Government Actuary's Department

Government Actuary's Blog

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15th Annual LGPS Governance Conference 'Clarity in Confusion'

Keynote Speech, 17 January 2019

Introduction

I'm grateful for the invitation to speak to this conference today. I've been the Government Actuary now for 4½ years, prior to which I was at the Pension Protection Fund for eight years and before that in the insurance industry for more time than I now care to think about. I still feel to be in my novitiate with regard to government functions, including the local government pension scheme. So apologies in advance for any outrageous howlers I shall make.

Working as an actuary for so long in insurance has given me a sense of risk and reward that I often find most useful in assessing novel situations. No insurance company takes risk without sufficient prospects of an appropriate reward. And whilst government often has no option but to accept a lot of risks, the attribution of the rewards – or more likely the costs – of those risks can pose very interesting problems to consider. Risks are therefore everywhere, from those pan-government risks, through the risks at a scheme and employer level, right down to those risks we carry as individuals.

Public service pensions

In the world of public service pensions the government has the risk of meeting pensions promises made to several million public sector workers over previous generations well into the unfolding decades of the current century. A major component of this landscape, the LGPS E&W is the largest DB scheme in the UK with 5.7 million members and around 17,000 employers. As the scheme's benefits are secured with the assistance of a huge pot of money, currently over £270 billion[1], it is also in aggregate one of the world's largest pension scheme investors.

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/748759/LGPS_England_and_Wales_2017-18.pdf

As Government Actuary I (and colleagues) advise MHCLG with regard to the LGPS, acting as scheme actuary for the purposes of the cost cap valuations – now every four years, not three – and reporting under Section 13 of the PS Pensions Act on all the valuations undertaken by fund actuaries for the 88 administering authorities[2]. We advise generally within the public sector on a variety of technical matters both pension-related and others. We do not directly advise any of the individual funds within LGPS.

We do however advise the other parts of the public service pension scheme landscape, the sizeable schemes for civil servants, Teachers, NHS workers and uniformed services etc. The majority of these pensions promises are unfunded and so the risks are directly carried by future generations of taxpayers. Expenditure on unfunded public sector pensions increased from about 1% of GDP in the early 1970s to about 2% of GDP following the financial crisis[3], but have been on a more stable trajectory following the Hutton reforms and in particular the switch to CPI from RPI for pensions indexation.

Nevertheless, the issues affecting these unfunded schemes often also have implications for the LGPS and a common theme across any pensions policy thinking and analysis are the burdens placed on future generations from decisions taken today. Within the public sector this has been thrown into very sharp focus in recent months by the double impact of the reduction of the SCAPE discount rate to 2.4% pa (in line with revised forecasts for long-term GDP growth) coupled with the results from the 2016 valuation round. The latter showed that all public service schemes had fallen through the cost cap floor – a breach that would potentially improve benefits and add more cost to current and future generations of taxpayers. Additionally a recent legal judgement has made finding the path forward considerably more challenging.

Even with this current confusion it is clear unfunded schemes should expect to implement increases in contribution rates. These will of course impact on local authorities that employ teachers or firefighters. Increases in the employer contribution rate in the Teachers Pension Scheme from about 17 per cent to 23 per cent after the cost cap breach has been remedied have been recently disclosed[4]– a 30% rise that reflects the limited potential of future economic growth to pay for today's promises.

[2] This excludes the Environment Agency open and closed funds.
[3] Good pensions that last HM Treasury November 2011 Chart 1.A p7
[4] https://consult.education.gov.uk/financial-strategy-unit/funding-the-education-sector-for-teacher-pensions/supporting_documents/Teachers%20Pensions%20Scheme%20Consulation.pdf

This was the first time that the rising costs of DB pensions had really reached employers in the unfunded public sector in a significant way. And raised understandable concerns – no employer wants to be unsighted on financial risks of this kind.

Government has discretion on how increasing pension costs are passed on, ie how exactly a fair balance between generations of taxpayers is struck. The Chancellor announced in his Autumn Budget, that additional funding will be provided to relieve the effect on central government departments of the immediate increase in pensions costs. It remains to be seen how that additional funding will be divided between employers, and it will be little comfort to non-statutory employers participating in these government schemes.

Nevertheless there was no doubt a large slice of schadenfreude enjoyed by private sector employers who had been subject to rising pensions costs since the turn of the century and the entry into what has been an extensive period of relatively low investment returns.

The LGPS

Which brings me back to local government pensions with its distinct difference from most other public service schemes in having funds backing the scheme. These present a different kind of risk to that to which unfunded schemes are exposed.

Financial markets are much more volatile than long term forecasts of the UK economy have been and, whilst the SCAPE rate reduction has brought the discount rate for unfunded schemes more into line with the market-related rates that are used by LGPS schemes, the latter are arguably more accustomed to managing the effects of volatility on contribution rates. The management of funding deficits can be used to a degree to reduce instability of contribution rates.

Thus a separate fund brings a degree of independence of investment strategy and local control over the contribution policy of the individual LGPS funds. It also brings responsibilities too – especially the management of public money and the stewardship of huge investment funds.

Section 13

That local independence carries its own risk/reward balance and this is one that I monitor as part of my work with MHCLG under Section 13 of the PSPS Act 2013. In this work we assess the valuations of the LGPS funds against the four criteria of compliance, consistency, solvency and long-term cost efficiency. We reported on these in September last year[5]. Our main conclusions were:

First: The LGPS in E&W is in good shape overall. A bull market up to the valuation date in 2016, together with substantial financial contributions from local government employers had strengthened funding (from 79% to 85% on prudent local bases and to 106% on our own best estimate basis). Most of those funds that had been "flagged" so to speak in our earlier dry-run of this exercise, as being most exposed to solvency and/or cost efficiency risks, had taken substantive steps to reduce those risks.

Secondly: We consider that funds and their actuaries can do much more through their valuation and contribution-setting processes to enable comparisons between funds to be made. In part this would be through improved and consistent disclosures, but in part also it would be through greater consistency in the approach to setting actuarial assumptions.

Thirdly: We would recommend that all funds review their funding strategy to ensure that the handling of surplus or deficit is consistent with CIPFA guidance. We think that funds should be able to demonstrate that any new deficit recovery plan is a continuation of the previous plan taking into account actual fund experience, rather than a roll-forward of the previous plan where the target date to achieve full funding is continually moved further into the future.

We also commented on the specific treatment of the 6,000 Academy employers[6], who have had a mixed experience from LGPS funds, and we recommended that a common basis for future conversions to academy status be adopted.

Our recommendations are not aimed at restricting local decision-making or strategies, but are principally designed to facilitate transparency and better enable comparisons between funds. Progress has already been made in this

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[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/743388/GAD_Section_13_Report.PDF

[6] Academies' LGPS Pension arrangements, GAD, Sep 2018 section 2 into p 3 https://www.gov.uk/government/publications/academies-lgps-pension-arrangements

area, and our recommendations look to build on this good work and enhance local governance by helping to benchmark performance more readily.

A hallmark of this review exercise has been the close and continued engagement between all those involved throughout, not least between MHCLG, SAB and other stakeholders including actuaries. We look forward to continuing this close interworking as the preparations for the post 2019 valuations exercise begin.

Investment pooling

There is more that is similar between the LGPS funds than different, and opportunities to trade on common knowledge and pool resources where appropriate within a framework of local decision-making should in my view be taken wherever possible. I am a big supporter of the pooling of investment funds to concentrate expertise, enhance buying power and leverage knowledge and intelligence.

The scale of the rewards, and risks, of investments, and the associated expenses, are very significant. This is highlighted in the SAB's excellent LGPS annual report which showed the return on investment to be over £45 billion in 2016/17.

In my experience at PPF which was the forerunner of what is becoming the consolidation of UK DB pensions, I saw first-hand the benefits of investment scale, being able to negotiate from a position of strength with investment managers anxious to be part of a pensions growth story and to carry the prestige of being a PPF supplier. Not only were fees reduced (and reduced again in some cases), but scale brought greater influence and opportunities that added to the investment rewards and diversified the risks.

Scale can enable specialist investments such as infrastructure to be accessed economically and can help access better returns from being a founder investor rather than a follower in new strategies.

And by concentrating the resourcing of management functions, a greater degree of risk-management can be applied to the execution of an investment strategy.

And at a more economic cost. The disclosed investment management expenses total over £800 million a year (£1 for every £11 spent on pension benefits to members and four times the cost of administration and governance combined). So any cost saving initiatives from pooling across the whole LGPS can have a big payback. Indeed the SAB has demonstrated a pooled approach to become an industry leader on transparency[7].

Pooling for scale benefits need not damage local decision-making on strategic issues. I would contend that the concentration of investment expertise within the investment pools coupled with the local oversight and strategic direction-setting by local boards is fully aligned with the Myners principles for institutional investment of which I am a big supporter. Myners noted that the single most influential factor in the investment value-chain is the asset allocation strategy. And if local boards wish to exercise the most influence then the retention of this responsibility is key. It is also the area where risk appetite and risk budget are most appropriately reflected.

Asset owners should manage their risks and where these are delegated to agencies through investment management agreements, those agreements and the performance of them are clearly the responsibility of the asset owners.

And ensuring that risk in a holistic sense – including those known as Environmental, Social and Governance as well as the more mathematical ones - is considered through those agreements sits firmly within those responsibilities. For me therefore responsible investment isn't an ethical question but one of enlightened risk management and here I speak with some experience in my time in insurance and at the PPF.

Cost cap

My theme of risk and reward now takes me to the cost cap mechanism in public service schemes. In the case of LGPS it is cost cap mechanisms as there are two of them – a HMT-led government one and a SAB-led LGPS specific one. These were introduced as part of the 2015 scheme reforms to control and share the costs of public service schemes. By law, scheme costs could not vary by more than 2 percentage points either side of a benchmark cost percentage before action on benefits must be taken to remedy the breach.

In order to reflect the risk-reward balance in the Government cost cap, only those costs related to actual scheme experience rather than economic or financial experience were included within the cost cap mechanism and not all past service was included in the mechanism.

As you may know, the Law of Unintended Consequences has applied to the cost cap mechanism and all the unfunded public service schemes have recorded a cost cap floor breach at the very first attempt! This would require

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[7] http://lgpsboard.org/index.php/structure-reform/cost-transparency

benefit improvements to remedy the breach which, in turn, would have increased pension contribution costs.

The breaches occurred because the financial effects that have caused aggregate costs to rise were excluded from the cost cap mechanism but other factors such as slower than expected longevity improvements and lower than expected salary growth, which have acted in the opposite direction, were included. Both these factors were much reduced at the 2016 valuation, leading to lower costs and therefore to the floor breach.

To its credit, the LGPS E&W had devised its own slightly more focused cost cap mechanism that was designed as an early warning to the Government's own mechanism and which would maintain a greater degree of control within the governance of the LGPS. And whilst this has breached also, the changes as a result of this SAB process may avoid higher cost increases were the HMT process to breach.

Other legal matters

To add to our problems (or perhaps confusion), the Government has recently lost a case (McCloud) at the Court of Appeal that the transitional arrangements put in place in the unfunded schemes to smooth the effect of transition from the old public service scheme rules to the new 2015 schemes was age-discriminatory.

Measures enacted with the best of intentions to reduce the effects of new scheme rules on those closest to retirement appear to be unlawful.

The ramifications for unfunded schemes are very significant. It may also carry potential implications for the LGPS, the final salary underpin introduced as part of the 2014 scheme reforms and previous age related protections in the scheme. Colleagues in Government are working to determine the best approach across the public service schemes and restore a measure of clarity for all the schemes.

This could involve a period of further review of these schemes to reach an acceptable conclusion despite the Government's original view that the 2015 reforms were fixed for a generation.

Transitional protection is just one of the legal developments that may impact on the LGPS. In October, the High Court's judgement in the Lloyds case might be the beginning of the end of almost 30 years of uncertainty on GMP equalisation.

But for the moment there is still a good deal of confusion, and there may be a good deal more pain, effort and expense before clarity is obtained.

These and other instances of inadvertent discrimination have proved to be significant risks to the scheme. A later session in this conference will no doubt cover them in more detail.

Academies and tier 3 employers

I briefly touched on the inconsistent treatment of new academies across the LGPS in my comments on the Section 13 report. In my view it shouldn't be a problem requiring a different approach by different LGPS funds.

But the appropriate terms of participation for a new academy does illustrate the risk and reward trade-offs in the LGPS. To what extent should the new body be responsible for legacy pensions costs and funding deficits? And on what basis are these to be calculated?

This is a small subset of a real issue for the LGPS which has some 17,000 participating employers of which close to 2,000 are tier 3 employers without any statutory, ie taxpayer backing[8]. Clearly the local authorities that effectively guarantee the funds assume a level of risk that is incapable of being underwritten by other participating employers such as charities or limited liability companies. Such employers may withdraw from the scheme or can simply go bust leaving the residual pension costs to be spread amongst the remaining participants and ultimately picked up by the local authorities.

Are these risks being compensated for?

Well, contribution rates vary across the employer pool so that a less strong employer might expect to pay higher contributions than an equivalent local authority. This represents a precaution against failure and means that the sub-funds notionally allocated to third tier employers are better funded all things being equal compared to the local authorities. And upon exit, the funds require the payment of the costs of the pension liabilities if that is possible.

Thus the sums at risk (ie pension deficits) are reduced and provision is made for an appropriate exit payment. But there is little actual reward for local authorities sharing their scheme with other employers.

Perhaps there should be?

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[8] Tier 3 employers in the LGPS, AON, Sep 2018, Exec Summary p1, top of 2nd column http://lgpsboard.org/images/PDF/Tier_3_employers_in_the_LGPS_FINAL.pdf

There are indeed strong arguments for the whole process and practice for the treatment of third tier employers in the LGPS to be made more transparent and consistent and for greater discussion of the issues across the whole LGPS. I am pleased that the SAB have begun to look at this and engaged Aon initially to research and scope the Tier 3 sector and its issues.

Based on our study of Academies in our Section 13 work and recognising that there are likely to be similar issues of consistency and transparency with other employer participants in LGPS, I am very supportive.

The implementation of new Fair Deal in the LGPS will also affect the composition of employers and the balances of risks and rewards. Employers will no longer be able to offer a broadly comparable scheme – they will participate in the LGPS either as a traditional admitted body or through a 'pass through' arrangement. Pass through arrangements offer the opportunity to outsource at lower cost with the local authority retaining most pension risks and not having to pay a premium for the outsourcer to carry them. Designing contracts that prevent the outsourced employer abusing these arrangements and driving up the local authority's pension costs will still be a challenge. But perhaps this is also an opportunity to develop some mechanisms to avoid cross subsidies between employers that are more practical than running a scheme with 17,000 employers and 17,000 different employer contribution rates.

Scheme data

My final comments would be stretching the risk and reward theme a little to place it in the same bracket. But there are risks associated with poor scheme data, many of which are borne by scheme members in the form of errors and delays. Our engagement with the standard of record-keeping occurs with our regular valuation work where we sometimes have to make heroic assumptions about the data that we cannot use for the purposes of our valuations. For all public service schemes this can have consequences about uncertainty in the contribution rates or indeed the size of any cost cap breaches, added to which is the sheer cost of trying to patch up data sets at each periodic valuation rather than having this as a standard ongoing requirement.

We recognise that this is not an easy task but we are supportive of the various initiatives to improve data quality.

These include the move towards monthly automated data submission and reconciliation by employers, as championed by West Midlands Pension Funds amongst others, which has also been taken up by the SAB. These sorts of initiative are essential to reduce the risks associated with poor data in future

Conclusion

I have covered my reflections on the technical issues affecting public service schemes and LGPS in particular. And there are many – the cost cap breach, the whole process of cost control, the insights and overview from my Section 13 work and the impacts of legal rulings most notably those affecting GMP equalisation and the implementation of the reformed schemes in 2015. I have touched on the specifics of LGPS data and the tricky technical and political issues around the admission of employers without statutory backing. And finally what might be, but hopefully not, a perennial refrain and appeal for better quality data.

However, I have also said that the scheme was in good financial shape at the latest valuation, that progress had been made on our earlier recommendations from the Section 13 dry run, that funds should be encouraged by the collaboration through the SAB and investment pooling for example to continue to work together, share experience and intelligence and develop a comparable and transparent methodological approach to scheme management and practice. There is much to be proud of and to build on in the challenging times ahead.

Martin Clarke

Government Actuary