the LGPS

Overview

This paper is deliberately brief. Its intention is to provide the Pensions Committee with a high level summary of four ‘hot topics’ that are currently affecting the LGPS.

A. National ‘cost cap’

Background

Part of the package of measures following Lord Hutton’s review of public sector pensions in 2011 included a national check on the ongoing cost of providing benefits. Its stated aim is ‘to ensure affordable and sustainable public sector pensions’ and it is enshrined in legislation via the Public Service Pensions Act 2013. The ‘cost cap’ calculations are carried out by the Government Actuary’s Department (GAD) – the Leicestershire Fund, like all other LGPS funds, has provided data to GAD but has no control over the subsequent calculations or results.

The first check on national LGPS costs in England and Wales is now close to completion. The purpose of the check is to assess how the cost of benefits being earned in the LGPS are changing. The period covered by this initial check is 1 April 2014 to 31 March 2016. Future checks will cover a 4 year period.

What impact does it have on Leicestershire’s funding strategies?

The cost cap process has no direct impact on funding strategies and employer contribution rates in the Leicestershire Fund. These will continue to be controlled by the Fund based on local decision making. However, any changes to the overall benefit structure of the LGPS that arise from cost management (see final section on page 2) will need to be reflected in liability calculations at the Fund’s next actuarial valuation.

What items of experience does the cost cap cover?

Importantly (and by design, as the Government’s intention was to capture changes in cost due to changes in the demographic profile of members over time), the cost cap only considers items which affect the value of benefits to members. It excludes any changes which impact the employer’s cost of providing the benefits, such as expected or actual investment returns. The following table summarises what is and isn’t included.

‘Member costs’ – will influence cap	‘Employer costs’ – won’t influence cap
Longevity changes	Financial assumptions
Promotional pay increases	Actuarial methodology
Rates of ill health retirement and withdrawal	Investment returns

The excluded ‘big ticket’ employer costs shown in the table are of course included when calculating employer contribution rates for the Leicester Fund.

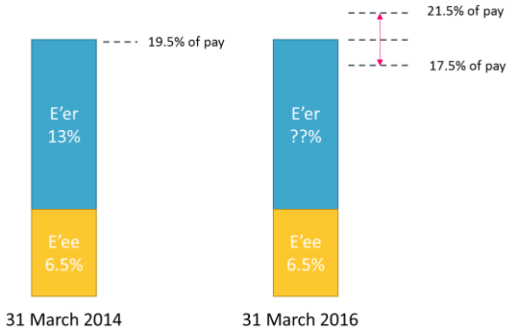
How do the cost cap calculations work?

In short, they are complex and would require more space than this briefing paper allows to explain them!

At a high level, there are two separate cost caps that work in similar ways but are not identical to each other, and are run by:

- Scheme Advisory Board (SAB) – this is non-statutory and is intended to give an ‘early warning’ of any changes to costs
- Her Majesty’s Treasury (HMT) – this is the statutory cost cap, and ‘trumps’ the SAB version

Both caps have a ‘target cost’. The following diagram shows the SAB version which targets a total cost of 19.5% of pay (determined using central Government assumptions):



The underlying legislation requires action to be taken if the target under the HMT cost cap is breached by 2% of pay e.g. if the target was 19.5%, a breach would occur if the cost fell to less than 17.5% or rose above 21.5%. The action involves changes to the benefit or employee contribution structure to bring the cost back to the target cost.

What results have been announced so far on the cost cap?

Our understanding is that initial results suggest that the HMT cost cap has been breached on the downside i.e. the cost has **reduced** from the target by more than 2% of pay. In addition, results from the SAB cost cap show that its total cost has reduced from 19.5% to 19.0% of pay.

The SAB intend to agree a package of benefit/contribution rate improvements to return the cost back to its target of 19.5%. The resultant package will then be implemented in the LGPS with an effective date of 1 April 2019.

Finally, we also understand that that the package of improvements agreed by SAB will be reflected in the HMT cost cap before it publishes its own final results. This may prevent the 2% breach mentioned above being triggered.

B. National Section 13 valuation

Background

This is another piece of legislation that appears in the Public Service Pensions Act 2013. It is designed to be a ‘health check’ on all LGPS funds in England and Wales, by giving comfort to Government that funds are being financially well managed and remain sustainable going forward.

GAD carry out the calculations based on data provided by the funds. They are required to report on whether the following aims are being achieved:

- **Compliance** (are funds complying with LGPS regulations?)
- **Consistency** (is a fund’s valuation being carried out in a way which is ‘not inconsistent’ with the other fund valuations within the LGPS?)
- **Solvency** (are employer contributions being set at appropriate levels to ensure a fund’s solvency?)
- **Long term cost efficiency** (are employer contributions being set at appropriate levels to ensure the long-term cost-efficiency of the scheme, as measured on a fund-by-fund basis?)

Highlights from the first section 13 report

This was published towards the end of September and is based on the results of the 2016 valuations. The report measures individual funds using a variety of metrics, and uses colour flags to highlight where funds have fallen outside predetermined acceptable ranges.

The headlines from the report were:

- Funding levels have improved over the 3 year period from 2013 to 2016 due mainly to positive asset performance. The average funding level, based on standardised assumptions used by GAD, increased from 87% to 95%.

- Actuaries are more cautious about the economic outlook. Average employer contribution rates for many funds have increased.

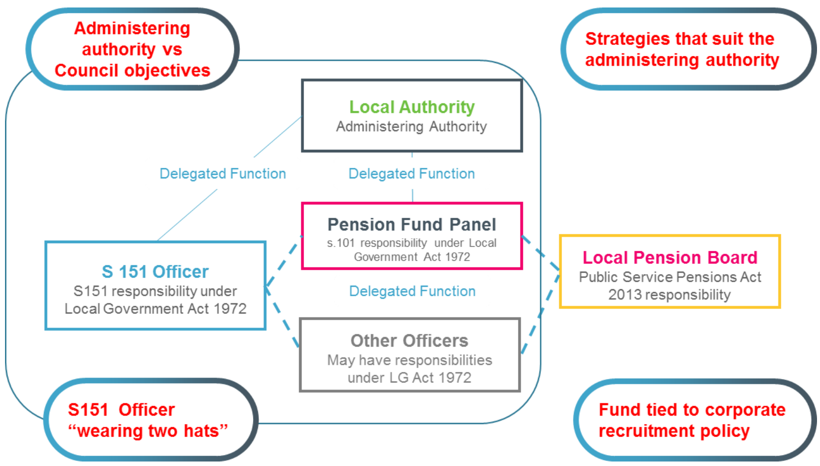
How did the Leicestershire Fund fare?

The good news is that the Fund has been flagged as 'green' across all measures considered by GAD. The funding level, based on the standardised assumptions used by GAD, was calculated to be 92%, which is slightly lower than the average across all funds.

C. The SAB 'separation project'

The SAB has issued a tender to interested parties to help it to develop options for change with regard to the separation of LGPS pension funds and their host authorities. The information will ultimately be used to potentially make recommendations to the Secretary of State.

There is a concern that current governance structures can lead to the sort of issues that are highlighted in red in the following diagram of a typical fund structure.



Four possible 'separation' options that are being considered are:

1. Status quo plus - existing governance structure but with beefed-up SAB guidance around managing conflicts, fund resourcing etc

2. Ring fence LGPS functions – fund has separate accounts, audit and annual governance statement, with a separate dedicated pensions officer who reports to a chief executive and has control over fund resourcing

3. Joint Committees - all LGPS functions delegated to a Joint Committee covering several funds, with a host authority (or perhaps a formal Combined Authority) used to gain efficiencies

4. Total separation - new non-local authority entities set up to manage LGPS funds with separate trustees (employer and member) appointed

No doubt we will hear more about this in the coming months as the project progresses.

D. Unfunded schemes – employer contribution increases

The Local Government Association (LGA) recently issued a note advising that the current Teachers' Pension Scheme employer contribution rate of 16.48% of pay will be increasing to an estimated 23.6% of pay, for the period 1 September 2019 until 31 March 2023. The increase is mainly due to a change in discount rate used by GAD, although it also allows for the improved benefits required as a result of the cost cap mechanism (see Note A in this paper).

The increase means that the cost to employers - councils, academies, colleges and universities - of Teachers' pensions will rise by around 40%. There will be funding from the DfE for the financial year 2019/20 to help maintained schools and academies (but possibly not colleges or universities) meet the additional costs, and a consultation process will take place to determine final funding arrangements. Funding for 2020/21 onwards will be discussed as part of the next Spending Review round.

Similar situations have arisen regarding the Police and NHS Schemes, albeit these will have much less impact on employers participating in the Leicestershire Fund. However, the overall picture is the same:

- Fund employers will need to spend much more on their (non-LGPS) pension obligations;
- The increases are principally due to a change in assumption by GAD, and benefit increases arising from the cost cap mechanism;
- HMT broadly speaking does not want to see benefit payments materially exceeding contribution income, as these unfunded schemes work on a "pay as you go" basis: the crucial difference for the LGPS is that the Fund has accumulated assets to help pay benefits, thus avoiding the need for such short term sharp changes.

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