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Public Service Pensions: Proposal to reform the cost control mechanism

I am writing as the Chair of the Firefighters' Pensions (England) Scheme Advisory Board (SAB) in response to HMT's consultation on proposals to reform the cost control mechanism. Thank you for the opportunity to respond. The SAB has already submitted a number of technical questions to HMT for the engagement session held on 28 July 2021 and this response should be read in conjunction with those questions. I have attached these questions as an appendix for ease of reference

We note that the review has been conducted based on an assessment against a number of objectives which the Government Actuary (GA) considered to be open to interpretation and to contain conflicts. As well as the objectives considered by the GA, we believe that the practical implications of the cost cap mechanism also need to be considered and that members should be able to plan their retirement with confidence. The individual Fire schemes are already extremely complex to administer and communicate.

Our responses to the individual questions are set out below.

I hope the responses are helpful; if you have any questions, please do not hesitate to contact me.

Yours faithfully

Joanne Livingstone
Chair of the Firefighters' Pensions (England) Scheme Advisory Board

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Response by the Firefighters' Pensions (England) Scheme Advisory Board

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 note that creating the "right" balance of risk between scheme members and the Exchequer is a different objective to that of creating a more stable mechanism. The proposal to include past and service reformed scheme benefits represents a compromise between these objectives which we think is reasonable.

Using a reformed scheme only design reduces (but does not eliminate) intergenerational unfairness, as the benefits being assessed and adjusted by the mechanism are more closely aligned.

Stability of benefits is key in maintaining members' confidence in public service pension schemes. The SAB considered whether stability could be further improved by more flexibility in how cost cap breaches are addressed, for example by a "smoothing" of any benefit changes arising from ceiling or floor breaches. However, we acknowledge that this would reduce simplicity and could potentially introduce additional intergenerational issues.

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

We understand from the modelling carried out by the GA that under the existing cost cap mechanism it is possible that a combination of reasonably plausible changes to the assumptions could result in a cost cap breach, rather than this occurring only as a result of "extraordinary, unpredictable events". Therefore, we support the proposal to widen the corridor to improve the level of stability.

However, we recognise that there are difficult trade-offs to consider, and while a wider corridor will result in fewer expected breaches, any breaches will naturally be larger as and when they do occur for the reasons set out in the response to questions 3.

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

As a scheme with a higher total long-term cost than most other public service pension schemes, we are concerned that, even with a widening of the corridor to +/-3% of pensionable pay, we may still be more likely to suffer breaches as

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a result of events that are not out of the ordinary, due to the fact that the cost corridor is proportionately narrower for the FPS than other public service pension schemes.

For example, a 3% corridor would require a 15% increase in long-term costs for the Teachers' Pension Scheme but only a 10% increase for the FPS, for the cost cap to be breached. Therefore, while the "average" scheme might expect a breach only once every 40 years, the Fire schemes might expect a breach more frequently than this. If instead the 40 years breach was set consistently between schemes, this could be achieved by setting the corridor as equal to the 15%, say, of the cost of the scheme. Thus, if the corridor was set at +/-3%, say, for the Teachers' Pension Scheme (which had a 2012 long-term cost of 20.5%), then the proportionate corridor for the FPS, would be +/-4.4%.

We understand that HMT considered the question raised by the GA of whether a proportional corridor would be more appropriate but rejected this on the grounds of subjective concerns about fairness and perceived inconsistency.

The SAB would like to ensure that members have as much warning as possible about future benefit changes and that these are designed to be intergenerationally fair. If a breach in the 2-3% corridor does not fall to be remedied, then it is possible that any further breach disclosed at the subsequent valuation is greater than would otherwise have been the case due to no action having been yet taken in respect of the original breach. We would hope that these impacts can be mitigated by carefully considering spreading periods for different cohorts of members. We would also recommend that if there is a breach within the 2-3% corridor, members are warned of this.

Given the high impact of corrective action in the FPS of a 3% corridor, it would be sensible to allow flexibility for the Board to recommend and allow changes in a narrower corridor with ministerial sign off – similar to the Local Government Pension Scheme. This allows earlier and milder intervention to support the stability, affordability, and integrity of the scheme.

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

Technical changes have previously been excluded from the cost cap mechanism. The introduction of an economic check fundamentally changes this. More transparent discussions are needed as to the interaction between the discount rate (whether on an STPR or GDP methodology) and member value before these questions can be adequately answered.

Modelling from GAD suggests that, after allowing for the proposed changes to widen the corridor to 3% and to use a reformed scheme only design, breaches can reasonably be expected to occur only once every 40 years or so for the average scheme. It is also worth noting that the "perverse outcome" at the previous valuation was as a result of changes in the discount rate, rather than

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directly arising from the cost cap mechanism. This latter point would be addressed by adopting a more stable approach to setting the discount rate, for example in line with the STPR.

Considering these two points above, we question whether an economic check is required at all. This change might be viewed by some as a fundamental change to the cost control mechanism and hence at odds with the agreement made in 2011 that no reforms would be made to the public service pension schemes for 25 years.

Nevertheless, the inclusion of an economic check, or a more subjective "review of breach" (perhaps by an independent specialist panel) as proposed by the GA, would help to protect schemes where the cost cap has been breached but some unforeseen circumstance has occurred that leads to a "perverse outcome". The SAB recognises that HMT have favoured an economic check over a review of breach saying that it is: "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." However, given that a breach is only expected to occur once every 40 years (if the corridor is widened and the cost control mechanism is changed to be a reformed scheme only design), it may be preferable to adopt a non-mechanical review process in order to qualitatively examine the reasons for the breach at the time, rather than rely on a purely technical process that may have been designed many decades before the breach.

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

We do not comment on this question, but comment on the use of different discount rate methodologies for the cost control mechanism and the economic check in Question 6 below.

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.

We do have concerns that the economic check will make the cost cap mechanism more complex and less transparent. This will be particularly the case if a different discount rate is applied for the Stage 2 economic check compared with the main valuation and the Stage 1 cost cap calculation. This could mean that three types of valuations are produced with potentially three different valuation directions.

Our response to the consultation on the discount rate methodology suggests that the STPR rate, if used for the SCAPE discount rate, should not be allowed to drift too far out of line with the GDP methodology approach. If this

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condition were adopted, this approach would mean that the economic check could still be carried out using the SCAPE discount rate (whether a GDP-based or STPR-based discount rate is adopted).

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

The Government should be aware of the impact of intergenerational unfairness, particularly when maintaining some past service costs in the cost-cap calculation, and with a wider corridor which may mean changes are delayed and only affect a later group of members.

We recommend that an equality impact assessment is undertaken and the results of this shared with all SABs before proceeding with any amendments to the mechanism.

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Appendix: Questions on the proposed reforms to the cost control mechanism

1. We understand that the cost cap methodology is impacted by the discount rate methodology but not vice versa. Do you agree with this and, if so, do you think that the consultation for this would have been more effective and the GAD's advice more impactful if the decision on the discount rate methodology has already been taken?

2. As a scheme with a higher total contribution rate we understand that we are more likely to breach the cost cap if it is set in nominal rather than proportionate terms. Can you explain HMT's view that a proportionate cap would be unfair?

3. It is important to us to understand the interaction of all the moving parts. For example, we cannot anticipate the likelihood of being caught by the cost cap without knowing the policy with regard to smoothing of longevity. Will further modelling be commissioned by the Government Actuary for example once the SCAPE rate is set at which point we would hope that the longevity question might also be settled?

4. Has any thinking or modelling been done about the impact of a wider cost cap in terms of less frequent but potentially larger changes to member benefits when breaches occur. This would be a concern to us and we believe that early warning mechanisms should be developed, particularly if the reform scheme benefits only are included and so sensitivity to the cost cap increases over time?

5. How would the cost control mechanism and economic check work together if the SCAPE discount rate were to change? You indicate in Question 6 that the Government might consider that the SCAPE discount rate was not appropriate for the whole cost control measure whereas the GA has indicated that a difference might just be needed for the economic check? If short term assumptions are still being used for the main valuation (as per question 6 on the discount rate methodology), how might these be varied for the cost cap and economic check calculations?

6. Did HMT have any views on the GA's remarks about the different ways of assessing member value and a change in discount rate was merely a technical factor or might be partially or wholly a contributory factor to a change in value?

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7. Given the difficulties of prescribing mechanisms and the GA's own warning that the judgement and review may be required, why did HMT choose not to take forward the suggestion of being able to review the breach?

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