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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 consultation on a benefit improvement 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.

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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.

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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)

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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

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- 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.

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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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21st December 2018