# Croydon Council

| | |
|---|---|
| **REPORT TO:** | **Local Pension Board**<br>**26 March 2019** |
| **SUBJECT:** | **Update on Developments in Respect of McCloud / Cost Cap** |
| **LEAD OFFICER:** | **Nigel Cook, Head of Pensions and Treasury** |

**1. RECOMMENDATIONS**

1.1 To note the contents of this report and the approach adopted to reflect the costs in the next actuarial valuation.

## 2. EXECUTIVE SUMMARY

2.1 The report sets out the context for the 2014 public service pension reforms and the cost cap mechanism. It sets out how this mechanism may be brought into play and the implications of the McCloud case.

**Background**

3.1 Following the reports of the Independent Public Service Pensions Commission, chaired by Lord Hutton of Furness, the Government passed the Public Service Pensions Act 2013. This introduced a framework for new public service pension schemes, including one for local government that was introduced from April 2014. The new structure is designed to manage some of the costs and risks to the government of providing public service pensions. For example, providing benefits based on career average revalued earnings (CARE) rather than final salary removes much of the 'salary risk' and adjusting the normal pension age in line with longevity through linking it to the State Pension age removes much of the risk of future increases in longevity.

3.2 Unlike the other main public service schemes, the Local Government Pension Scheme (the LGPS) operates on a funded basis. Its rules are in regulations set at national level, but the scheme is made up of different funds, operated and governed at local level. Each fund is subject to periodic valuation (every four years now) to ensure it has sufficient assets to meet its liabilities and to set the employer contribution rate accordingly. These valuations are on the basis of assumptions set locally.

3.3 Each LGPS pension fund is required to appoint their own fund actuary, who carries out the fund's valuation. The fund actuary uses a number of assumptions to value the liabilities of the fund. Liabilities are split between those that relate to the past (the past service cost), and those that relate to the future (the future service cost). The results of the valuation may lead to changes in employer contribution rates for both future and past service costs.

3.4 The portion of the total employer contribution which relates to the past service cost is known as the deficit contribution, and is often payable in cash terms. The portion of the total employer contribution which relates to the future service cost is known as the future service rate and is normally payable in percentage of pay terms.

3.5 There is an additional valuation conducted at national level, based on a model fund, for employer cost cap purposes.

**Detail**

3.6 Under the new cost management process, the costs of the LGPS will be reviewed every three years from 31st March 2016 to ensure that they remain in line with agreed targets. The process includes additional valuations that will be carried out at national level. The purpose, assumptions and output from these cost management valuations are all different from the local valuations carried out by LGPS funds. This cost management process can only lead to changes in benefit levels and/or employee contribution rates that will be made at national level.

3.7 Before the cost cap mechanism is tested, the LGPS Advisory Board (SAB) for England and Wales will run an additional cost control process with the aim of "providing greater control over the contribution rates actually paid by employers participating in the scheme." The agreed target future service rate for the LGPS in England and Wales is 19.5% of payroll.

3.8 In the national cost management process, the costs of the LGPS will be assessed in line with the agreed target future service rate for LGPS benefits, the 19.5% of payroll (made up of an average yield of 6.5% in employee contributions and an average yield of 13% in employer contributions). A 2% or more movement from the target in either direction must result in agreed recommendations for action to move back to the target or a default process to move back to the target will be triggered, and recommendations for action may be made following changes of less than 2%.

3.9 The cost management process will (when changes in cost become apparent) only lead to changes in benefit levels and/or employee contribution rates and these changes will apply to all employees in the LGPS. Any changes to benefit levels and/or employee contribution rates will be made at national level and so will impact on all participating employers.

**The Latest Developments**

3.10 In September 2018, the Government proposed bringing LGPS cost cap valuations onto the same quadrennial cycle as for the unfunded schemes. It said this would minimise complications and assist with comparison. On 10 October 2018, the SAB stated that the total cost of the LGPS was 19% and that it would look at ways to return costs to the target 19.5%.

3.11 The Board agreed to delegate to the Chair and a representative from both the employers and employees' sides, assisted by a small technical group, responsibility for agreeing a package of benefit changes to return the scheme to its total target cost of 19.5% while also looking at employee contributions at the lower end. The resultant package will be put to the full Board for agreement as soon as possible to ensure that scheme changes are on the statute book by April 2019.

3.12 However, on 8 February 2019, it announced that this work had been put on hold pending the outcome of legal proceedings in relation to the transitional protection arrangements for the 2015 schemes – the McCloud case. The case concerns the transitional protections given to scheme members, who in 2012 were within 10 years of their normal retirement age, in the judges and firefighters schemes as part of public service pensions reform. Tapered protections were provided for those 3-4 years younger. On 20th December 2018 the Court of Appeal found that these protections were unlawful on the grounds of age discrimination and could not be justified.The Board's initial results showed that the protections in the new cost cap mechanism mean public sector workers will get improved pension benefits for employment over the period April 2019 to March 2023. This test, known as the cost control mechanism, was introduced to offer taxpayers and employees protection from unexpected changes in pension costs. Where the value of the pension scheme to employees has changed from the levels set when reformed pension schemes were introduced in 2015, steps must be taken to return costs to that level. A breach of the cost floor would require steps to be taken to return costs to their target level. Where agreement could not be reached on how to do this, the default would be an increase in the accrual rate.

3.13 On 30 January, the Chief Secretary to the Treasury, Elizabeth Truss, announced that this element of the valuations had been put on hold pending the outcome of a legal challenge to the transitional arrangements put in place when the 2015 schemes were introduced (the McCloud case). The Government has announced a pause to one element of the valuations of public service pensions, following a court ruling on part of the 2015 pension reforms. In December 2018, the Court of Appeal ruled that the 'transitional protection' offered to some members as part of the reforms amounts to unlawful discrimination. The Government is seeking permission to appeal this decision. If this is unsuccessful, the Court will require steps to be taken to compensate employees who were transferred to the new schemes.

3.14 On 7th February the SAB received confirmation that the cost cap pause and the uncertainty caused by the McCloud case applies equally to the LGPS as to the unfunded public service pension schemes. Given that confirmation the SAB considers it has no option but to pause its own cost management process pending the outcome of McCloud. As a result there are currently no changes to benefits planned in respect of the cost cap. This situation will be reviewed once McCloud is resolved which is not expected for some months.

3.15 With regards to the 2019 valuations the SAB is consulting LGPS administering authorities as to how to reflect these potential costs. They have proposed two options.

3.16 Option A is to receive guidance from the SAB designed to promote a consistency of approach on how McCloud and/or cost management should be taken account of as part of the 2019 triennial valuation exercise. Such guidance would take the form that:

I. If there is no finalised outcome on McCloud/Cost cap (including a commitment by government to detailed benefit changes) by 31st August 2019 then the scheme benefit design used in the valuation should be as set out in current regulations.

II. Each administering authority would then, with their Actuary, consider how they approach (and reflect in their FSS) the risk around this matter in the same way as they would for other financial, employer and demographic risks.

III. Once the outcome of McCloud is known and appropriate benefit changes are made administering authorities would, if they deem appropriate, re-visit employer contributions under such guidance or provision in regulation as may be available at that time.

IV. There is a consistent approach to delaying or method of estimating exit credits and payments

3.17 The alternate option is to have no central guidance and instead leave it to each administering authority to determine their own approach to their valuation (including any potential cost from McCloud or cost cap) taking advice from their actuarial adviser.

3.18 This authority has opted for A.

---

**CONTACT OFFICER:**

Nigel Cook, Head of Pensions Investment and Treasury,
Resources department, ext. 62552.