Firefighters' Pensions England
Scheme Advisory Board

COST EFFECTIVENESS COMMITTEE

ACTIONS AND AGREEMENTS
Tuesday 13 July 2021
MS Teams

PRESENT

Cllr Roger Phillips (RP)	Chair
Joanne Livingstone (JL)	SAB Chair
Glyn Morgan (GM)	SAB member representative
Helen Scargill (HS)	Technical/ Admin representative (WYPF)
Barrie Fullbrook (BF)	FRA Finance representative (Kent FRS)
John Weston (JW)	FRA/ LPB representative (South Yorkshire LPB)
Mark Hemming (MH)	Fire Finance Network Chair
Craig Moran (CM)	First Actuarial
James Allen (JA)	First Actuarial
Rob Hammond (RH)	First Actuarial
Clair Alcock (CA)	LGA – Board secretariat
Claire Hey (CH)	LGA – Board secretariat (minutes)

1. Introductions

1.1. Apologies were received from Liz Mowl and Ian Hayton who had been invited as an observer.

1.2. RP welcomed all to the meeting to discuss HM Treasury's (HMTs) consultations on proposals to reform the cost control mechanism and the discount rate methodology. The proposals to reform the cost control mechanism follow a number of recommendations made by the Government Actuary (GA) in his review.

1.3. RP explained the need to respond to these consultations due to the unique nature of the FPS and stated that the committee's role was to advise the Scheme Advisory Board (SAB) on making a response. HMT will also be holding engagement sessions for Boards.

2. Background

2.1. CA gave a brief background to the scheme valuation process, explaining that GAD undertake two valuations every four years; one to set employer contributions and one to measure the cost-cap cost. CA stated that the 2016 valuation resulted in a significant increase in employment contributions due to a change to the SCAPE discount rate.

2.2. As the cost-cap valuation uses different assumptions and objectives, GAD found that the cost of providing benefits had gone down in the 2016 valuation and the cost-cap floor had been breached, meaning that member benefits were liable to be improved. This indicated a discrepancy in how the cost control mechanism works and a review was proposed.

2.3. The cost-cap valuation was subsequently paused due to remedy, although the increase to employer contributions went ahead, incorporating the additional expected cost of the improvement to member benefits.

2.4. The valuation is now being finalised and the Government Actuary (GA) has completed his review of the mechanism and made several recommendations. Following this HMT published the two consultations.

3. First Actuarial presentation

3.1. CM delivered a set of slides developed by First Actuarial. CM said that CA had given a succinct background to the valuation process and reiterated that HMT has published two consultations which affect all public service schemes.

Cost control mechanism consultation

3.2. A breach should only occur in extraordinary circumstances, but all public service pension schemes breached in year one of the cost-cap valuation and it was therefore deemed that a review was needed. CM said that the GA's review of the mechanism had been published in May 2021 and the consultations were launched in June 2021 and sought views on some of the recommendations made.

3.3. CM described the initial policy objectives of cost-cap and two additional considerations set out in HMT's Terms of Reference. One point that requires further clarification is the interpretation of value to members. CM explained that the objectives have been rated subjectively by First Actuarial as to whether they had been met or not:

3.3.1. The cost-cap a did good job of maintaining value/ cost to members subject to changing assumptions and the current

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mechanism allows the Government to respond to future developments.

3.3.2. It fell down on stability and certainty as evidenced by breaches across the sector and the likelihood of future breaches.

3.3.3. It does not protect taxpayers as evidenced by increased member benefits as a result of the cost-cap floor breach, concurrent with increased employer contributions as a result of the discount rate change.

3.3.4. There is an element of intergenerational unfairness as remedy costs fall to younger members; there is a mismatch between where the breach arises and where it is remedied.

3.4. CM noted that the cost-cap calculation currently includes past and future service accrued in FPS 2015, plus past service for active members in the legacy schemes. Also included are member experience and demographic assumptions. It excludes past service in the legacy schemes for deferred and pensioner members and changes to the discount rate. Inclusion of remedy costs is a recent addition.

3.5. CM said that the target cost of the scheme is 16.8 per cent and the existing breach corridor is 2 per cent; if the breach exceeds this, member benefits become liable to be amended. At the 2016 valuation, a floor breach of 5.2 per cent occurred. Benefits were due to be improved; however, inclusion of remedy costs has now caused a material ceiling breach and HMT has confirmed that the impact will be waived for the finalisation of the 2016 valuation.

3.6. HMT requested a review of the mechanism as all public service schemes breached the cost-cap floor significantly and this was primarily as a result of legacy scheme benefits costing less than assumed on the cost cap methodology. This raised questions around the suitability of the 2 per cent corridor, as a wider corridor would make it less sensitive to changes.

3.7. The GA made recommendations in two stages: mechanism and validation. HMT then selected three of these recommendations to consult on. Two are tweaks to the mechanism; to include reformed scheme benefits only (past and future service) and widening the corridor to 3 per cent for all schemes. While using reformed scheme will improve stability in the short/ medium-term, CM noted that some intergenerational unfairness would remain in the long-term.

3.8. CM explained that for an average scheme a breach could be expected to occur once every 20 years if reformed scheme only benefits are included, and the corridor remains at 2 per cent. This would increase to once every 40 years with a 3 per cent corridor.

3.9. The validation recommendation is an economic check which would take place if a breach occurred and would look at employer contribution rates in relation to the discount rate, among other things, before benefits are amended. CM explained that, under the proposed mechanism, changes to the discount rate cannot cause or worsen a breach but can reduce or remove a breach. Having an economic check in place would have offset the floor breach in 2016 and would be a more fundamental change to the operation of the cost-cap.

3.10. The impact of the proposals on members and employers was considered:

Change	Members	Employers
Reformed scheme only	• Reduces intergenerational unfairness • Fewer expected changes over the short to medium term	• Any gains or losses from legacy schemes are borne by employers / taxpayers
Widened corridor	• Less frequent but larger changes	• Wider corridor means larger costs could occur without remedial action (and vice versa)
Economic check	• Fewer benefit changes • Treasury decisions that increase employer costs can offset changes when member "value" is falling (and vice versa)	• More stable costs • Could prevent "perverse outcomes"

3.11. CM outlined several items in the GA's report that were not included in the consultation, such as adopting a scheme specific corridor to account for schemes having different long-term costs, as some are more expensive and more likely to breach a fixed corridor. In HMT's view this would have been overly complex to administer and explain. Also not included was a review of breach by, for example, an independent panel which would have introduced a "layer of judgment". HMT felt that this would have introduced a subjective element to a process intended to be a purely technical mechanism.

3.12. JL sought clarity on the GA's view that the technical amendments by themselves would not meet all of the objectives, and therefore the additional validation stage had been recommended. CM agreed that no combination will meet all five objectives; there will always be a trade-off, and one of the SAB's roles is to ensure the most appropriate balance is reached.

Superannuation Contributions Adjusted for Past Experience (SCAPE) discount rate consultation

3.13. CM explained that the SCAPE discount rate represents the expected return to the Government; for funded schemes this would reflect the expected return on the fund's assets. The rate is currently based on the expected long-term GDP growth.

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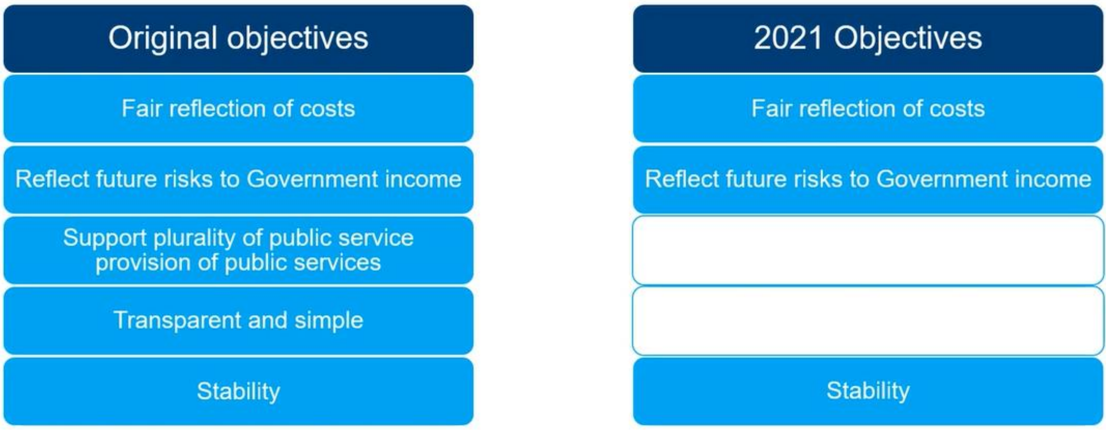
3.14. The discount rate is mainly used to set employer contribution rates for unfunded schemes and is also used to calculate some factors for the FPS, such as commutation (FPS 1992 only), scheme pays, and transfers. SCAPE is currently 2.4 per cent above price inflation (CPI) and has been fairly volatile in recent years.

3.15. CM said that the last review of the SCAPE rate methodology had taken place in 2010-11 and had taken account of and prioritised different objectives to the 2021 review, which now gives a higher priority to stability than in 2010:



3.16. CM explained that employer costs increase when the discount rate reduces, and further reductions are expected based on the latest GDP projections. Frequent changes cause difficulty in setting budgets, and this is the rationale for reviewing the methodology.

3.17. CM added that HMT is consulting on two different approaches to setting the discount rate; either continue to use GDP or move to the Social Time Preference Rate (STPR) which was previously used. CM added that the Office for Budget Responsibility (OBR) set GDP projections, whereas the STPR is prescribed by HMT guidance. There would potentially be minor adjustments to whichever approach is adopted. HMT has also proposed aligning the SCAPE rate review with the scheme valuation cycle.

3.18. The STPR is made up of three elements which currently equate to 3.5 per cent and has not changed in around 20 years. The elements are time preference, catastrophic risk, and wealth effect. HMT has indicated that the catastrophic risk element of 1 per cent could potentially be removed, equating to a discount rate of 2.5 per cent plus CPI, which is commensurate with the current SCAPE rate of 2.4 per cent.

3.19. CM highlighted the key differences between the methodologies:

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Using long-term GDP	Using STPR
GDP is a proxy for tax revenue growth, which is where future benefits will be paid from.	Pensions are essentially a form of investment for the government, so value them consistently with other public spending projects.
SCAPE could be used for economic check for cost-cap if continued to be linked to GDP	Less commonly understood.
OBR reviews GDP regularly, not in line with SCAPE review cycles.	Set by Treasury, so greater control.
GDP set by OBR, not Treasury, so greater transparency.	Has been unchanged since 2003, so much more stable.
Has not been stable in last 10 years.	May need modifications i.e. removing the catastrophic risk element.
Could lead to high employer contributions if realigned to latest estimate of 1.8%.	

3.20. CM reiterated that a lower discount rate equals higher employer contributions. The next rate change has been delayed by one year to 1 April 2024. There are no direct impacts on members, however, possible consequences are changes to factors and the interaction with the cost-cap via any economic check. Higher employer costs may also impact services.

Next steps

3.21. CM asked the committee to consider whether responses should be made. CM commented that not all SABs will have the resources or technical appetite to respond. Consideration should also be given as to whether to respond in general terms or to the specific consultation questions. CM confirmed that the deadline for both consultations is 19 August and a special meeting of the full SAB has been scheduled for 20 July.

3.22. RP said that it would be sensible to respond as the opportunity has been given and considering the unique impact on the FPS. RP highlighted that there may be differing views on the SAB; however, the Board should try to reach a common position in its response to reflect broad feelings.

3.23. RH commented that HMT is offering alternative ways to feed in, including engagement sessions with small groups such as SABs. JL confirmed that the FPS England SAB has received an invitation. JL's understanding is that the session is to run through the process rather than provide views.

3.24. JL felt it was crucial for the SAB to respond, although not necessarily to the technical questions but to address the bigger picture such as whether the objectives are reasonable. GM agreed that it was fundamental to the Board's role to try to agree a response. RH agreed that the SAB should respond and suggested reviewing the consultation questions to agree a position.

3.25. RP observed that it was not essential to reach a unanimous position as a range of views can be provided, although it would be good to obtain broad agreement. The committee considered the questions in order.

4. Proposals to reform the cost control mechanism

4.1. Question 1: Is the proposal to allow only costs from the reformed scheme the right balance of risk and would it create a more stable mechanism?

4.2. JL asked if it was possible to break the question down to look at the different impacts against objectives in order to consider whether the Board should favour intergenerational fairness over stability, or vice versa. RH observed that the questions could be potentially leading towards HMT's preference, and any one of the proposed methods might not achieve both risk balance and a stable mechanism. CM explained that a reformed future service only model would be the most stable, but all costs arising from past service would then fall to the taxpayer. The current model is least stable and provides more protection for the taxpayer. RH broadly acknowledged the attempt to achieve balance within the solution but recognised the unique challenge to the FPS.

4.3. GM said including reformed scheme service only is the way forward, as the cost-cap does not apply to the legacy schemes; however, there is a concern over who picks up the cost. GM commented that the Government erred in applying the transitional protections, so they should pay. CA noted that the reforms were intended to reduce costs to the taxpayer, so HMT could argue that remedy costs should fall to scheme members. CA commented that the Government had tried to do the right thing by offering protections. RH agreed with both points and stated that the proposal to include past and future service is a reasonable compromise.

4.4. JL suggested that it is reasonable for legacy scheme benefits to be excluded to improve the position on intergenerational unfairness, particularly if stability is the key objective. GM recognised the Government's compromise based on past experience and supported the inclusion of past service costs; however, much depends on other factors such as the SCAPE rate and affordability.

4.5. Questions 2 and 3 were taken together. CM reiterated that the corridor is currently fixed at 2 per cent and a breach could be expected to occur once every 20 years if reformed scheme only benefits are included. This would increase to once every 40 years with 3 per cent corridor. RH asked for views on whether a scheme specific corridor would be more appropriate as breaches would be more frequent for the FPS as a higher cost scheme.

4.6. JL noted that the GA had put both proposals forward and HMT had rejected a scheme specific corridor. JL assumed that one breach in 20 years was for an ‘average’ scheme and would be more frequent for the FPS. CM confirmed this and noted that the figures from GAD were heavily rounded. CM added that GAD could work backwards to calculate the specific likelihood for the FPS.

4.7. GM expressed some concern that a wider corridor would mean a bigger impact in case of a breach, although GM appreciated that it would increase stability. GM suggested that these changes should not be considered in isolation and asked whether there is a mechanism for offsetting, such as the economic check.

4.8. CA asked what the administrative effects would be of a 2 per cent corridor if this led to an accrual rate change every four years; for example, how to explain annual benefit statements and communicate changes to members. CA highlighted that this would make retirement planning difficult and a wider corridor may alleviate this issue.

4.9. CA queried the intention behind paragraph 5.17 of the consultation which discounts proportional corridors as this could benefit some schemes more than others. RH said that the existing corridor probably benefits members of some schemes over others, so the argument is questionable as it would be unlikely that all schemes would breach again at the same time. CA said that this should be challenged within the Board’s response.

4.10. RH said that the Board should put forward strong reasons for adopting a scheme specific corridor and refute the reasons not to. RH commented that GM had made a good point about the impact of widening the corridor and the Board may consider recommending a sense check in addition to the economic check.

4.11. RP explained that the Local Government Pension Scheme (LGPS) SAB operates a “could, should, and must” approach to the cost control mechanism if the breach falls between 1 and 2 per cent, which considers any action the Board needs to take. JL agreed with GM's point and said that smoothing and spreading mechanisms should be considered.

4.12. HS expressed concern that large breaches less frequently could affect a smaller group of members disproportionately and suggested that smaller more frequent breaches could be preferable for intergenerational fairness. RP summarised that although there would be benefit to a widened corridor of 3 per cent, the Board would want to retain the ability to monitor the likelihood of future breaches.

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

4.14. CM explained the principle of a simple mechanistic check which could remove or reduce a breach, but not worsen it. CM said it is worth noting that the proposed assumptions for the check would be set by HMT. JL commented that there is a lack of transparency over impact on value to members which makes it difficult to make an informed response.

4.15. RH commented that the alternative common-sense review proposed by the GA was rejected by HMT; removing subjectivity but introducing a mechanistic check which is within their control. The Board may wish to consider whether the rejected option would be more appropriate.

4.16. HS noted that the economic check is intended to bring stability to the benefit structure of the scheme, which would be more beneficial to the member if benefits were due to o be worsened and less beneficial if improvements were due. It is again an issue of the balance of stability against member risk.

4.17. GM said that sustainability of the scheme is the key factor i.e. affordability and longevity, and it was difficult to support the proposal without more detail. RH said that the Board should indicate that they would want to be consulted on the potential impact of any change to the economic check before supporting this proposal. RP agreed that this would bring transparency to the process.

4.18. CA commented from an employer perspective that this would bring balance back into the calculations and would be fairer across member and employer expectations. RP agreed it has a balance of fairness but wanted to understand more about the operation of any check. JL said that it needs to be clear what is included within the check, whichever methodology is chosen, to ensure that value to members is retained.

4.19. Questions 5 and 6 were considered together. CM confirmed that the proposal is that the economic check will be based on the SCAPE rate, which is currently based on GDP, but which HMT is concurrently consulting on changing to the STPR methodology. STPR is more within HMT’s control and does not currently fluctuate with changes to the economy, therefore it is less volatile. Adjustments would also be likely be made for its use for public service pension schemes. If the SCAPE methodology changes to STPR, HMT asks if expected long-term GDP should be used as an alternative for the economic check.

4.20. RP highlighted that the committee has identified stability as a key objective, yet the change to STPR for SCAPE and therefore the economic check would give HMT much greater power over the mechanism. GM asked if STPR would be likely to remain stable in the long term. CM responded that this was difficult to quantify due to the proposed tweaks which could be subject to future change.

4.21. CM noted that introducing an alternative measure for the economic check would increase complexity at each valuation. RH agreed that there should be a measure of consistency between the two processes.

4.22. CA felt that the same methodology should be used for both measures for transparency and simplicity. CA asked whether all of the proposed changes would be adopted or if there would be scope for introducing the mechanistic changes but not the validation, and what the consequences might be. CM explained that stability would be achieved by changes to the mechanism; the economic check additionally offers protection to the taxpayer. CA summarised that an economic check is sensible and should reflect the outcome of the discount rate consultation, to achieve the right balance between members and employers.

4.23. On question 7, CM highlighted intergenerational unfairness as an equality impact which will increase in the reformed scheme over time due to past service costs. The committee has already established that widening the corridor may lead to a higher impact less often; RP commented that this could create a disproportionate effect. GM could not envisage any issues but noted that this was not a legal view.

4.24. CA summarised that a note would be drawn up and responses to the questions followed up with JL. CA noted that the tone of the response had not been considered; however, the Board should not tie itself into agreeing to any of the proposals where the questions are leading. CA added that the Board will want to prioritise stability and fairness and felt that there was more work to do around transparency of the mechanisms. CA noted that the committee had outstanding concerns in relation to intergenerational unfairness. CA reiterated that an economic check seems reasonable and should be based on the SCAPE methodology agreed by the relevant consultation.

5. Consultation on the discount rate methodology

5.1. JL was interested in the reason for moving from STPR to GDP and potentially back again. JL commented that reverting to a fixed measure may not be reflective of economic reality. JL would like to hear from HMT on this at the forthcoming engagement session, in addition to picking up the point on loss of transparency.

5.2. RH noted that there are hidden implications of the SCAPE rate changing for the FPS, such as actuarial factors for calculations, which need to be considered in the consultation response.

5.3. CA said that the Board should not ignore the significant impact on employers of continuing to use GDP for the SCAPE rate due to the likelihood of future reductions. CA acknowledged that this is not the purpose of the consultation, which does not consider the funding position, however, CA queried whether this is a conversation which needs to feed into the spending review.

5.4. CM noted that the discount rate is the most influential assumption in scheme valuations. The current projection based on expected GDP is a reduction to 1.8 per cent and this could not be offset by tweaks to other assumptions. CM said the logical alternative for HMT is reversion to STPR, which is stable and also set by the Treasury.

5.5. CA reminded the committee that the purpose of the discount rate is to mirror market conditions for funded schemes. CA asked if the outcome would be the same for funded schemes, whereby contributions have to be increased if the discount rate falls or if there is an alternative mechanism. CM said this is difficult to quantify as the schemes are fundamentally different. CM explained that funded schemes can forecast contribution deficits based on assets and expected returns, while unfunded schemes are reliant on the future tax base and member contributions.

5.6. CM said that an assumption is needed to place a value on the cost of benefits being built up and what members will need to pay. CM could not comment on whether GDP would be a better or fairer measure than the STPR. CM observed that comparing funded and unfunded schemes was not necessarily helpful in this scenario.

5.7. GM commented that public service pensions represent a measure of deferred pay and there should be a political judgment as to the value of public sector workers, rather than linking directly to markets. RP noted that stability is a key objective for HMT and STPR may offer greater stability.

5.8. JL remarked that HMT may be sensitive to criticism and, while the Board may prefer to support a methodology that results in a higher discount rate, views of other commentators should be monitored. CM responded that funded private sector schemes are backed by an employer who may have a finite time horizon. In comparison, public service schemes are backed by the strongest covenant in the country, with the ability to raise tax revenues.

5.9. JL said that the Board’s response should draw out these differences between funded and unfunded schemes.

5.10. CA suggested that the proposal to align reviews of the SCAPE discount rate with the scheme valuation cycle was reasonable and invited comments from First Actuarial (Question 7). CM agreed that the proposal to review every four years is reasonable.

5.11. RP asked whether the committee had identified any equalities impacts of changing the methodology (Question 6). JL commented that the impact of the discount rate on factors such as commutation should be raised in response to this question.

5.12. RP asked if the committee were content with the discussions or whether there were any further points to raise. RP summarised that views on the discount rate consultation questions would be collated and presented to the Board.

5.13. CA suggested that the Board may want to consider a more general approach to questions 1 to 5 of the consultation which would support the principles of stability and any potential lowering of costs, rather than addressing each separately and offering complicit agreement. CM agreed that the committee had made a number of general observations to respond to these questions in the round.

6. Next steps

6.1. RP commented that the meeting had been good preparation for the engagement session with HMT on 28 July. CA asked whether any questions had arisen during the discussion which could be forward for the joint session with the Police SAB. The following suggestions were received:

6.1.1. Discounting of proportional or scheme specific corridors.

6.1.2. Policy decisions taken by HMT in shaping the recommendations to be consulted on i.e., options proposed in the GA's review but not taken forward.

6.1.3. Disappearance of transparency objective from discount rate methodology review.

6.1.4. Timescale on reviewing approach to longevity.

6.1.5. More detailed explanation of STPR – who runs it, how transparent it is.

6.1.6. Definition of value to members.

6.2. RP requested that any further questions be submitted to CA in advance.

6.3. RP noted that a paper summarising the committee's discussions would be submitted to the SAB prior to the special meeting in order for a response to be drafted. RP reiterated the importance of the Board responding to the consultations. RP thanked First Actuarial for their clear and comprehensive presentation.

i. ***First Actuarial to draft a note for the SAB meeting on 20 July of points to consider in responding to the consultation.***

COST EFFECTIVENESS COMMITTEE: ACTION SUMMARY

Date/ Number	Action	Comments	Priority	Owner
13 07 2021 (i)	First Actuarial to draft a note for the SAB meeting on 20 July of points to consider in responding to the consultation.	Complete: Cost control mechanism and SCAPE consultations note for SAB	High	First Actuarial

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