HYMANS ROBERTSON

Private & Confidential
Workforce, Pay and Pensions
HM Treasury
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By email: CCMConsultation@HMTreasury.gov.uk

6 August 2021

Dear Sir/Madam

Public Service Pension Schemes

Cost control mechanism consultation

Hymans Robertson LLP is pleased to provide its response to HM Treasury's consultation on the above topic. The Annex to this letter sets out our formal response to the questions set out in the consultation.

About Hymans Robertson LLP

Hymans Robertson has grown up with public service pension schemes, particularly the LGPS. The firm was founded to provide advice to the LGPS in 1921, just as the first Funds were being created. Whilst our business has developed over the decades, working with the public sector remains at the heart of what we do.

We have a specialist public sector actuarial team, which employs over 60 people exclusively advising on public service pensions. We are appointed as fund actuaries to almost half of LGPS funds. Alongside our actuaries there is a team of 15 investment consultants providing investment advice and a team of governance, administration and project consultants providing advice to our public sector clients.

We believe that we are well placed, therefore, to respond to the questions posed by HM Treasury in this latest consultation paper.

Yours faithfully

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Annex 1

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?
We agree that a reformed scheme only design would create a more stable mechanism as there will be less liabilities in scope of the valuation. As such, any future cost variations will be smaller in absolute terms, resulting in a smaller change in the cost of the scheme when expressed in percentage of pay terms.

A reformed scheme only design makes sense from the point of view that cost variations will only arise from factors that affect the cost of benefits in the reformed schemes, not the legacy schemes.

We do not feel in a position to be able to comment on whether the reformed scheme only design would achieve the 'right' balance of risk between scheme members and the Exchequer. Only the Exchequer and scheme members, or their representatives, will be able to definitively answer that question.

However, we would wish the Government to consider that, within the LGPS, costs relating to the legacy schemes would then fall on employers, who are not necessarily taxpayer funded. We do think the Government should consider if there are alternative ways to manage risk and protect employers from cost changes associated with the legacy schemes. This does not necessarily need to be done with a cost control mechanism. For example, the final salary link could be removed from these schemes to reduce the risk of salary growth being higher than expected.

Similarly, we would encourage consideration of whether the inclusion of liabilities accrued in the reformed scheme in respect of deferred and pensioner members are included in the cost control mechanism. By keeping these liabilities in the mechanism, cost variations associated with these ex-members may have a direct impact on the benefits of current members. To members of this scheme this may seem unfair and not a 'right' balance of risk.

Question 2 - Do you agree with the Government's intention to widen the corridor? If not, why not?
We agree that widening the corridor will lead to a more stable cost control mechanism, as per the Government's stated intention. However, we do not agree that this is the best way to achieve stability within the mechanism.

By widening the corridor, the Government will move the balance of risk back to the taxpayer for the sake of stability. However, stability could be more easily achieved by implementing the Government Actuary's 'Review of breach' recommendation. This recommendation would allow the Government to introduce stability by allowing it to decide not to take forward the results of a cost control valuation, if it believes the cause is transient or a short-term blip. The absence of such a check, or safety valve, for the cost control mechanism was its biggest weakness when initially implemented and, based on the current consultation, will continue to be going forward.

Instead, the current proposal means that if there is a future long-term or sustained variation in the cost of benefits of 2%-3% of pay, the Exchequer will now bear the full cost instead of being able to pass it back to the members.

Question 3 – Do you think that a corridor size of +/-3% of pensionable pay is appropriate? If not, why not?
Although the consultation sets out the justification for selecting a value of 3% based on modelling from the Government Actuary's Department, we are concerned that too much weight and certainty has been placed on these results. This modelling, by its very nature, is very uncertain and should be treated as such. Additionally, a wider corridor could result in a loss of the ability to recognise and respond to actual changes in costs as they emerge.

Given the Government only wants a breach of the corridor due to "extraordinary, unpredictable events", we believe a more appropriate approach would be to keep the corridor at 2% (unless there is a desire to redress the balance of risk between scheme member and Exchequer/employers) and have some form of review to ascertain if the causes for a breach fall into the category of extraordinary and unpredictable.

We also disagree with the application of an absolute value for the corridor. Instead, we think it would be fairer to use a proportional corridor as mentioned by the Government Actuary in their report. Given that most cost variations will be in proportionate terms, an absolute corridor will likely penalise those public service pension schemes with higher costs of benefits e.g. Armed Forces.

Question 4 – Do you agree with the proposal to introduce an economic check?
Yes. We welcome the proposed introduction of an economic check to avoid the perverse outcome of the 2016 valuation.

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 purpose of the economic check will be to avoid the situation where the costs to employers of public service pension schemes move in one direction and the cost control mechanism moves in an opposite direction. Therefore, given that the SCAPE discount rate is currently used to assess and set the employer cost of these schemes, it seems sensible and expected for the SCAPE discount rate to be used for the cost control mechanism (except for the LGPS – see next paragraph). We do note the Government's other consultation on the SCAPE discount rate. If that consultation results in a change to the SCAPE discount rate, then we would expect the 'new' discount rate to be used in the cost control economic check.

We do not believe the SCAPE discount rate should be used for the LGPS cost control mechanism. We disagree with the Government Actuary belief that UK GDP is a good measure for LGPS funds' future investment returns. Most LGPS funds have a significant level of investments in overseas markets, which will not move in line with UK GDP. Furthermore, most LGPS funds have a very broad and diverse investment portfolio, which will again weaken the link between future excepted returns and UK GDP. It would be preferable for the LGPS cost control mechanism to use an LGPS specific discount rate which is constructed to reflect a neutral or best estimate expected return from the overall asset allocation of LGPS Funds.

The consultation also does not consider that, as well as future expected investment returns, a large driver of employer contribution rates is realised investment returns. These affect the past service position of funds and the contribution rates paid by employers. Therefore, for the Government to avoid a perverse outcome, we would recommend that this factor is also taken into account in the cost control mechanism for the LGPS.

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.

As commented on in question 5, we believe that the cost control economic check should be aligned to the methodology underlying the contribution rate employers are paying. Anything else will risk the potential for a situation like 2016 re-occurring with employer contribution rates moving up/down and, as a result of cost control, member benefits being increased/decreased.

If such a divergence did occur between the discount rate used for the cost control mechanism and the quadrennial valuations, then this would be further justification for implementing the Government Actuary's 'Review of breach' recommendation.

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

Aside from the intergenerational issue we have noted in the response to question 1, we do not envisage any other specific equality issues with the consultation proposals.