Scottish LGPS Scheme Advisory Board

Pre-breach mechanism for the employers cost cap

Introduction

The Hutton review, published in March 2011, led to the introduction of a set of new public sector pensions schemes, including the Scottish LGPS in 2015. The review set out a number of principles on which these new schemes should be founded, including that they should be sustainable and affordable in the long term in a manner fair to both the public service workforce and the taxpayer.

One of the proposals, recommendation 12, stated: "The Government, on behalf of the taxpayer, should set out a fixed cost ceiling: the proportion of pensionable pay that they will contribute, on average, to employees' pensions over the long term. If this is exceeded then there should be a consultation process to bring costs back within the ceiling, with an automatic default change if agreement cannot be reached."

This was called the "Employer Cost Cap" or ECC. It is a target cost of employee benefits expressed as a percentage of pensionable pay. This "target rate" exists for all public sector pension schemes based on a common calculation, though the exact rate varies by scheme.

This notional amount based on a formula and certain assumptions, and applies to all public sector pension schemes. It is quite different from individual local fund valuations in the LGPS, which are based on the actual financial position of LGPS Funds.

If this notional rate deviates by more than 2% from it's target rate (15.5% in Scotland, soon to be adjusted to 15.2%) then one of two things would happen.

- If costs were too high, and the cost collar was breached on the upper end (ie costs were above 17.5%) then the scheme would have to be adjusted back to the target cost by being made "cheaper" (including reducing benefits, or increasing employee contribution rates).
- If the costs were too low, and the cost collar was breached on the lower end (ie costs were below 13.5%) then the scheme would have to be adjusted back to the target cost by being made "more expensive" (including improving benefits, or decreasing employee contribution rates).

The specific changes could be unanimously agreed by the SAB within a period of time, or would default to a change in the accrual rate.

The England and Wales approach

In England and Wales, the LGPS SAB also has a parallel mechanism to ECC called the Future Service Cost (FSC) process. There are many similarities, but crucially:

- The SAB runs FSC process
- It allows intervention before the ECC is breached

The ECC and FSC are similar and operate on advice from GAD. However, all assumptions in the ECC are generic across all public service pension schemes, but some of those in the FSC refer more specifically to just the LGPS.

The specific mechanism in the SAB's FSC is that:

- A movement of between 0% and 1% from the target in either direction **may** result in agreed recommendations for action to move back to the target.
- A movement of between 1% and 2% from the target in either direction **should** result in agreed recommendations for action to move back to the target.
- A movement of 2% or more from the target in either direction **must** result in agreed recommendations for action to move back to the target.

The Scottish SAB working group met with the deputy secretary to the English and Welsh SAB to discuss their experience of their mechanism, and how it may evolve.

They have a view of the mechanism as positive and useful. It operated every four years in tandem with the scheme valuation. If it were to be revised in light of experience, and the revised Treasury ECC mechanism, this would need to be done by regulation, as it is based on a Statutory Instrument. Part of the discussion touched on whether a mechanism should move costs back to the Target Rate, or simply to be inside the cost collar. If it were to adjust costs to stay within the cost collar, this would "dampen" any changes. For example:

- The current target rate is 15.2%. The 2% cost collar is between 13.2% and 17.2%.
- Imagine that costs rise to 17.5%.
- Under the Treasury's ECC, a 2.3% change is required to take the costs back to the target level of 15.2%.
- However, a SAB mechanism could pre-empt this, by making only a 0.4% change to take costs back to 17.1%, which is within the 2% cost collar.

This is a much smaller adjustment for workers or employers.

The working group also asked for more information on details of the mechanism, and technical details and costs of the SAB's valuation.

The McCloud judgement

In the first valuations under the new arrangements were from 2016, where it was found that most public sector schemes had breached the cost collar on the lower bound. This meant that schemes needed to be changed to be made more generous, and therefore employers contributions would rise. Note that this is under the notional ECC valuation, which is largely unrelated to actual local LGPS Fund valuations.

The process started to review schemes to make them more generous, but this was paused following the McCloud judgement on equality in transitional protections for workers moving to the new schemes. This was because the remedy for the McCloud judgement involved a financial cost. In Scotland, the LGPS valuation was one year behind other schemes, and so the outcome had not yet been announced.

The changes would have added significant costs to employers. However, once the costs of the McCloud judgement had been included in the pension scheme valuations, it was found that none of the public sector pension schemes, including the Scottish LGPS, had broken the cost collar. However, the potential breach had been unexpected and raised questions about the existing ECC mechanism.

Recent Treasury changes

In 2021, HM Treasury consulted over changes to the ECC, to which the Scottish LGPS SAB responded. The outcome of the consultation was three reforms:

1. The cost control mechanism would only consider past and future service in the reformed schemes (post-2015 SLGPS)
2. The cost corridor would be widened from +/-2% to +/-3% of pensionable pay
3. An economic check would be introduced, so a breach of the mechanism would only be implemented after long-term economic assumptions were considered.

Point 2 means that the cost collar is wider, and therefore less likely to be breached. However, if it is breached, then the adjustment would be even bigger.
Point 3 means that if the cost collar is breached on the lower side, changes to increase scheme benefits would only be introduced if they were affordable to the taxpayer. Note: there is no parallel in point 3 that detrimental changes to pension benefits would only be introduced if they were affordable to the workers.

Scottish LGPS approach

There is currently no SAB "FSC" pre-breach mechanism in Scotland. However, when the initial E&W LGPS valuation showed cost collar had been breached, there was concern that Scotland could face a sharp adjustment with consequentially higher costs to employers. Northern Ireland was also in a similar situation. This was reflected in feedback to Scottish Ministers, and the SPPA then requested that the SAB provides a steer on developing a Scottish cost control mechanism.

Options for Scotland

There are a number of options which the SAB could recommend to Scottish Ministers, some of which are below with some commentary.

1. **Do nothing**
   It is likely that the 3% cost collar is less likely to be breached than the previous 2% collar, and the introduction by the Treasury of an "economic check" means even if there is a breach (on the upper end), it may not trigger an unaffordable change. A new SAB mechanism is likely to require some funding, and may be unwieldy.
   However, in an increasingly unstable world (with crises in Ukraine and Taiwan) economic shocks may be more likely which may lead to a cost collar breach. If the SAB wanted a mechanism to be put in place, this would have to be agreed before it was called upon. Finally, the economic check addresses a breach on the upper-end of the cost collar – meaning increased costs for employers - but

it does not address a breach at the lower end which would have detrimental effects for workers.

2. **Introduce a mechanism which reflects real world LGPS costs**
   A SAB mechanism could look at the real world assets and liabilities of the LGPS Funds in Scotland, rather then the output of a nominal calculation based on Treasury assumptions across public sector pension schemes.
   Although this would better reflect the financial situation of the Scottish LGPS, it is likely to give quite different results from the Treasury's ECC. Therefore it would not fulfil the policy objective of allowing the SAB to pre-empt breaches and dampen any financial impacts.

3. **Mirror the English and Welsh SAB mechanism**
   This would be a relatively straightforward approach, as there is a model to follow which has already been used.
   However, the English and Welsh SAB is currently reviewing their own mechanism to see if it can be improved, and some potential enhancements already came up in discussion. In addition, the Scottish LGPS operates on a somewhat smaller scale than that in England, and it might be appropriate to take a commensurate approach.

4. **Create a completely new mechanism**
   There could be a fundamentally different approach taken, which might be a substantial improvement on existing options and more suitable for Scotland. Something completely new is likely to require significant technical expertise and the cost and other resources to manage a project to deliver a satisfactory output. There are also no firm options for this, and as the policy objective is to mirror a breach of the Treasury's ECC, a whole new mechanism may be simply unnecessary.

Recommendation

The existing English and Welsh mechanism appears to offer a 'safety-net', especially for a lower-end cost collar breach. It aims to revert costs to the target rate, which may be an unnecessarily severe change when the policy objective is simply to keep costs within the cost collar.

It is recommended that the SAB seeks a 'green light' from Scottish Ministers to take forward a variant around Option 3, and if this is received to bring back a more comprehensive proposal for the SAB to consider and approve, or otherwise.

Appendix A
"Future Service Cost" Regulations in England and Wales

The Local Government Pension Scheme (Amendment) (Governance) Regulations 2015

Scheme advisory board: additional functions
116.—

(1) The Local Government Pension Scheme Advisory Board ("the Board") must obtain a Scheme cost assessment from the Scheme actuary detailing the overall cost of the Scheme and the proportions of that cost being met by Scheme employers and members on the dates specified in regulation 62(1)(a) (actuarial valuations of pension funds).

(2) Subject to paragraphs (5) and (6), where the overall cost of the Scheme is above or below the target overall cost, the Board may make recommendations to the Secretary of State as to the steps to take to bring the overall cost of the Scheme back to the target overall cost.

(3) Where the proportion of the overall cost of the Scheme which is met by contributions by employers is above or below the target proportion, the Board may make recommendations to the Secretary of State as to the steps to take to bring the proportion of the overall cost of the Scheme which is met by contributions by employers and members back to the target proportion.

(4) The Board must, before obtaining a Scheme cost assessment under paragraph (1), prepare and publish a statement setting out its policy concerning recommendations to the Secretary of State about the steps to be taken to bring the overall cost of the Scheme back to the target overall cost and the proportions of that cost met by Scheme employers and members, back to the target proportion.

(5) The Board must not make recommendations under paragraph (2) if steps are required to be taken under regulation 115 (employer cost cap).

(6) Subject to paragraph (5) the Board must make recommendations under paragraph (2) if the overall cost of the Scheme is above or below the target overall cost by 2% or more of pensionable earnings of members.

(7) In this regulation—
"the overall cost of the Scheme" means the total cost as calculated by the Scheme actuary as part of a Scheme cost assessment making use of the data provided under regulation 114(4) (Scheme actuary) according to such methodology and assumptions as are determined by the Board;
"the target overall cost" is 19.5% of the pensionable earnings of members of the Scheme;
"the target proportion" means Scheme employers meeting two-thirds and members meeting one-third of the overall cost of the Scheme.

(8) Each administering authority must provide the Scheme actuary with any data that the Scheme actuary requires in order to carry out any valuations and produce reports in accordance with directions from the Board for the purposes of this regulation.

(9) Unless the Board is prevented by paragraph (5) from making recommendations under this regulation, it must, within 23 months of the date on which a Scheme cost assessment is obtained under paragraph (1), publish a report setting out—
(a)the overall cost of the Scheme;
(b)the proportions of the overall costs of the Scheme met by employers and members;
(c)the assumptions and methodology used by the Scheme actuary; and
(d)any recommendations made to the Secretary of State under this regulation.

(10) The Board must send a copy of a report published under paragraph (9) to the Secretary of State and the Scheme actuary.

(11) The Secretary of State must publish a response to a report received under paragraph (10) within six months of the date on which that report is received.”.