

LGPS COST-SHARING AND COST-CAPPING – POSSIBLE MECHANISMS AND ILLUSTRATIVE SCENARIOS

Stage 1 – Assessment of Model Fund

- The Government Actuary's Department (GAD) will carry out an actuarial valuation of the combined LGPS "Model Fund" to coincide with each three-yearly actuarial valuation of the local Funds undertaken by the individual Fund actuaries. The next valuation (the first valuation for the purpose of establishing the Model Fund) is to be "as at" 31 March 2010.
- The assumptions to be used in the valuation will be set by CLG Ministers, with input from the Policy Review Group (PRG) and GAD, in the light of scheme experience and other available data. The assumptions include items such as:
 - financial assumptions associated with the "notional fund" – these might be based on those set by Treasury through the SCAPE (Superannuation Charge Adjusted for Past Experience) mechanism, where SCAPE is the valuation process used for unfunded public service pension schemes enabling them recognise the relevant elements of scheme experience when assessing pension costs, or might be on some other basis.
 - demographic assumptions – for instance: longevity of the membership (active members, pensioners and people with preserved benefits), rates of staff turnover and retirement, pay rises, rates of ill-health retirement and the extent to which people give up ("commute") pensions for lump sums on retirement.
- Once the cost-share arrangements are fully established, GAD will commence at each valuation round by producing an initial report including statements of:
 - the *Model Fund Benefit Cost* and
 - the *Movement in Benefit Costs*
- The *Model Fund Benefit Cost* will be expressed as a percentage of aggregate LGPS pensionable payroll. It will reflect the expected cost of ongoing accrual of pension benefits by active members following each valuation date, as adjusted for:

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- projected contributions payable by scheme members, and
 - adjustments necessary to eliminate any notional surplus or deficit in the Model Fund which has arisen since it was established (and which has not yet been distributed/met by means of changes to the contribution and/or benefit structure). This will include adjustments in relation to surplus or deficit identified at previous valuations of the Model Fund. The period for spreading notional surplus or deficit will be determined as part of the valuation but might range from 10 to 20 years.
- The statement of *Movement in Benefit Costs* will give details of the change in the *Model Fund Benefit Cost* as between the current Model Fund valuation and the one before, and will break this movement down, as far as possible, into the different contributory elements.
 - It has been suggested that the initial Model Fund might be established as at 31 March 2010 at the level of the aggregate accrued liabilities of the LGPS as at that date, so that there would be no initial surplus or deficiency (local Funds would then need to deal with any local surplus or deficiency in the normal manner, subject to any changes to the benefit or member contribution structure arising as a result of implementing the cost-sharing arrangements).
 - It would also be possible to set the baseline position for cost-sharing going forward from 31 March 2010 in terms of the expected cost of ongoing accrual of pension benefits by active members over the 2010/2013 inter-valuation period, less the projected yield from member contributions, both as assessed in the context of the 2010 Model Fund calculations.
 - The examples below are based on this assumed approach, and for illustrative purposes alone assume that, within the Model Fund, there would be a cap of 14% on the Model Fund employer contribution rate and a 50:50 sharing ratio. The operation of the Model Fund would have no direct effect on local recommended employer contribution rates (for which no cap would apply), although these would be affected indirectly if there were changes to the benefit structure or the tiered member contribution structure.

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Assumptions and caveats

- a) The principles and example are based on one possible mechanism for sharing and capping. Various details of the final mechanism to be applied could differ from those described here.
- b) The example does not attempt to cover all possible scenarios; in particular, it does not include illustrations of how the mechanism for placing surplus employer or member contributions into a reserve would work (ie by allocating them as negative Category C or D items).
- c) The example is based on the assumed definitions of shareable and non-shareable items (as stated).
- d) The Model Fund might exclude certain elements of experience such as investment performance.
- e) Local funds will continue to be able to be valued (if so desired) based on different assumptions and methodologies from the Model Fund.
- f) In order to illustrate the principles involved, examples have been chosen including large increases or decreases in certain elements of cost. These should not necessarily be regarded as realistic scenarios, as in practice it is hoped that experience may be reflected gradually.
- g) In the example, the first valuation is used to set the benchmark for future Model Fund valuations; in practice, it may be necessary to consider other approaches, depending on the outcome of work undertaken in the run-up to establishment of the Model Fund.

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Example (2010 valuation)

Suppose that the 2010 Model Fund valuation produces a *Model Fund Benefit Cost* of 20.0% of aggregate LGPS pensionable payroll. (On the working assumption adopted for this paper, at this initial valuation, this would represent the expected cost of accruals of benefits from 31/3/2010.)

The projected yield from the tiered member contribution structure is 6.3% of aggregate LGPS pensionable payroll.

The notional employer contribution in the Model Fund is 20.0% less 6.3% = 13.7% so there is no need to invoke the cost share arrangements or make changes to benefits or contribution rates, which thus remain unchanged until the next valuation of the Model Fund as at 31 March 2013.

Example (2013 valuation)

At the 2013 valuation of the Model Fund, the *Model Fund Benefit Cost* has risen to 21.3% of aggregate LGPS pensionable payroll, whilst the expected yield from members contributions remains at the level of 6.3%.

Stage 2 – Analyse the movement in benefit costs

- CLG and PRG will carry out an analysis of the GAD report, attributing the different elements in the statement of *Movement in Benefit Costs* to different Cost Categories. These are:
 - (A) Subject to cost-sharing and cost-capping
 - (B) Subject to cost-capping (but not cost-sharing)
 - (C) Attributed entirely to employers
 - (D) Attributed entirely to members
 - (E) Elements which cannot be attributed to any of (A) to (D) and which are outside the scope of cost sharing and capping
- Any surplus arising from overpayments during the period covered by the valuation will go into category C (employers only) and category D (members only) as appropriate.

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- The following elements will normally be attributed to category C (employers only):
 - changes to financial assumptions, or
 - changes to actuarial methodology
- Elements which reflect scheme experience or changes in demographic assumptions would normally go into category A (cost sharing and cost capping). This would include items such as:
 - How long people are living – *if people are living longer than GAD has assumed, then this will tend to increase scheme costs*
 - The level of pay rises – *if pay rises have been less than GAD has assumed, then this will tend to reduce scheme costs*
 - The rate of ill-health retirement – *if rates of ill-health retirement in each relevant category have been higher (or lower) than GAD has assumed, then this will tend to increase (or decrease) scheme costs*
 - Retirement behaviour – *if people are working on beyond their protected minimum pension ages, then this will tend to decrease scheme costs.*
 - Choices made by members – *choices made on retirement, such as commuting pension into lump sum, may tend to increase or decrease scheme costs.*
- Unidentified cost movements will normally go into category E (out of scope). While GAD will do its best to reconcile the cost movements from one valuation to the other, it is likely to be the case that a complete reconciliation will not be possible.
- Other elements will be considered on their merits at the time.

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Example (2013 valuation)

The *Movement in Benefit Costs* between the 2010 and 2013 Model Fund valuations is = 21.3% - 20.0% = 1.3%

The different elements are shown by GAD as:

- Pay rises less than assumed -0.3%
- Improved longevity 1.1%
- Poor ill-health (IH) experience 0.3%
- Change in methodology 0.2%

The cost pressures identified at the 2013 Model Fund valuation are attributed as follows:

Cost category A longevity + pay + IH = 1.1% - 0.3% + 0.3% = 1.1%

Cost category B -

Cost category C methodology = 0.2%

Cost category D -

Cost category E -

Stage 3 – work out the impact on employers and members

- CLG and PRG will work out:
 - the *Model Fund Employer Cost* to apply for the next few years, and
 - the *Remaining Cost Amount* which is the responsibility of the scheme members
- The first step in working out the *Model Fund Employer Cost* is to work out the *Capped Employer Cost* – that is, the maximum above which the *Model Fund Employer Cost* cannot go.

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- It is assumed for this example that the *Capped Employer Cost* will be 14% initially and will be adjusted at each valuation by any items falling into Category C (other than surplus arising from overpayments). The *Capped Employer Cost* would then never fall below 14%.
- The *Model Fund Employer Cost* will then be calculated as the lesser of:
 - The *Model Fund Employer Cost* from the previous valuation + Category C cost pressures + Category B cost pressures + one half of Category A cost pressures; and
 - The *Capped Employer Cost*
- Where the *Model Fund Employer Cost* is the same, or greater than, the amount that the employer is currently paying, the employer contribution will move to the level of the *Model Fund Employer Cost*. But where the *Model Fund Employer Cost* is less than the amount the employer is currently paying, the employer may carry on paying the same rate as before. This would tend to lead to a surplus which would appear as a negative category C cost pressure (ie for the benefit of the employer) at the next valuation.
- The *Remaining Cost Amount* will be defined as
 - the *Model Fund Benefit Cost* less the *Model Fund Employer Cost* less the expected yield from member contributions less Cost Category E items (often this will equate to half of category A cost pressures + category D cost pressures + the effect of the cost cap (if any) at this valuation). This will be offset by any negative *Remaining Cost Amount* brought forward from a previous valuation.
- The definitions are intended to ensure that, where the effects of the cap are to allocate cost increases unequally, subsequent cost decreases will be allocated so as to restore equal sharing as rapidly as possible.

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Example (2013 valuation)

At the 2013 Model Fund valuation, the illustrative *Capped Employer Cost* =
 $14\% + 0.2\% = 14.2\%$

Model Fund Employer Cost

= Minimum(14.2% , { $13.7\% + 0.2\%$ (Cat C) + 0.55% (Cat A x $\frac{1}{2}$) = 14.45% })
= 14.2%

Employer contribution goes up from 13.7% to 14.2%

Remaining Cost Amount

= 0.55% (Cat A x $\frac{1}{2}$) + 0.25% (effect of cost-capping = $14.45 - 14.2$)
= 0.8% (or equivalently, $21.3\% - 6.3\% - 14.2\%$)

Stage 4 – Consideration of the *Remaining Cost Amount*

- If the *Remaining Cost Amount* is negative, consideration will be given to the possibility of holding it in reserve for the members' benefit rather than being returned to the members (so as to reduce any tendency towards requiring frequent but often small changes in employee contributions or benefit structure). In that event no action might need to be taken and the Model Fund valuation can be finalised – see Stage 5. This policy of maintaining a reserve will be reviewed in the event that a large reserve builds up.
- If the *Remaining Cost Amount* is positive, CLG and PRG will consider options for handling the Remaining Cost Amount based on relevant advice from GAD. Options could include changes to any of:
 - (i) benefit design (including pension age) and/or
 - (ii) member contribution rates.

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Example (2013 valuation)

PRG suggests the following options for eliminating the Remaining Cost Amount of 0.8%:

- (i) increase the pension age for future service (to a new age as advised by GAD) to obtain a saving of 0.8% of payroll or
- (ii) change the tiered member contribution scale to obtain an extra yield (as estimated by GAD) of 0.8% of payroll.

CHECKS:

- (i) $(21.3\% - 0.8\%)$ (total cost) – 6.3% (members) = 14.2% (capped employer cost)
- (ii) 21.3% (total cost) - 7.1% (members) = 14.2% (capped employer cost)

Stage 5 – Finalising and implementing the valuation

- CLG will consult with GAD, and will take account of any report prepared by PRG, in formulating its proposals for handling any *Remaining Cost Amount*, and will then proceed with consultations on its proposals (as no adverse changes can generally be made to benefits already accrued, it is likely that proposals would impact only on benefits to be built up in the future).
- GAD will produce a final report on the Model Fund valuation to reflect CLG's implementation plan. This will include details of:
 - the *Movement in Benefit Costs* (from the last valuation)
 - the potential *Capped Employer Cost*
 - the *Model Fund Employer Cost* and, where different, the actual *Model Fund Employer Cost* to be paid (ie before elimination of the *Remaining Cost Amount*)

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- the *Remaining Cost Amount*
- the steps if any taken to eliminate the *Remaining Cost Amount*
- where applicable, the final *Model Fund Benefit Cost* (ie after any changes made to the scheme to eliminate the *Remaining Cost Amount*)
- details of any amounts held in reserve as a result of overpayments by the employer or the scheme members
- the estimated yield from tiered member contributions, both before and after any changes to this contribution structure resulting from the valuation

Example (2016 valuation Scenario I)

Suppose that the 2016 Model Fund valuation produces an *Model Fund Benefit Cost* of 19.1% of aggregate LGPS pensionable payroll, whilst the projected yield from the tiered member contribution structure is 7.1% of aggregate LGPS pensionable payroll (6.3% + 0.8% following a decision to adopt Option (ii) at the 2013 valuation).

The *Movement in Benefit Costs* between the 2013 and 2016 Model Fund valuations is = 19.1% - 21.3% = -2.2%

The elements of the movement in costs listed by GAD are all Cost Category A.

Because there are no new Cost Category C items, the *Capped Employer Cost* remains unchanged at 14.2%.

The *Model Fund Employer Cost* is the minimum of (I) that calculated at the previous valuation (14.45%) plus one-half of the new Category A costs/savings (-1.1%), that is 13.35%, and (II) the *Capped Employer Cost* of 14.2%.

The *Remaining Cost Amount* is 19.1% - 13.35% - 7.1% = -1.35%, and this could be used to reduce average member contributions to 5.75%.

CHECK: 13.35% + 5.75% = 19.1%

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Example (2016 valuation Scenario II)

Scenario II is as Scenario I except that it is assumed that Option (i) was adopted following the 2013 valuation. This would mean that there was a *Model Fund Benefit Cost* of 20.5 % (21.3% - 0.8%) from 2013 following implementation of this option, with member contributions yielding 6.3% as prior to the 2013 valuation.

The *Movement in Benefit Costs* between the 2013 and 2016 Model Fund valuations would then be $= 19.1\% - 20.5\% = -1.4\%$, and these are again assumed to be entirely Cost Category A items. (Note that the experience in Scenario II is considerably less favourable than in Scenario I.) The *Capped Employer Cost* remains unchanged at 14.2%.

The *Model Fund Employer Cost* is the minimum of (I) that calculated at the previous valuation (14.45%) plus one-half of the new Category A costs/savings (-0.7%), that is 13.75%, and (II) the *Capped Employer Cost* of 14.2%. The *Remaining Cost Amount* is $19.1\% - 13.75\% - 6.3\% = -0.95\%$, and this could be used to reduce average member contributions to 5.35%.

CHECK: $13.75\% + 5.35\% = 19.1\%$

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FURTHER CHECKS:

Scenario (I): The *Model Fund Benefit Cost* of 19.1% at the third valuation is 0.9% less than at the first valuation (or 1.1% after adjusting for the Cat C item in 2013 of 0.2%); the member rate of 5.75% is 0.55% lower and the *Model Fund Employer Cost* of 13.35% is 0.35% lower (or 0.55% after adjusting for the Cat C item in 2013 of 0.2%). Thus the 1.1% shareable savings arising in 2010 to 2016 have been fully shared

Scenario (II): The *Model Fund Benefit Cost* of 19.1% at the third valuation is 0.9% less than at the first valuation (or 0.3% less after adjusting for the Cat C item of 0.2% and the 0.8% benefit adjustment in 2013); the member rate of 5.35% is 0.95% lower (ie 0.15% plus the 0.8% benefit adjustment) and the *Model Fund Employer Cost* of 13.75% is 0.05% higher (or 0.15% lower after adjusting for the Cat C item in 2013 of 0.2%). Thus the 0.3% savings arising in 2010 to 2016 have been fully shared.