

Public Service Pensions: cost control mechanism consultation Proposal to reform the mechanism (HM Treasury)

SLGPSAB response to consultation

The Scottish Local Government Pension Scheme Advisory Board (SLGPSAB) was established under the Public Service Pensions Act 2013 to provide advice to Scottish Government Ministers on the desirability of changes to the design of the scheme and the implication of other policy issues. The SLGPSAB also provides advice to the Scheme Managers or the Scheme's Pension Boards in relation to the effective and efficient administration and management of the scheme.

The SLGPSAB is pleased to have the opportunity to respond to HM Treasury's consultation on the cost control mechanism. The response covers general comments which the SLGPSAB should be considered, followed by specific answers to the questions set out in the consultation. The SLGPSAB is a bi-partite body made up of equal numbers of Employer (Local Government and admitted bodies) and Employee members, and it is the view of the whole membership which is provided in this response. Whilst this response is the overall view of the Scheme Advisory Board, due in large part to the brevity of the timescales, the SAB was not able to reach consensus on all issues.

General Comments

From the SLGPSAB's perspective there are four general comments to make in relation to the cost control mechanism.

Firstly, the SLGPSAB feels significant disquiet about the short notice of the consultation which has been conducted over the summer period, at a time when SAB Members and Advisers have been on leave. The SLGPSAB understands that these concerns are echoed across the Local Government Pension Scheme Advisory Boards from all parts of the UK, that there has not been sufficient time to enable a properly informed discussion. Equally there are concerns over how the consultation has been conducted, with only limited opportunity to engage both with GAD, in conducting its review, and HMT then consulting on this. The SLGPSAB would therefore urge HMT to re-open this consultation, to allow for more meaningful consideration of what are highly significant issues for the Local Government Pensions Scheme in Scotland.

Secondly, it is noted that the mechanism covers all public sector pension schemes, funded and unfunded, however it makes no distinction between funded and unfunded schemes. The Scottish Local Government Pension Scheme (SLGPS) is a funded scheme which has assets set aside to meet pension liabilities. This is an important distinction when considering the purpose of the cost control mechanism, to ensure stability and to secure a balance between employee benefits and cost to the taxpayer. LGPS costs are heavily dependent on investment returns, with employer contributions for set based on local valuations. For this not to be taken into account in a cost control mechanism is not appropriate, with the mechanism currently in place acting as an artificial valuation, being applied to all the public sector pension schemes regardless of their differences. A further point is that local valuations are undertaken 3-yearly which is out of sync with the 4-yearly cost control valuation mechanism.

Thirdly, the proposed mechanism results in a major cliff edge if the cost collar is breached. Whilst an adjustment will be unavoidable, we believe that its severity can be reduced if the SAB is able to adopt an internal cost-control mechanism which is triggered before the Treasury cost collar is breached. We envisage a somewhat simplified version of the system that the English and Welsh SAB use and would welcome early engagement with HM Treasury and other stakeholders on specific options around this.

Fourthly, the SLGPSAB felt some disquiet with the approach to the 2016 Valuation, this being the first since the new pension public sector schemes were introduced. In particular there are concerns that there was little scope to influence the assumptions used by GAD in calculating, for example, life expectancy, as well as the lack of consideration of investment returns. The point being that a mechanism was introduced which seemingly does not take account of the circumstances prevailing to different pension schemes. The decision to include the impact of the McCloud judgement adds to the disquiet as it feels as if this was added in order to offset the risk of the cost cap being breached resulting from the 2016 process.

Fundamentally the SLGPSAB would question whether it is a case for review in the way that GAD was asked to undertake, or whether in fact it is a question of re-visiting first principles of what the cost cap is trying to do. The reason that there is a review is that the mechanism is not producing results which were initially perceived to be the intention of having such a protection built in to the LGPS. This in itself is a subjective judgement, ie we don't like the results it keeps coming up with, so let's re-work it so it won't produce such results in future. An ask of a review could reasonably be what are the exceptional events that the cost control mechanism is meant to capture and what is it about the event(s) which has triggered the breach?

SLGPSAB Responses

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?

To focus on the reformed scheme is understandable given that the cost cap mechanism is intended to ensure stability into the future. However, this in turn raises the question of how should ongoing risk of costs becoming excessive in legacy schemes be dealt with? Would the risk fall to the schemes themselves to accommodate?

Recognising that cost liabilities for legacy schemes are falling away over time, it may be more sensible to continue to include legacy schemes in the calculation, in order that any ongoing risk is included.

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

The SLGPSAB is not convinced of the reasons for a move to a 3% cost corridor at this time and that this will ensure that will establish a fairer balance of risks between taxpayers and scheme members and create a more stable mechanism. It would result in less "exceptional" events arising in future valuations, however, there is a considerable risk that potential problems go undetected and only then manifest themselves at a later point, with potentially greater cost. The SLGPSAB believes that that the SAB should

have the flexibility to consider adjustments to the scheme if it is approaching a breach, as detailed in our opening comments.

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

Widening the corridor would undoubtedly reduce the impact of events which may not in themselves be considered exceptional. The concern is that a measure like widening the corridor is effectively seeking to dampen down the impact of issues arising in the schemes, rather than understanding the risks that these issues potentially pose. It would still be the case that, if there is a breach, this would then require action to be taken reactively to address the breach, often with a cliff edge scenario triggering the need for change.

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

An economic check seems a sensible way forward, particularly to address potential cliff edge scenarios. The question is what's the best way to do such a check. The SLGPSAB is aware of the proposals put forward by the English and Welsh SAB which would effectively apply an economic check but using factors specific to the LGPS. It would make sense to further consider these proposals, in order that there is a more tailored approach to the LGPS cost cap approach.

The SLGPSAB has received actuarial advice that that the Subjective analysis could add value alongside the economic check, the issue being implementation and the political risks associated. Given there are risks with this approach and that HMT is ruling this out in any case, the SLGPSAB would like to suggest a wider approach which would not be a Subjective analysis, but would be a data driven approach.

The E&W SAB has proposed its mechanism for local review, earlier than the 4-year periods of cost cap review. This highlights a point about the cost cap review itself, that it is always at a point in time and that a mechanistic approach may not be more effective. Were there to be a more continuous review process which would accumulate over time, involving a mature approach to considering wider data then, at a suitable point, this could then translate into action required. Such an approach could be based perhaps on a combination of the E&W SAB model and work undertaken by GAD, but crucially would be on a continuous basis. This would not however mean that breaches or non-breaches would be measured or that changes would need to be applied more frequently, as any decision to change could come at an agreed point in time.

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

The SLGPSAB's understanding of the SCAPE Rate is that it is an artificially calculated measure which is used in the absence of actual measures within the public sector pension schemes. It makes sense to apply the SCAPE Rate as an economic measure for the unfunded schemes for this reason. However, the LGPS has measures by way of local discount rates. These of course vary by Fund but, for instance, with the E&W SAB's proposal there would be a pooled discount rate which would be applied.

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.

The SLGPSAB has not provided comments on the SCAPE Rate consultation, however the point made in question 5 stands, that there may be a more useful measure which can be derived for the LGPS schemes, which would be more appropriate to use as an economic measure.

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

Equalities impacts could potentially arise if the revised measures reduce the degree of consideration of the cost issues arising in the scheme, given the profile of LGPS membership in Scotland, where there are a larger number of female members.