Government
Actuary's
Department

Cost control mechanism

Webinar - Government Actuary's review of the cost control mechanism

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Agenda

- Cost control mechanism - Background
- Review of the existing mechanism
- Proposed changes to the cost control mechanism
- Q&A

Cost control mechanism

Background

Public Service Pension Schemes

Civil servants
Judiciary
Local government
Teachers
Health service
Fire and rescue
Police forces
Armed forces

Over **5 million** active members[1]

Nearly **£40bn** of pensions paid out each year to over **4 million** pensioners[1]

Benefit payments equate to around **1.9% of GDP** in 2010-11[2]

Total past service liabilities of around **£1trillion**[1]

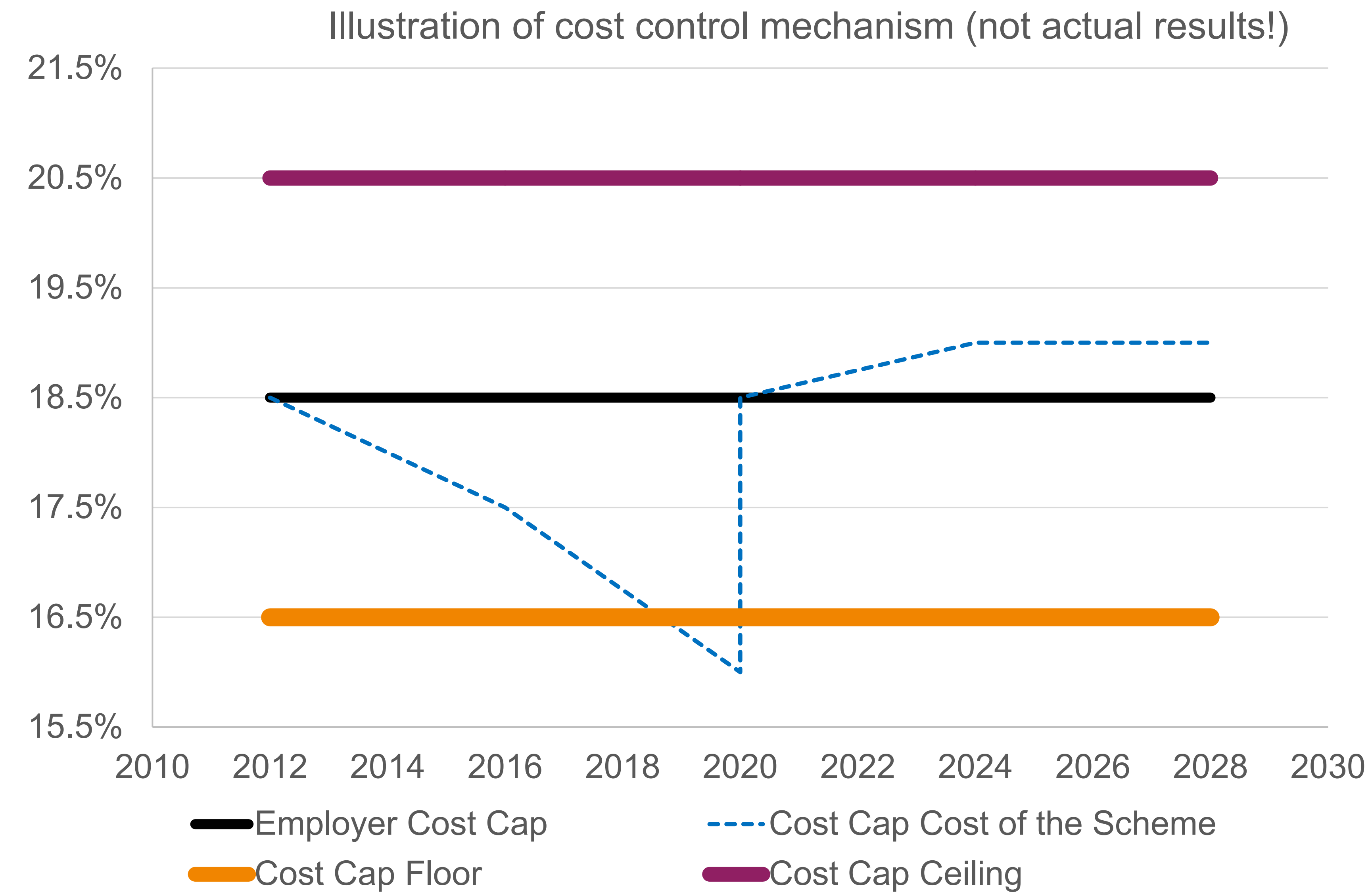
[1] https://www.gov.uk/government/publications/public-service-pensions-2016-actuarial-valuation-reports

2 https://www.gov.uk/government/publications/independent-public-service-pensions-commission-final-report-by-lord-hutton

What is the cost control mechanism?

Tool for managing the value of benefit provision in public service pension schemes

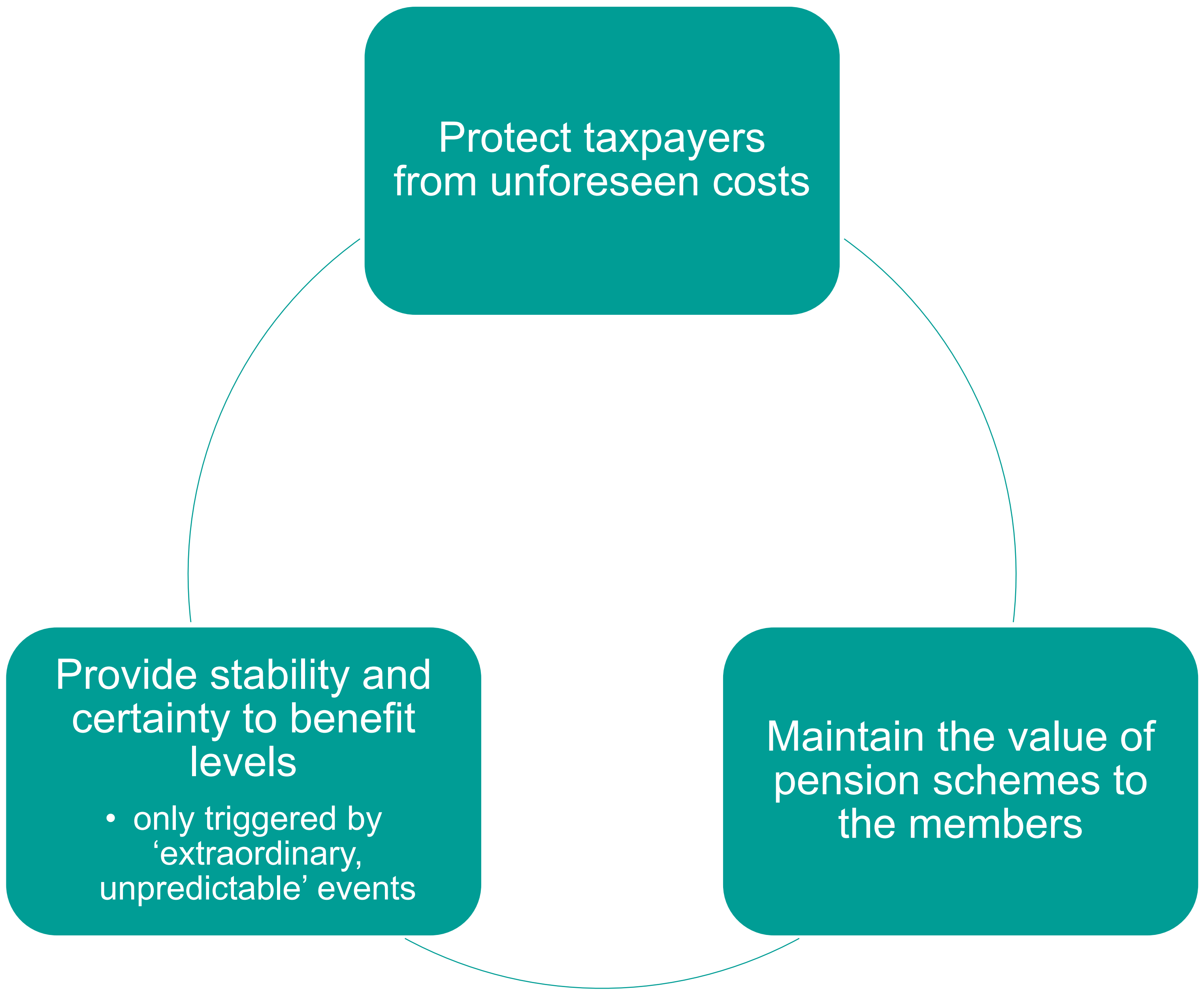
- Employer cost cap set as part of the 2012 valuation
- At each subsequent valuation, measure employer's share of cost
- 2016 was to be first assessment



Breach occurs if cost of scheme is ± 2% from target cost (outside corridor)
Position "rectified" by adjusting benefits or amending member contributions

Objectives of cost control mechanism

The cost control mechanism is designed to ensure a fair balance of risk with regard to the cost between members of those schemes and the taxpayer.



Effect on intergenerational unfairness

Respond to future developments

Government Actuary’s review

Concern that the cost control mechanism was not operating in line with its original objectives; in particular, the intention that it would only be triggered by ‘extraordinary, unpredictable events’.

GA review objectives:

- To assess whether – and to what extent – the mechanism is working in line with original policy objectives for the mechanism.
- To make recommendations as to any changes to the mechanism that could be made to ensure it is working in line with these original objectives.

Review of the existing mechanism

Assessment of the current mechanism

Summary of changes in employer cost at preliminary 2016 valuation, averaged across six of the largest unfunded schemes

	Past service	Accrual cost	Commentary
Change in short-term financial assumptions	↓ -1.1%	n/a	**Reduction** in the assumed level of **future salary increases**, leading to reduced cost of past service in the legacy schemes. No impact on accrual cost as benefits accrue on CARE structure in reformed schemes.
Change in mortality assumptions	↓ -0.9%	↓ -0.9%	**Reduction in assumed life expectancy** between 2012 and 2016 arising from a change in ONS future projections, leading to reduced costs.
Changes in demographic assumptions	↓ -0.1%	↓ -0.3%	Changes in **other demographic assumptions**, such as retirement, commutation and promotional salary increases
Other changes	↓ -0.2%	↓ -0.3%	Change in average age, average State Pension age, experience gains
Total Change in cost cap cost of the scheme (past service/accrual cost)	↓ -2.3%	↓ -1.5%	The **past service change** in costs was the **larger element**. In isolation, the change in accrual cost was within the 2% floor.
Change in cost cap cost of the scheme	↓ -3.8%		A 3.8% reduction in costs, which exceeded the 2% floor.

Red figures are those where the impact for that change by itself exceeded the 2% corridor. Figures in **amber** are those where the impact exceeds 0.5% but is insufficient to breach the 2% corridor in isolation. Figures in **black** are the remaining smaller impacts of less than 0.5%.

Assessment of the current mechanism

Legacy schemes (i.e. those in place before the 2015 reforms) were the main driver of the breaches, yet the cost control mechanism can only amend benefits in the reformed schemes which tends towards intergenerational unfairness.

Further, the cost reductions relate to risks that have largely been mitigated in the reformed schemes.

The 2016 valuation resulted in employer contribution rates increasing, while provisional cost control results found that all schemes breached the floor which would have led to benefit improvements resulting in a further increase to employer contribution rates.

It does not seem possible for the mechanism to be able to protect taxpayers unless it takes into account more of the factors affecting the actual cost of providing a pension.

Current corridor is too narrow and will lead to excessive volatility in the mechanism

Proposed changes to the cost control mechanism

Recommendations

Stage 1

Mechanism

- Retain existing mechanism

OR

- Reformed scheme only (past and future service)

OR

- Future service reform scheme only

AND / OR

- Widened corridor

Stage 2

Validation

- No further process

OR

- Affordability offset assessment*

AND / OR

- Review of breach

Longevity allowance

*Referred to as 'Economic check' in consultation documentation

Reformed scheme only

Proposal

Remove any allowance for legacy schemes, so the mechanism solely considers the reformed schemes (both past and future service).

Rationale

Consistency between benefits assessed and those that can be adjusted

Legacy schemes will be closed as far as is deemed appropriate from 2022

Considerations

Improve short to medium term stability and intergenerational fairness

Fewer costs are captured by the mechanism

Government takes on all the risk associated with the legacy schemes

Widen corridor

Proposal

Widen to reduce the frequency of breaches

Stability of benefits vs responsiveness of cost control

Rationale

Breaches will continue to happen without an “extraordinary, unpredictable event” occurring

Simple solution

Considerations

Improves stability and certainty of benefit levels

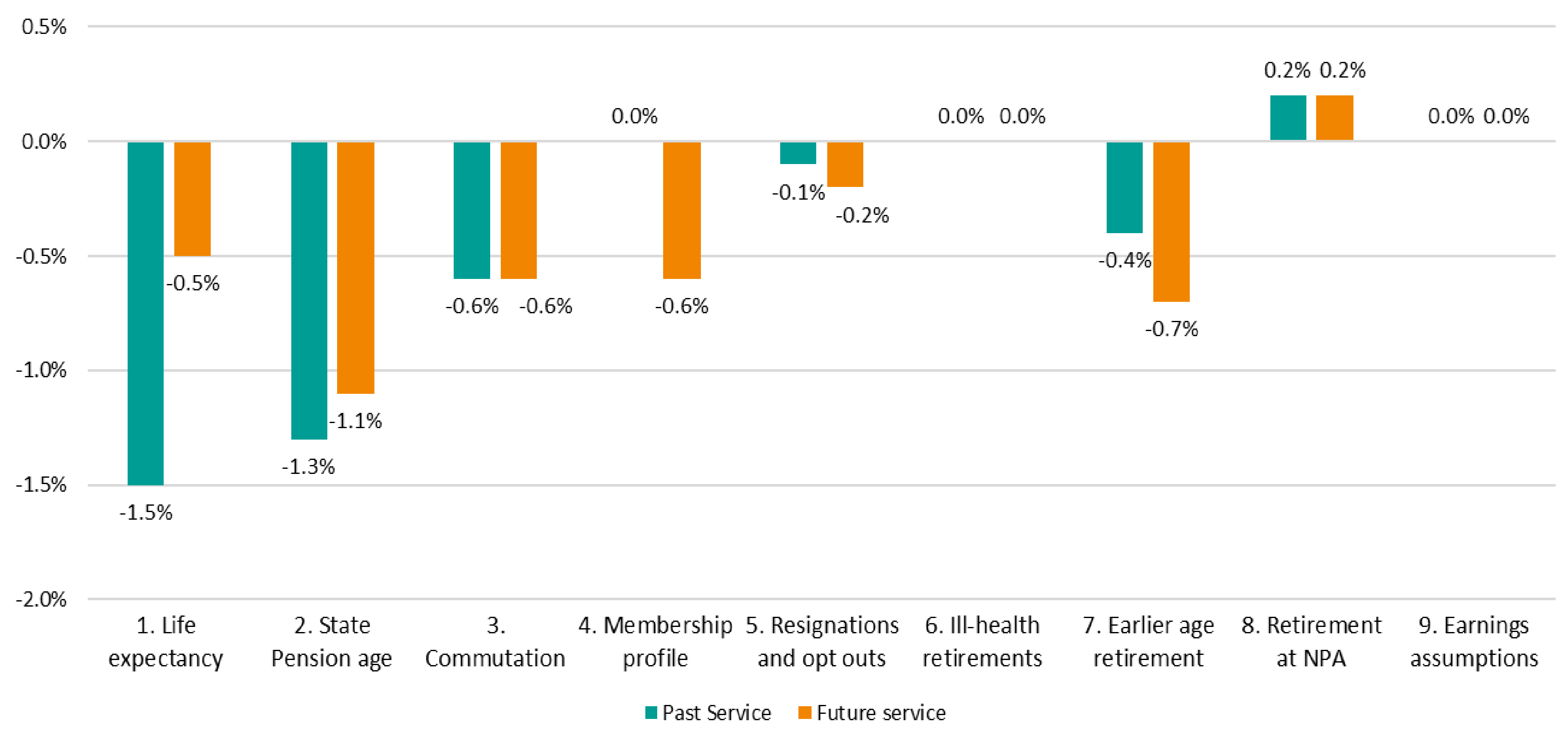
Reduces ability to protect the taxpayer or maintain value to members

Even out effect of causes of cost variations

Exacerbates “cliff edge” nature with larger changes

Widen corridor

Illustration of sensitivities to assumptions of a reformed scheme only or future service only mechanism (% of pensionable pay)



1. The impact of reducing assumed future improvements in life expectancy. Broadly this reflects a one-year reduction in life expectancy for a member currently aged 65.
2. Increase in State Pension age of one year.
3. Increase in the proportion of pension commuted for cash where the directed commutation assumption is used, from 17.5% to 25%.
4. Two-year decrease in average age.
5. Increase in the withdrawal assumption by 10%.
6. Increase in the ill-health retirement assumption by 10%.
7. Additional 20% of members retiring at age 55.
8. All members retiring at the scheme's Normal Pension Age.
9. Increase of 0.25% pa in the assumed short-term and long-term rates of public service earnings.

Expected breach frequency for a reformed scheme only mechanism

Corridor size	Expected breach frequency for a single scheme
+/-2%	Breaches broadly expected every 5 valuations
+/-3%	Breaches broadly expected every 10 valuations
+/-4%	Breaches broadly expected every 20 valuations
+/-5%	Breaches expected to be rare

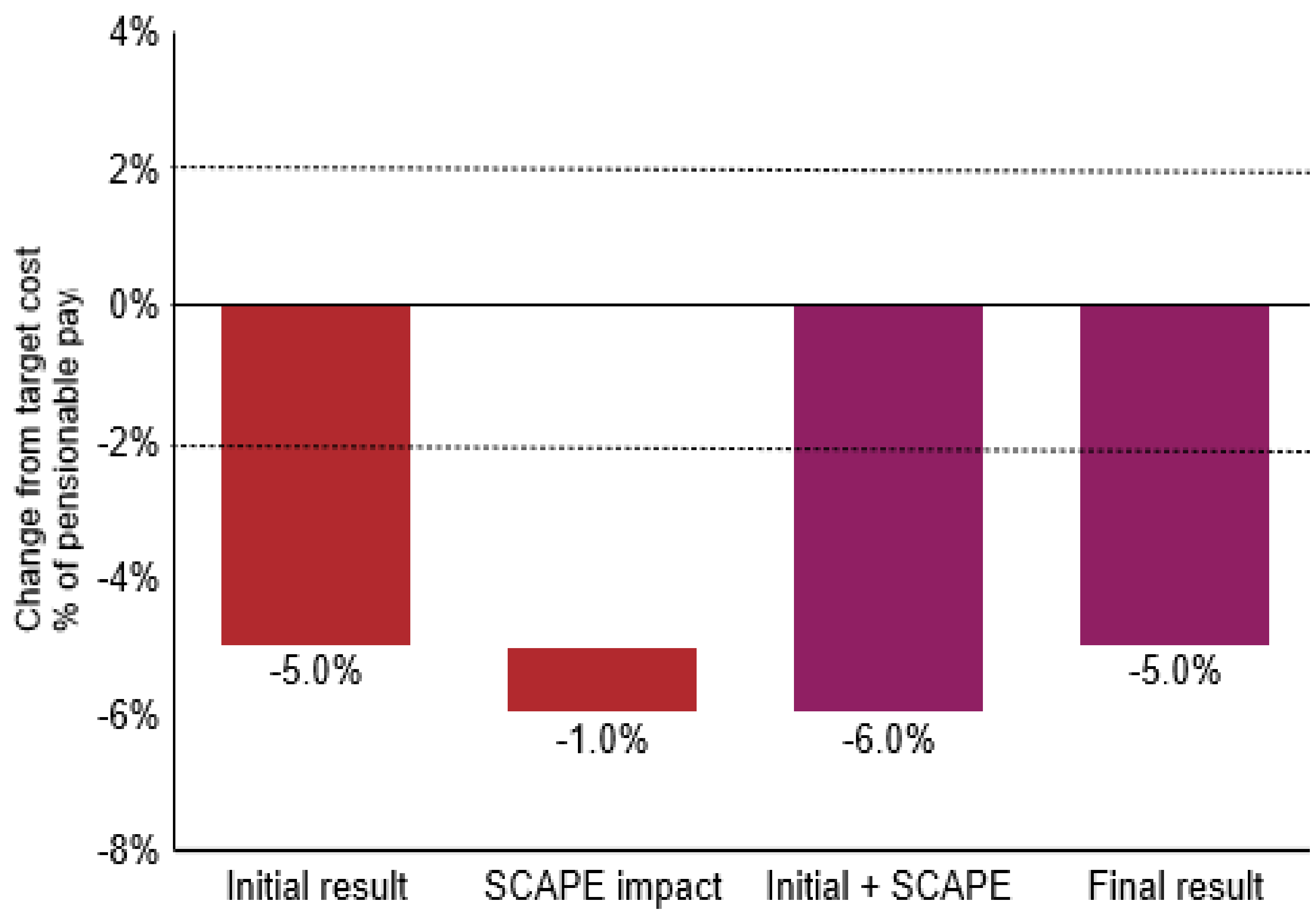
Affordability offset assessment*

Proposal	Rationale	Considerations
Affordability check	Not possible to protect taxpayers without considering more factors	Increases stability and improves protection to taxpayers
Implement breach only if it would still have occurred considering the change in long-term economic assumptions	Including SCAPE fully would likely create significant instability	Costs could still increase without any corresponding reduction in benefits.
SCAPE would be able to offset any breaches but would not be able to cause or increase the size of a breach	Pragmatic balance	Introduces elements that were not originally designated “member” costs, albeit in a limited way

*Referred to as ‘Economic check’ in consultation documentation

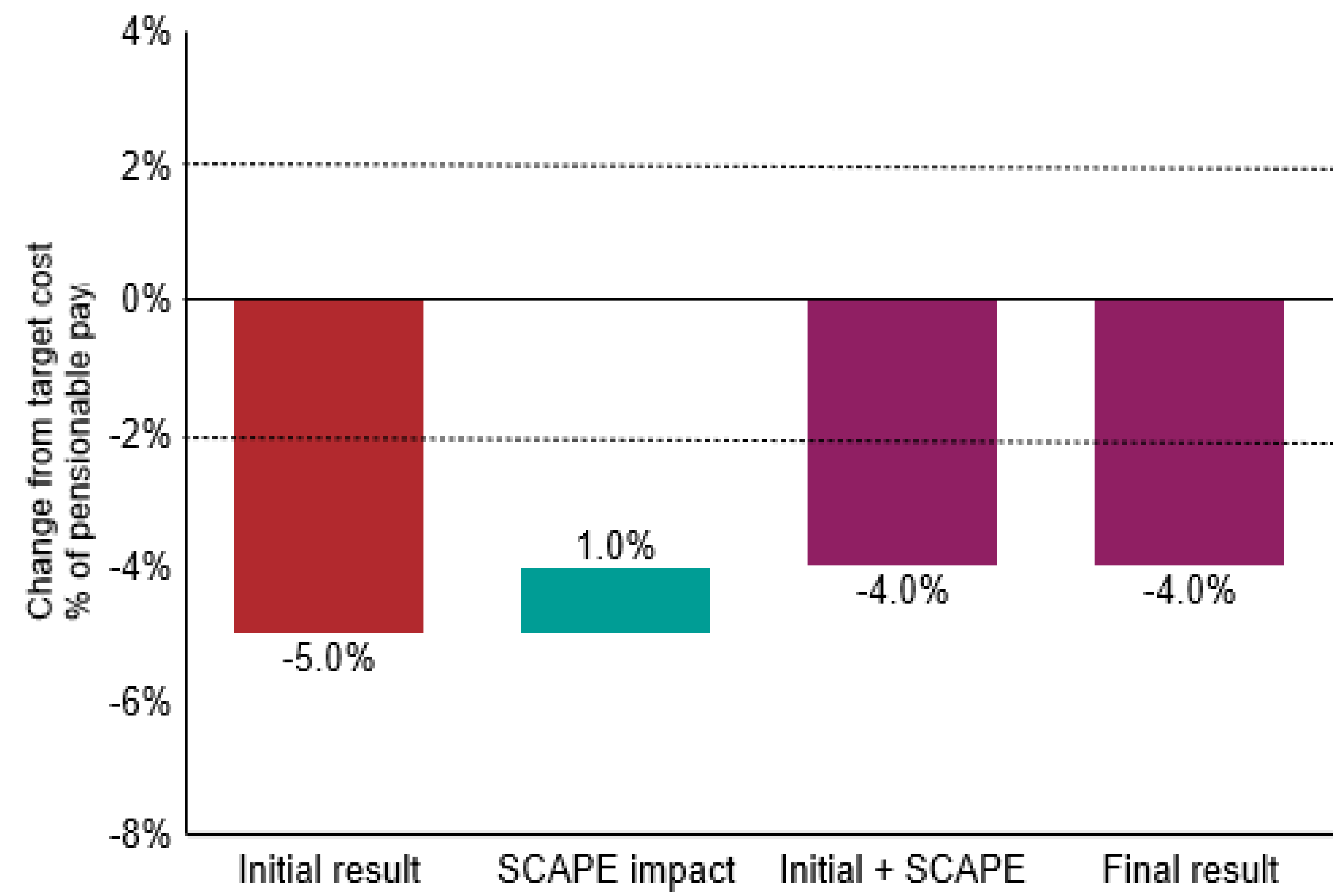
Affordability offset assessment - examples

Scenario 1



SCAPE does not further increase the breach

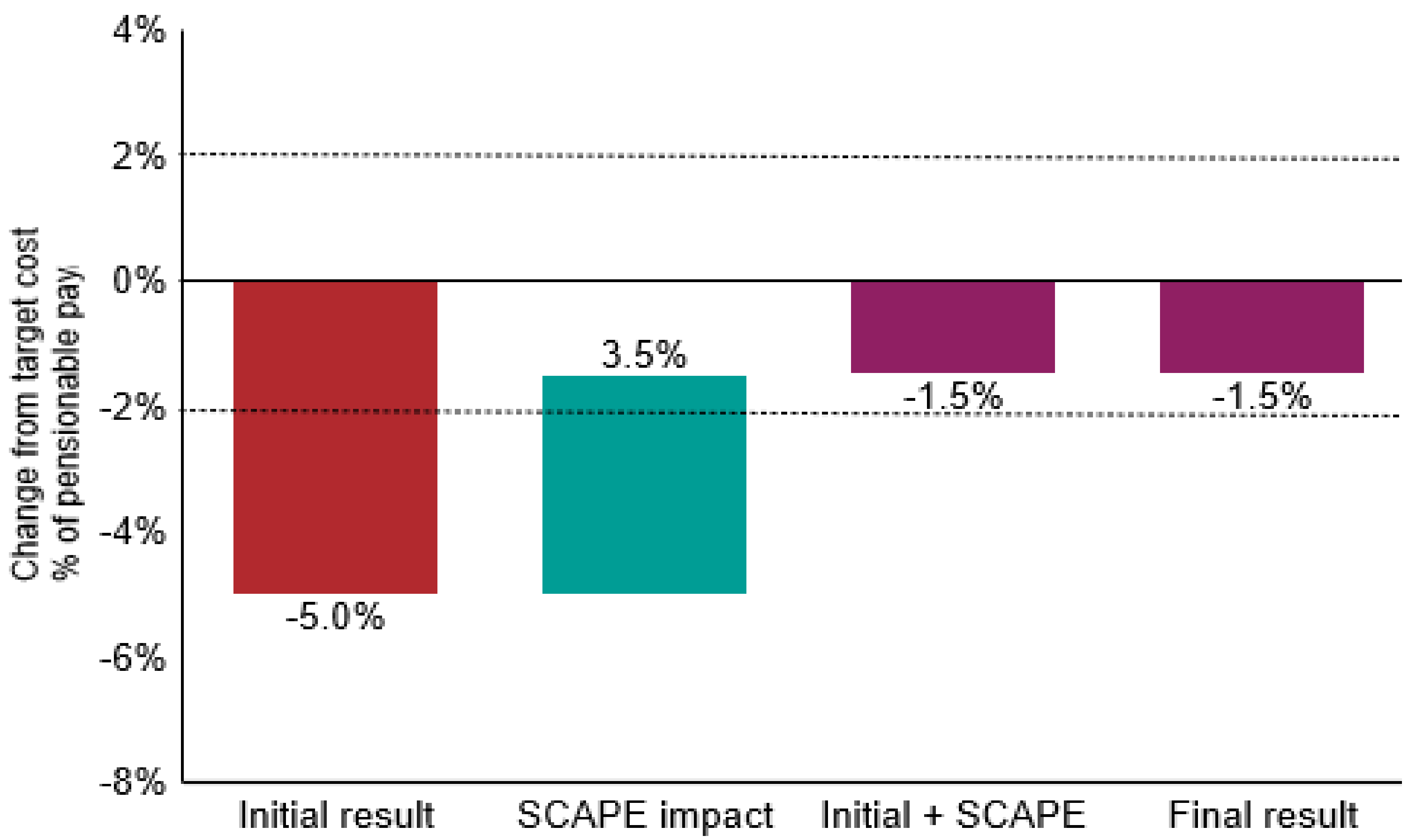
Scenario 2



SCAPE partially offsets the breach

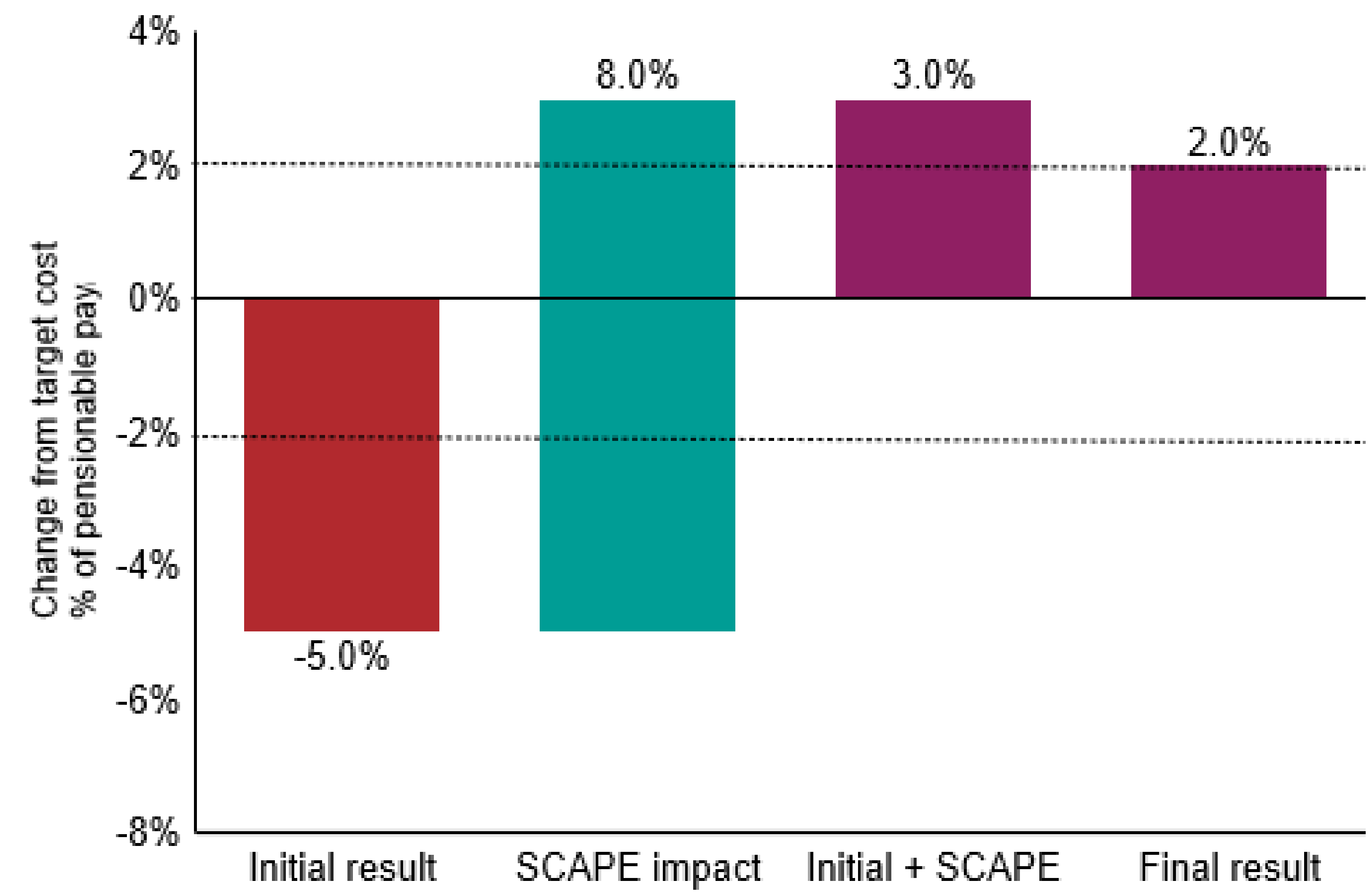
Affordability offset assessment - examples

Scenario 3



No breach as SCAPE offsets to within corridor

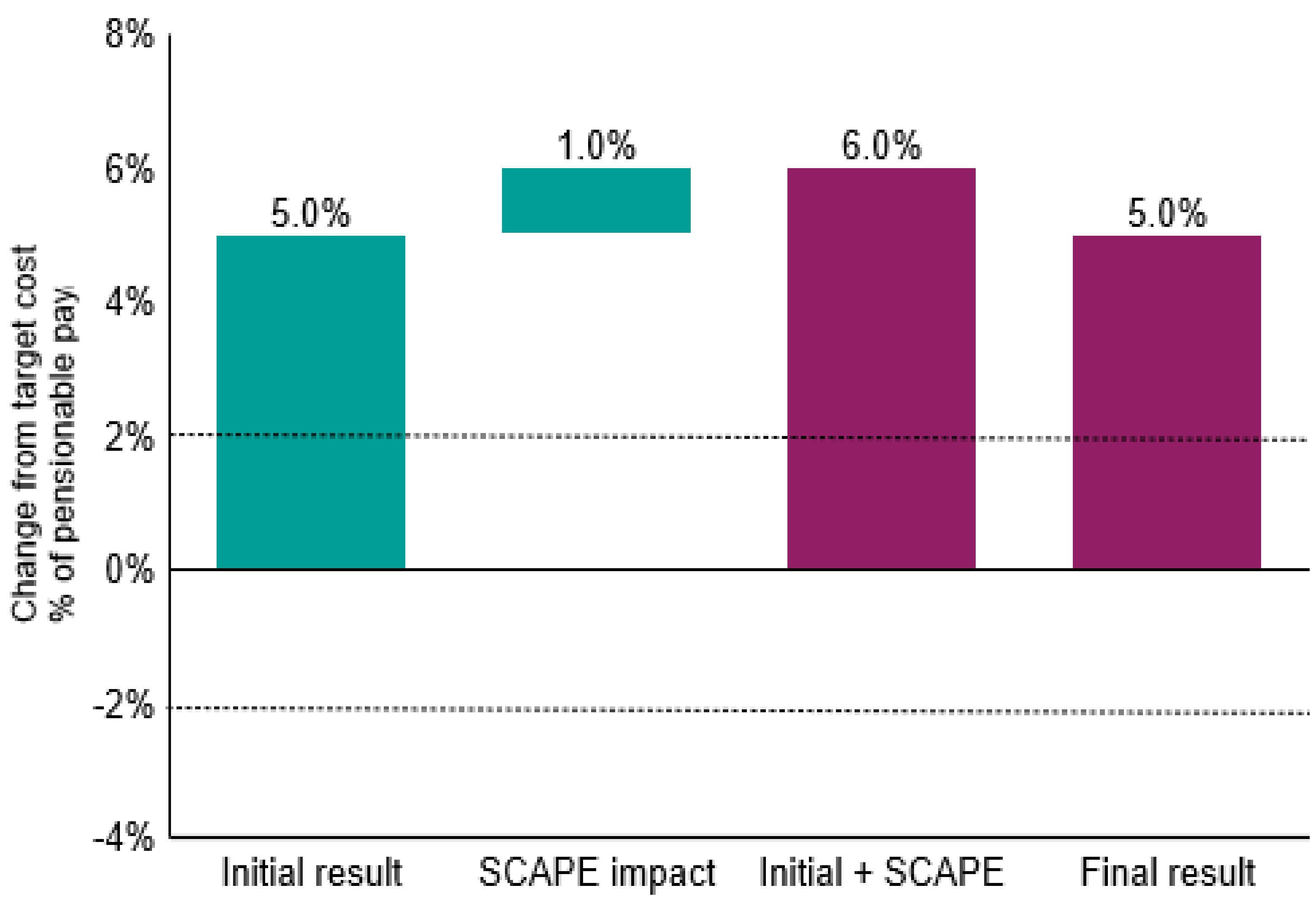
Scenario 4



No breach. SCAPE can only offset and cannot cause a breach in the opposite direction.

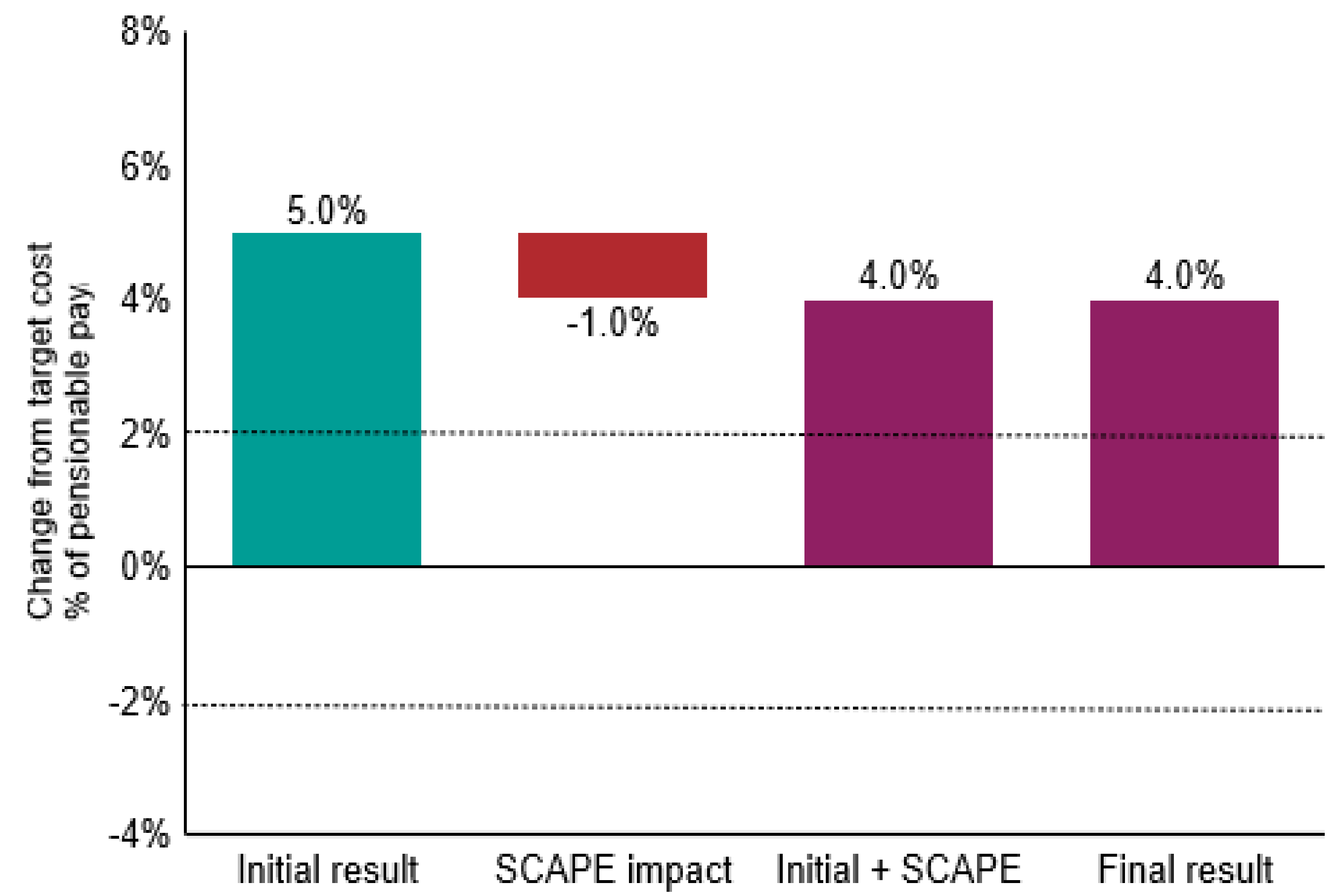
Affordability offset assessment - examples

Scenario 5



SCAPE does not further increase the breach

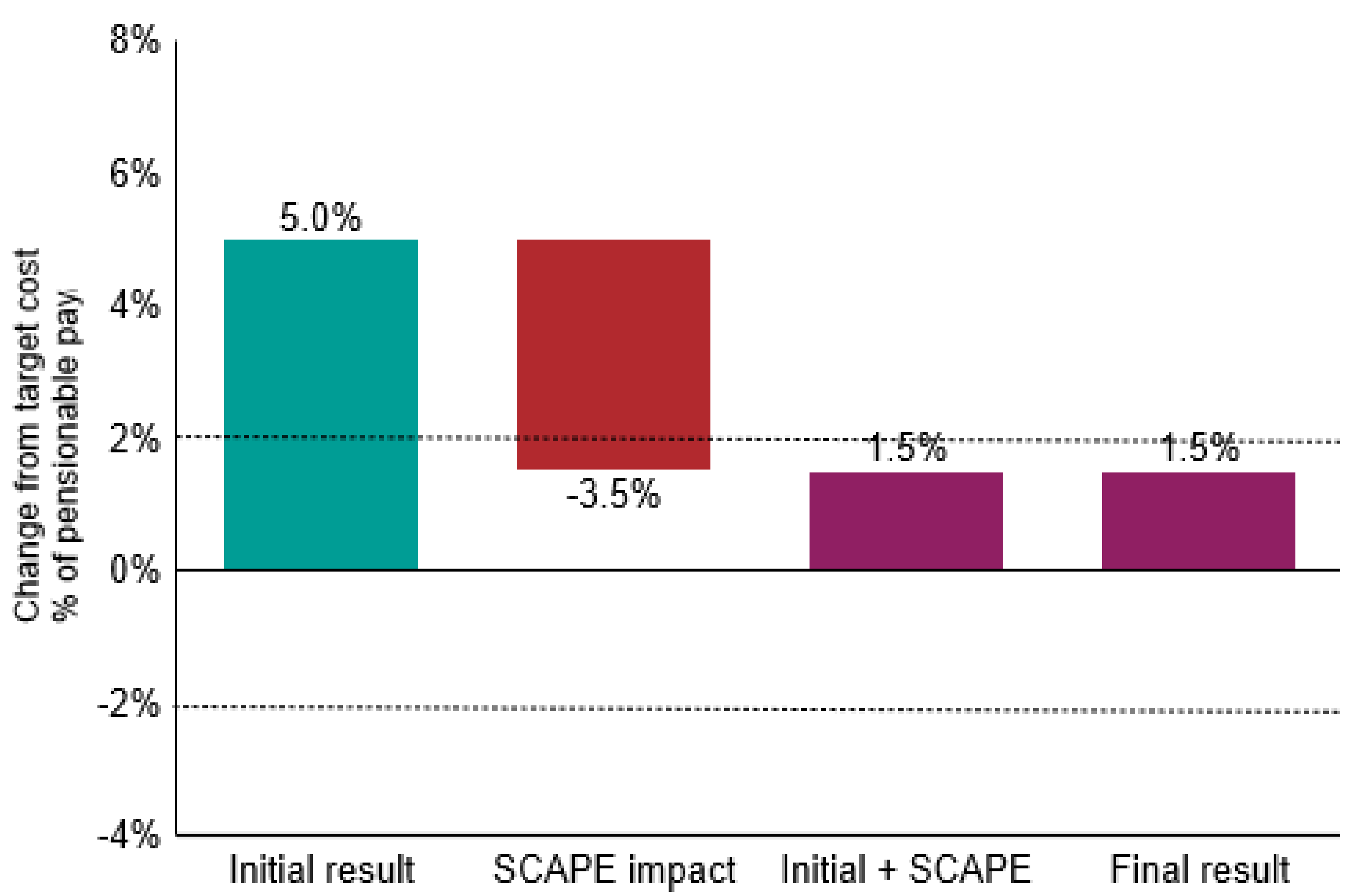
Scenario 6



SCAPE partially offsets the breach

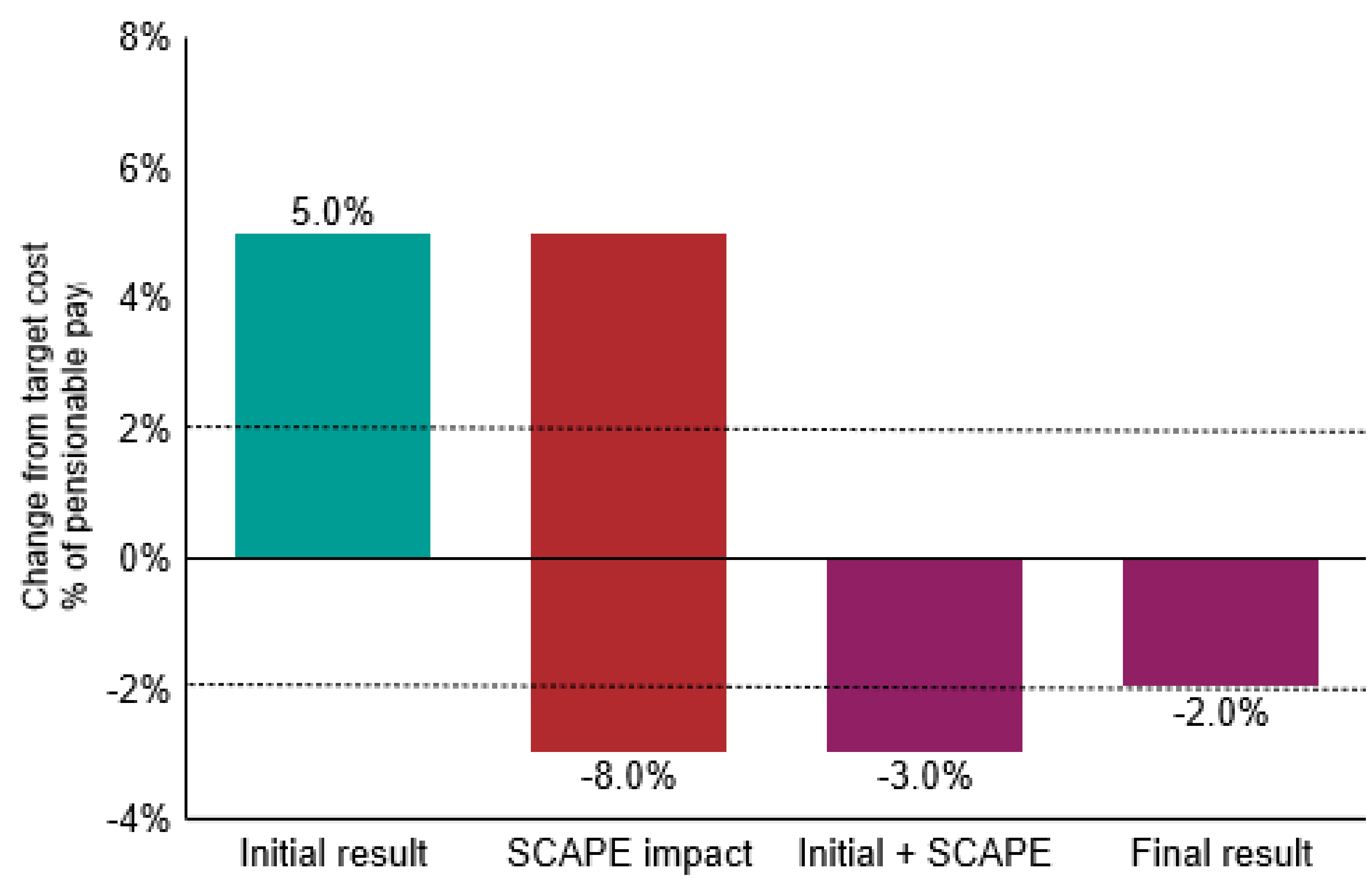
Affordability offset assessment - examples

Scenario 7



No breach as SCAPE offsets to within corridor

Scenario 8



No breach. SCAPE can only offset and cannot cause a breach in the opposite direction.

Recommendations not taken to consultation

Future service only

Proposal

Cost of future service accrual in the reformed schemes

Rationale

The mechanism can only adjust future benefits

Reasonable to only consider the cost of those future benefits in its assessment

Considerations

Further increases stability and intergenerational fairness

More simple and easier to understand mechanism

Reduces strength of the cost control

- Government is only consulting on the reformed scheme only proposal and not the future service only proposal.
- Government view is that future service only design would tip the balance too far towards the Exchequer bearing the majority of the risk.

Corridor consistency across schemes

Comparison of 2% corridor to expected long term cost

Scheme	2012 expected long term ongoing cost % of pensionable pay (pp)	2% corridor as proportion of 2012 cost
Armed Forces	34.6% pp	6%
PCSPS GB	24.1% pp	8%
LGPS Northern Ireland	23.4% pp	9%
NHS Scotland	21.3% pp	9%
Teachers' Pension Scheme England and Wales	20.5% pp	10%

All schemes are subject to the same +/-2% of pensionable pay corridor, but because schemes have different overall pension costs, that 2% level represents a different proportion of the pensions cost for each scheme.

More easily breach the cost control mechanism for, say, the Armed Forces scheme where only a 6% proportional change in costs is required, than the Teachers' Pension Scheme where close to a 10% proportional change is required.

Government is consulting on widening the corridor to +/-3% for all schemes

Review of breach

Proposal	Rationale	Considerations
Qualitative review	No single mechanistic control can meet all objectives	Different formats
Reasoned judgement to determine whether to apply the results	Even revised mechanisms remain imperfect	Independent panel
	Reality check	Government decision

- Government view that preferable to allow the mechanism to continue operating as a purely technical process.
- Introducing a layer of discretion would lead to a subjective final decision and a reduced level of transparency.

Longevity

- Significant factor in costs, is liable to movement in either direction and, for non-uniformed schemes, already mitigated by linkage between NPA and SPa
- Consider removing or smoothing impact of longevity in cost cap mechanism

Government will consider these recommendations on longevity to longer timescales.

Summary

Summary of benefits of proposed changes to mechanism

Reformed scheme only

- Consistency between benefits assessed and those that can be adjusted
- Reduction in intergenerational unfairness
- Improve the stability of the mechanism over the short to medium term

Widen corridor

- Improves stability and certainty of benefit levels
- Allows time to even out effect of causes of cost variations
- Breaches broadly expected to halve under a +/-3% compared to a +/-2% corridor

Affordability offset assessment

- Improves stability and certainty of benefit levels
- Improves protection to taxpayers

Question & Answer session

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