ASSOCIATION OF CONSULTING ACTUARIES
First Floor (129) · 40 Gracechurch Street · London · EC3V 0BT
Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

Workforce, Pay and Pensions
HM Treasury
2/Red 1
Horse Guards Road
London SW1A 2HQ

Submitted via email to:
CCMConsultation@HMTreasury.gov.uk

19 August 2021

Dear Sir/Madam

HMT Cost control mechanism consultation

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above-named consultation.

The ACA is the representative body for UK consulting actuaries. Our members are all qualified actuaries – mainly Fellows of the Institute and Faculty of Actuaries. Members provide advice to thousands of employers and pension schemes with assets exceeding £1 trillion, including most of the country's largest schemes as well as thousands of smaller arrangements.

This response is submitted on behalf of the Association's Pensions in Public Services (ACA PiPS) Committee which monitors developments and makes representations on pension arrangements for those working in public services.

Our comments on specific questions raised in the consultation are set out below.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 07770 392883 or at Bart.Huby@lcp.uk.com

Yours sincerely

Bart Huby
Chair, Pensions in Public Services Committee
On behalf of the Association of Consulting Actuaries Limited

Response to consultation questions from the Association of Consulting Actuaries

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 with removing the legacy schemes from consideration of past service within the model fund. Our view is that Government should bear the full risk on those legacy schemes and not seek to share those risks with the future workforce on the basis that it would be unreasonable for public servants who were never part of the legacy schemes to suffer a detriment to their future benefits as a consequence of the gains enjoyed by legacy scheme members.

When considering a reformed scheme only design, at successive cost management valuations the reformed schemes' past service will increase and bring more risk into consideration for sharing with members. Having a process that adjusts future service rights to recover notional past service surpluses/deficits is likely to cause intergenerational fairness issues. The rights of new joiners will be increasingly influenced by the past gains/losses of older joiners, and this will lead to stability issues for the mechanism in the longer term. Inherently a future service only design is the fairest model for new joiners. It would remove the debate on what level of past service recovery period achieves the desired level of intergenerational cost sharing.

The Independent Public Service Pensions Commission recognised that certainty of benefits was an important consideration in the new scheme design, and this informed the recommendation to disregard scheme designs which shared *'past service'* risk with members, for example conditional indexation. Arguably an extension of that principle is that past service risk should not then be transferred onto future service rights, and the Government should stand behind the promises it makes without seeking to share emerging gains or losses with future workforces. By sharing those risks this could weaken the adequacy principle for future generations of public servants and lead to more fundamental scheme reform being needed.

In our view the case has not been sufficiently made for the choice of a reformed scheme design (with past service) over a future service only design. There is a risk this decision was influenced by a behavioural bias of choosing the middle of the three options presented. Arguments given are predicated on the assertion that Government should be able to recover losses incurred on the benefit promises made to earlier generations from the benefits that are to be earned by the next generation of public servants, to protect the exchequer. The example of the McCloud judgement is given as where flexibility is needed. However, where Government is found to have acted unlawfully is it fair that those costs should be passed onto future public servants? The rationale for a reformed scheme only design is set out as "… *ensure(ing) consistency between the set of benefits being assessed and the set of benefits potentially being adjusted*". Our understanding is that it would be the intention for only future service benefits to be adjusted, rather than adjusting the past service reformed scheme benefits, so this justification appears to favour a future service only design.

The consultation has not considered if the assumptions adopted for the baseline costing for the cost management process were or are appropriate. This is fundamental to the outcomes of future cost management valuations. If assumptions contain a degree of prudence this will emerge as positive experience at successive valuations and a ratchet up in benefits at the expense of the exchequer. A starting point for the baseline cost of the cost management valuations could be the cost upon which the Government reached a negotiated settlement on those schemes, upon which a cost envelope was set. However, we understand the assumptions underlying the base cost of the cost management process were updated from those used in the original scheme costings leading to an increase in cost beyond that understood by Government. Arguably some or all of this increase is a member cost.

With the benefit of hindsight and the opportunity to review the cost sharing mechanism at this time, given developments in longevity and cost constraints impacting public service pay awards, we believe an opportunity is being missed to review those assumptions and reaffirm that they are best estimate.

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

- We agree that stability is desirable, in conjunction with finding the right balance between the Treasury (and ultimately tax-payers) and members. If the reformed scheme approach is adopted, GAD's modelling indicates that changes are likely every 20 years. If we consider a full working life to be around 50 years (noting that it is shorter for some public servants) this means that an active member might expect to have between two and three changes during their working life. Given that public service pension schemes are very long-term vehicles, reducing the number of changes feels appropriate, as long as the approach can be justified.
- The main issue we can foresee with widening the corridor is the resulting step change to benefits when the corridor is breached. There should be a balance between stability of the frequency of change of benefits and the stability of the level of benefits.
- We note that there is no further discussion about the period over which past service differences are spread for the purposes of assessing the cost cap. We understand the current period is 15 years, which traditionally is akin to future working lifetime of active members. However, if stability is being sought and it is recognised that change should occur less than every 20 years, it also feels appropriate to spread gains and losses over a much longer period and therefore suggest that this assumption is also reviewed. We would suggest that consideration is given to spreading the deficit over something closer to a full working lifetime ie 50 years.
- There is an assumption in GAD's report that spreading experience over a long period is intergenerationally unfair. We would like to challenge this assumption as it warrants further discussion. If, for example, the cost cap assessment was to lead to a significant surplus followed by a return to normal a tranche of member would benefit if that surplus is spread over 15 years. This in itself could be seen to be generationally unfair. In this context (and with reference to question 1), a reformed scheme approach with a short recovery period could be more unfair than a future service approach.

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

- We answer this question based on the current approach continuing. We have made some comments on this approach in both Question 1 and Question 2.
- Based on GAD's calculations, and the fact that we support greater stability, a move to +/-3% leads to the cost controls on benefits being required around once every 40 years but it is important to note that the benefit changes required would be a significant step change when the corridor was breached. In broad terms a member might expect around one change during their working life. This seems like a reasonable target, subject to the points below and accepting that the change, if and when it happens, is significant. As mentioned above, there should be a balance between stability of the frequency of change of benefits and the stability of the level of benefits.
- We note that by achieving this outcome the Government is clear that public service pension schemes are long-term vehicles designed to deliver pension benefits across whole working and

retired lifetimes for many generations. The recovery period should be considered in this context (see also question 2).

- GAD's observation that the cap is currently set at an absolute level and therefore will have different effects for different schemes is an important one. We do not think that the consultation provides sufficient evidence that this should not be considered further. For example, the comment that it could cause confusion assumes that members think of the public service schemes as a whole rather than just the scheme they are in. Whilst we note that there are practical considerations, a clearer case should be made for this over-riding the policy objectives assessed on a scheme-by-scheme basis.
- On longevity, our view is that this should be included. It is interesting to note that the suggestion to exclude any allowance (leaving this element of the cost control in the hands of the review of SPA) would leave longevity effects being spread over the very long-term, which according to GAD's own principles would be intergenerationally unfair. Furthermore, removal of longevity would diminish the credibility of the cost cap mechanism and reduce transparency. We consider that it would be better to include longevity, but to have a longer past service smoothing mechanism (much longer than 15 years – see Question 2) and, if necessary, some additional smoothing on the future service cost element.
- Finally, we would challenge why a floor exists at all. The Independent Public Service Pensions Commission only recommended a cap on employer costs (not a floor). The exchequer bears the risk of increasing costs arising from the financial elements of the assumptions (higher inflation, lower economic growth), yet does not share in the gains from reductions in member costs. Consideration could be given to either removing the floor or adopting an asymmetric corridor where greater cost reductions are required before triggering member benefit increases or contribution reductions.

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

- We agree that there should be a process in place to check that any conclusions made as part of the cost control valuations are appropriate and have considered other relevant factors which do not form part of the cost control mechanism such as economic growth.
- We agree that there should be consistency between the assumptions used to calculate contribution rates in the unfunded schemes and the economic check. Otherwise, this may lead to perverse results which should be prevented where possible.
- We suggest that the other actuarial assumptions are reviewed as part of the review of the cost control mechanism. In particular, we note that the longevity assumption is not being reviewed and this is an important assumption to the cost control mechanism (as it caused the breach of the floor in 2016). For similar reasons, we would like the salary assumption to be reviewed.

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

- On the basis that the SCAPE discount rate is used to set employer contributions in the unfunded public service pension schemes, use of the SCAPE discount rate for the cost control mechanism seems appropriate for reasons of consistency – we think it would be appropriate that the same discount rate that is used for the unfunded scheme valuations is the same as that used for the unfunded cost control mechanisms.
- We do not comment on the SCAPE rate methodology here except to note the desire for consistency between the rate used for the economic check and the approach to setting contributions in the unfunded public service pension schemes.
- A different approach should be considered for the LGPS as a funded scheme as the contributions are not set using the SCAPE rate. They are set as part of the local actuarial valuations and are

based on Fund-specific discount rates. However, it would not be appropriate to use the discount rates adopted for the local actuarial valuations as these include a margin for prudence whereas we would expect that the cost control mechanism should be a best estimate basis.

- An alternative may be some sort of proxy for a best estimate return for the LGPS based on the views of the four actuarial firms. A review of the overall asset allocation of the LGPS could be carried out in order to set such a best estimate return. Of course, the asset allocation of individual funds could range significantly and therefore it may be difficult to agree the most appropriate return to use.
- An alternative approach to the economic check is to use the cost control mechanism run by the Scheme Advisory Board. We understand that this was successfully used at the 2016 valuation.

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.

- For the purposes of this consultation, we would suggest that any changes made to the SCAPE methodology are also reflected in the economic check as it is so key to the level of employer contributions paid in the unfunded pension schemes.
- We agree with the objective of stability in the SCAPE methodology and an STPR approach would provide this. However, by moving to the STPR approach for the SCAPE methodology then this removes the need for the economic check as it would not change from one valuation to the next. However, we would not agree to the SCAPE methodology changing to the STPR approach if this was not reflected in the economic check.
- An alternative discount rate based on long-term GDP could be an acceptable alternative, however, there would be risk of perverse outcomes in terms of consistency of the cost control mechanism and changes in employer contribution rates due to the underlying discount rate approach for both being different. Therefore, we do not agree that such an approach would be appropriate.
- For the LGPS, we believe alternatives for the economic check discount rate are potentially required to achieve the same objectives and we elaborate on this in our response to Question 5.

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

As the proposed reform would apply to all benefits accrued in future, we do not see any obvious equalities impacts. Any future proposed benefit changes should still be reviewed as normal to ensure that they do not cause any inequalities.

We would be happy to discuss our response further if that is helpful. In that event, please contact Bart Huby, Chair of our Pensions in Public Services Committee, on 07770 392883 or at Bart.Huby@lcp.uk.com

Produced by: **Association of Consulting Actuaries (ACA)**
First Floor (129) · 40 Gracechurch Street · London · EC3V 0BT
Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

19 August 2021