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SUSTAINING THE LOCAL GOVERNMENT PENSION SCHEME IN ENGLAND AND WALES

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COMMUNITIES AND LOCAL GOVERNMENT
WORKFORCE PAY AND PENSIONS
FEBRUARY 2008

Contents

Introduction

1. This consultation paper sets out **principles and propositions** for analysis and comment on how best to prepare the mechanism required to be in place, no later than 31 March 2009, to provide the basis for future cost-sharing in the LGPS.

2. It takes account of the helpful and constructive discussions of the Local Government Pension Scheme (LGPS) Policy Review Group since its inception in May 2007, and concurrent developments in other public service pension schemes.

3. Responses to this informal paper are now invited by **30 May 2008.** As explained in more detail in paragraphs 46-50 below, the onward timetable will involve a **statutory, national consultation exercise** later in 2008 and the subsequent making and laying of actual regulations as soon as possible after but no later than 31 March 2009.

The policy context

4. The Government's policy objective for the Local Government Pension Scheme is that it must remain affordable, viable and fair to all – employees, employers and taxpayers. This objective is shared by all stakeholders across the Scheme and, in policy terms, it continues to provide a clear context for on-going Scheme reforms and amendments.

5. In a Statement to Parliament on 23 November 2006, **(Hansard Official Record 70WS, 71WS and 72WS)** the then Local Government Minister, Phil Woolas MP, confirmed the continued provision of good quality pensions for the local government workforce, and other employees eligible for LGPS membership, through benefits provided by an equality-proofed, final salary, pension framework:-

> *"The Government are mindful of the need to maintain stability of costs in the new-look scheme and a fair and equitable balance in its long-term resourcing between members, employers and taxpayers. The Government's intention throughout this reform process has been to ensure that no additional costs are imposed on taxpayers. It is intended, therefore, to establish an appropriate mechanism for sharing future cost pressures and to have the arrangements in place by March 2009. These will both inform and take account of the 2010 actuarial valuation of the scheme. The new arrangements can be taken into account when individual fund actuaries set new employer contribution rates in the valuations which will take effect from 1 April 2011."*[1]

6. The Government remains mindful of the need to maintain stability of costs in the new-look Scheme for all stakeholders, and to achieve a fair, rigorous and equitable balance in its long-term resourcing between members, employers and taxpayers. The intention throughout the Government's reform process has been to achieve cost-stability in the Scheme to ensure that no additional costs arising from future Scheme experience as it impacts the Scheme's liabilities are imposed on taxpayers. This has been made clear in several Ministerial Statements to Parliament, and elsewhere.

7. It is not intended to use a similar detailed formulaic approach to cost-sharing for the LGPS as established for the TPS, which is a centralised pay as you go scheme. Rather, the LGPS, with its overarching statutory provisions overseen by the Secretary of State and its 89 separate funds in England and Wales administering the Scheme at local level in conjunction with the numerous employers of varying sizes and budgeting arrangements, does not lend itself to such an approach. However, as with all the other public service schemes for which the Government has regulatory responsibility, a shared approach will need to be introduced to ensure long term viability for the LGPS. This means that all stakeholders have an active role to play in the cost-sharing process and that the mechanism itself must be workable, evidence-based, equitable and transparent.

The regulatory context

8. The regulations outlining the new-look Local Government Pension Scheme (LGPS), the *Local Government Pension Scheme (Benefits, Membership and Contributions) 2007 regulations* (SI 2007/1166) come into effect on 1 April 2008. These regulations deliver the Government's promise that the new-look Local Government Pension Scheme is affordable, viable, and fair to all tax-payers who ensure its continued security and stability.

9. The cost-share arrangements when finally introduced are intended to both inform, and take account of, the 2010 Scheme actuarial valuation exercise. The new arrangements are intended to be in place, therefore, when individual fund actuaries consider new employer contribution rates, initially from the 2010 valuation exercise, which will take effect from 1 April 2011. Similarly, the outcomes of the valuation exercise will be reflected in the final decisions on the form and content of the cost-share arrangements themselves and how they will impact on successive valuations.

Governance

10. To establish a workable cost-sharing mechanism for the LGPS it is necessary to consider appropriate governance matters and a satisfactory means of determining the actual outcome of the cost-share process itself. No final decisions have yet been taken about the actual, detailed elements of that process. However, given the nature of the LGPS and its nationally-regulated status, final decisions on the outcome of the process will be for Ministers, after the necessary statutory consultations.

11. The precise series of steps likely to be needed within the cost share process now need developing. It should not be necessary to set all of these out in legislation; that would be unwieldy and bureaucratic. However, there may be merit in some minimal prescription to begin and end the exercise, to provide a framework for it, and to clarify the statutory role of Ministers and the active involvement of stakeholders.

12. Consultees may wish to consider and comment on that balance as part of this consultative phase. Discussions at the Policy Review Group, led constructively by Public Sector People Managers Association, have suggested that the following principles could be adopted: -

- the arrangements for cost-sharing should be transparent, and be an integral part of the cost-share process itself;
- equality principles should also apply;
- the factors which would lead to a triggering of any cost-sharing mechanism to only be amended following prior consultation with national stakeholders;
- the factors to be shared should not be amended without prior consultation with national stakeholders;
- there should be close affinity between the cost-share exercise and the timing of each triennial actuarial valuation exercise cycle;
- while structure and certainty are seen as inherent in the process to achieve certainty and stability, so too should there be flexibility;
- the focus of the process should not rest solely on short term decisions but also on longer-term options and risks when considering necessary effects and consequences and;
- the integrity of the actual cost share assessment process is critical to the success of the mechanism, especially in terms of acceptability to stakeholders.

13. Some scheme interests have mooted whether there should be a clear administrative role for the Group, or an offshoot of it. As has been previously indicated, Ministerial approval of the mechanism process and its integral factors is necessary for Scheme governance and legal reasons. However, consultees, may wish to consider and comment on how best the range of relevant views could be involved as part of this exercise, and how these might be factored in to the exercise, and at what particular stages.

14. There appear to be several critical stages in the process: -

- **establishing** the initial cost-share arrangements including its timetable, its form and content - for example, relevant elements and factors to be shared; data needs and sources;

- **operating** the actual cost-share;

- **administering** the outcome of the cost-share;

- **consequential actions** of the cost-share.

- **monitoring experience** of the cost-share and **linkage** with the tri-annual actuarial valuation exercises; and

- **beginning** a subsequent cost-share exercise.

15. As the cost-share mechanism is already a statutory requirement of the new LGPS, from 1 April 2008, consultees' views on how most effectively to take the process and delivery of the whole exercise forward would be welcomed.

16. It may be that some of the actual content of each of the above stages (and others) could be set in the regulatory framework, for example in a dedicated schedule to a statutory instrument or, alternatively, in statutory (or non-statutory) guidance prepared by CLG. Consultees views would be welcomed on this aspect.

17. A clear downside of too fragmented a governance framework is that agreement among a range of stakeholders, with different priorities and principles, could be difficult and endlessly time-consuming. On the other hand, to ensure a stable base for Scheme affordability and viability, a satisfactory degree of stakeholder engagement is essential. Much can be achieved by statutory-based consultation, effective governance and active engagement with a clear understanding that final decisions are for Ministers, within the established statutory framework.

Objectives to apply for the new arrangements

18. There are several core objectives which could form the basis of an LGPS cost-share arrangement: -

to share future cost risks between employers and pension scheme members;

to provide a framework within which a satisfactory control of the cost risks can be achieved;

to ensure effective cost stability for employees and employers by helping to manage the effects of changing liabilities and other variables;

to provide a rigorous framework within which to manage specific necessary changes to contribution levels or benefits;

to raise awareness among the membership of the full costs of guaranteed, final salary pensions; and

to foster a mutuality of responsibility between local authority employers, and scheme providers and scheme members.

Types of cost risk

19. Establishing a cost-risk arrangement involves a full understanding and assessment of the LGPS and its components. Demographic features vary widely across the Scheme by region and fund type, as well as by individual employers. Geographical location also appears to be a key factor. Securing and applying the most appropriate data is an essential element of the whole exercise.

20. Discussions at the Policy Review Group established a range of data sources / types and categories which are necessary to feed into the cost-share framework. These data sets include: -

membership mix and demographic assumptions[1]

pay growth, including promotional pay increases

price inflation

scheme benefits

ill-health retirement rates

death in service

compulsory retirements

[1] This includes the increasing age of new entrants, the changing nature of local government workforce delivery, the general ageing of the workforce and issues such as inter generational dynamics

other retirements

post retirement mortality

commutation take-up rates

early leavers

options exercised by the membership

investment returns

married / partnership rates

21. Individually, and collectively, these elements (and there may be others) provide the evidence base that pension fund actuaries initially, and the Government Actuary's Department subsequently, will need to identify, assess and use to provide the basis of the cost-share arrangement. Communities and Local Government believes that this data can be provided from existing sources without the need for statutory requirement. Any foreseen impediment to that should emerge as part of this consultative exercise and consultees' views on this point would be helpful.

What costs might be shared?

22. Consultees will wish also to consider carefully and comment on the propositions outlined below as an indication of how each cost factor might be treated within the new arrangements.

23. The inclusion of investment returns within the cost share, however, runs the risk of extending a volatility which already exists for employer contributions to member contributions as well, which is in contradiction to the underlying policy objective of establishing stability and the requirement in the extant Scheme regulations that contribution rates should not vary too much after each triennial valuation.

24. Accordingly, judgements must be made given that stability of contribution rates for both employers **and** employees is considered an essential element of providing a pension scheme. This can be achieved in the cost-share for members by excluding significant, potentially unpredictable and volatile influences on contribution rates, including investment returns and the financial actuarial assumptions. Consultees views on this and other approaches to maintaining longer term stability are invited.

25. The following table, therefore, indicates, for each influential cost factor, who might bear the risk and each is provided with a summary rationale, as developed by the Government Actuary's Department. Consultees' views are invited on the three columns' contents and further suggestions and commentary will be welcomed.

Factor	Cost/benefit Risk to be borne by	Rationale
Changes to expected longevity	Cost Shared	Improving longevity will increase the value of the pension scheme to members and the increased cost should be shared. However, as members are receiving an additional benefit and the employers do not have influence over longevity improvements, it could be argued that the cost risk should be borne solely by the members.
Other Demographics	Cost Shared	As neither party has sole influence on the outcome of demographic factors. Such as staff turnover and rates of ill-health retirement, the risk of a change in costs due to a change in demographics should be shared.
Pay increases	Cost Shared	Members do not have a significant direct influence over the level of pay increases. However, greater than expected pay increases will increase the value of the pension benefits for active members and the increased costs should be shared. As employers have a direct influence on the level of pay increases, it could be argued that the risks of increased costs should reside solely with the employer.

Options (for example, added pension contracts and the facility to exchange pension for a tax-free lump sum)	Cost-Shared	Scheme options are not a compulsory feature of the scheme and are entirely at the members' discretion. There is a risk of generational cross subsidy for the members in that any costs/savings which arise from the current options would emerge as a deficit/surplus at a later date and be picked up by the next generation of members. Members may not have influence over the pricing of options. Taking into account the balance of these factors and the influence of the parties, it would seem reasonable to share the cost risks between members and employers.
Benefit structure	Cost Shared	Changes to the benefit structure represent a change in the amount of benefit paid to members and thus a change in their overall remuneration package. However the employer has influence over changes made and thus the cost risks should be shared.
Benefit Structure imposed as a result of overriding legislation	To be discussed on a case by case basis when the need arises.	Changes to the benefit structure imposed by overriding legislation are outside the control of both the employers and the members. Changes may affect either all or only a minority of members. The cost impact should be considered on a case by case basis, as and when it arises.

Investment return	Employer	Scheme members have no influence over investment returns or investment policy. Including investment returns within cost-sharing could result in increased contribution rate volatility for members due to the large and unpredictable nature of the experience. If member contribution stability is a priority, and given the lack of member influence, it would seem appropriate for investment risks to be outside of cost share envelope. However, changing investment returns can increase/reduce the cost of providing the benefits and it could be argued that these costs should be shared.
Financial assumptions	Employer	Changes in financial assumptions do not generally impact upon the amount of benefits paid to members, only the value placed upon them for a particular purpose. This would seem to indicate that the impact of such changes should fall outside the cost envelope. In the case of price inflation, it might be argued either way depending on whether benefits are viewed in real or nominal terms.
Actuarial methodology	Employer	Scheme members have no influence over the actuarial methodology used to determine scheme costs. The ultimate cost and value to the members of the benefits paid out depends on the actual membership experience and not on the actuarial methodology. The impact of changes to actuarial methodology should therefore fall outside of the cost envelope.

Establishing a model scheme

26. Given the nature of the LGPS, it is essential to provide a cost-share arrangement which is relevant to it. In particular, its funded and varied multi-employer status renders the approach taken by the unfunded, centrally-managed public service Schemes as not being appropriate. The distortions this would create would indeed undermine the status of the Scheme as a single national arrangement, raising questions as to its continued status as a single scheme. It would be technically difficult also, and too complex to establish a cost-share for every local single LGPS employer. Instead, therefore, a bespoke LGPS approach, but still encompassing the essence of the Government's requirements for public service schemes is required specifically to meet the needs of the Scheme, and its stakeholders.

27. To simplify the processes, therefore, one proposed approach is to establish a model, notional, national fund and for it to be maintained centrally by CLG, with the assistance of the Government Actuary's Department with the co-operation of key stakeholders. The model scheme would represent the position of all LGPS funds, but would be adjusted accordingly, to only take into account those items included within the cost-share model. Maintaining a centrally-managed model scheme would also enable the efficient running of "what if" scenarios which would otherwise need to be compiled as the aggregate of numerous local calculations.

28. The model, notional fund would be used to calculate the proportion of costs (or savings) which fall to the member. This amount could be recognised by an increase (decrease) in the members' contribution rate, or a change in the benefits provided by the scheme. The output of the model scheme (e.g. a change to the member contribution rate) would then be fed back into the local valuation processes to determine the local employer rate necessary to locally finance scheme benefits.

29. It is suggested to consultees that surpluses or deficits which exist in the local funds at the commencement date of the model scheme would be excluded from the notional fund and should not form part of any cost-sharing envelope, as these are related to experience which occurred <u>prior</u> to the implementation date. Views on such an approach are therefore sought.

30. This would mean that surplus/deficiency already recognised at the implementation date of the new system would continue to be the responsibility of employers.

31. The size of the initial model fund, therefore, would be the total accrued liabilities of the membership at the commencement date, calculated from full membership data. The initial future service contribution rate of the model would be based on active membership at the appropriate commencement date, for example 31 March 2009.

32. An important aim is to ensure stability throughout all elements of this mechanism. The stability of the contribution rates could be improved by having regard to long term rather than short term fluctuations in experience and by adopting a long period over which any surplus or deficit is spread. Typically, private sector pension schemes adopt an amortisation period of around 10 years as this is the longest period normally permitted by the Pensions Regulator. However, the LGPS is exempt from this requirement and amortisation periods on average of some 20 years are not un-typical in LGPS funds. The current 2007 actuarial valuation average amortisation period could, at the outset, be adopted in the notional fund. Views are sought on how this could be managed.

Actuarial assumptions for setting up a notional LGPS for cost-share purposes

33. Any cost-share mechanism should be robust enough to provide a framework which allows for a process to accommodate changes in the costs of pensions for existing and future members, or even benefit accrual going forward, for example, for future members in the light of emerging experience.

34. Before even arriving at that point, however, it is necessary to establish the cost framework of the initial model scheme. It is proposed that the most recent LGPS actuarial valuation (post 2008 set) exercise costings and assumptions, weighted by pensionable payroll to recognise the size of the membership to which it relates should be developed. It could then prove possible to set the main demographic assumptions centrally having regard to the experience of the scheme in the years prior to starting the cost share.

35. The delivery of robust data is, of course, crucial in the whole exercise, as discussed in paragraph 21. This would avoid any need for establishing expensive and less realistic centrally developed experience and assumptions.

Subsequent cost share calculations

36. The actuarial assumptions underlying the cost share calculation could be monitored regularly and be informed by local valuations, taking into account the local experience observed over the inter-valuation period. The inter-valuation experience could be examined to determine whether it would be appropriate to change the existing assumptions taking into account materially, and expectations of long term trends. Consultees may wish to consider the periodicity of these stages.

37. Changes in experience would not necessarily be introduced into the assumptions in one fell swoop. Rather, the assumptions would be set in a way that trended towards the experience – changing the assumptions more gradually in response to actual scheme experience. This smoothed, best estimate approach should serve to reduce the volatility of members' contributions / benefit changes (where identified), as well as dampen inter-generational cross subsidies.

38. Using smoothed best estimates in these subsequent calculations also has the advantage of reducing the "double cost impact" of changes to the assumptions. Double cost impact here means that if for example ill health retirement rates turn out to be higher than assumed, the funding position will worsen because there are now more ill health pensioners, than expected, and will worsen further still if the assumptions for future ill-health retirement rates are then changed in line with the experience. Views of consultees on this and related experience issues are sought.

39. A criticism of the smoothed best estimate approach is that the amount by which assumptions are changed from valuation to valuation can be subjective. An alternative approach would be to fix the actuarial assumptions at the outset of the notional fund. In this case, there would be no double cost impact because the assumptions for the future would not change. Rather it would be necessary to wait for actual experience to come through before there was any impact on costs. This approach does not, however, follow normal actuarial practice and would introduce a greater risk of inter-generational cross subsidy because the effects of experience (such as improving longevity) being different to that expected might take a very long time to emerge (and therefore the cost or saving from the experience, which could have been anticipated earlier, might instead be picked up by future generations of scheme members). Consultees' views on how best to achieve inter-generational balance are invited.

40. It is proposed that the model scheme is maintained centrally and compared to the value of scheme liabilities assessed on the actuarial assumptions and membership dataset prevailing at the appropriate valuation date. The difference between the notional fund and the accrued liabilities represents the notional surplus/deficit which, when spread over an agreed amortisation period, is deducted from / added to the standard cost of providing scheme benefits as calculated using the same assumptions and dataset.

41. The actuarial methodology for calculating the standard cost of scheme benefits is a matter which will need further consideration by the Government Actuary's Department and other interested parties.

The proportion of risks to be shared

42. The costs emerging from the model scheme would be shared between employers and members. A 50:50 share of the costs is proposed for the LGPS. This split has and is being adopted by the other public service schemes e.g. NHSPS and TPS. The share need not necessarily be 50:50; consultees may wish to consider the range of possible alternatives and to justify alternative ratios as part of this informal consultation exercise. This does not simply impact on contribution rates and views are sought as to other approaches to sharing these risks.

Employer contribution rate cap

43. Employer contributions to meet the costs of future service could be paid up to a limit known as the employers' contribution rate cap. This would help to demonstrate a consistency of approach with other public service schemes and protect the long-term affordability (and therefore viability) of the scheme. It would also increase contribution rate stability for the employers, an existing regulatory requirement of the LGPS.

44. It is proposed that the cap should be set for the model scheme at national level and not applied locally. To gauge responses at this state it is suggested, for this exercise that a notional fund cap of 14% be adopted for the LGPS. A lower rate for the cap sets a greater risk that elements of cost-sharing which should, arguably, be borne by the employer will be pushed back on to the member in an unfair way. Conversely, a slightly higher figure (which might emerge in any event from the 2007 valuation exercise) would provide flexibility to guard against fluctuations of variables.

45. Consultees' views are invited on the principle of a notional cap within the cost-share framework, and on its initial level going forward from April 2009.

Timetable

46. The financial impact of cost-sharing needs to start being recognised in the level of members' contributions subsequent to April 2011, as prescribed by regulations, with a model scheme established as at 31 March 2010 to coincide with the triennial LGPS valuation exercise. Some concern has been expressed that this timetable is too tight and that a two year time horizon should be considered instead. This could be achieved by either extending the deadline for implementation to 2012, or by bringing the modelling exercise forward to 2009.

47. Retaining an implementation date of April 2011 and establishing the notional fund in 2009 would necessitate some double running of calculations for local fund actuaries, first to establish a validated dataset and second to determine an actuarial basis. This process would need to be repeated a year later at the 2010 valuation of the local funds, although the analysis of experience conducted in 2009 could be used to inform the 2010 local fund actuarial basis. Establishing the notional fund as at 31 March 2009 would also introduce a time lag element as cost-sharing would not include an experience element relating to the period 2009-2010.

48. On the other hand, deferring the implementation date to 2012 would remove the need to double run calculations, but would mean that the implementation of cost-share was not on a consistent timetable to the implementation of the results of the 2010 cycle of actuarial valuations.

49. In the table in the Appendix, two prospective timetables are set out. The first timetable has the notional fund established as at 31 March 2009 and an implementation date of April 2011, and the second with the notional fund established as at 31 March 2010 and an implementation date of April 2012.

50. Consultees' views on the most appropriate and beneficial timetable position are invited, given the objectives set out above in paragraph 18. Consultees may also wish to comment on the timetable and process needed to establish the cost-share arrangements, given the 31 March 2009 regulatory timetable and the earliest date from which the results of the first cost-share (should one be needed) is implemented.

Arrangements in other public service pension schemes

51. For some time it has been the Government's policy for the LGPS to ensure that no additional costs arising from the Scheme reforms or amendments should pass on to taxpayers. For the new Scheme the cost-envelope established as part of the reform process provides a clear position for all interest.

52. More broadly, it is Government policy for all the public service pension schemes to limit taxpayers' exposure to increases in employers' future service pension costs. Like the LGPS, the objective of ensuring affordability, viability and fairness to taxpayers remains in place going forward. The need to unite a fair and proportionate balance between the elements of each public service scheme benefit package and the cost of provision is essential.

53. Information on the current position of each public service schemes' progress (i.e. (CLG (07) PRG 15) can be found on the Policy Review Group page at www.xoq83.dial.pipex.com.

54. Other schemes have developed or are currently developing their own arrangements.

Consultation Questions: 1-14

CLG would like your views and comments on the following questions:-

1. Consultees may wish to consider and comment on how best the range of relevant views on governance could be involved as part of this exercise, and how these might be factored into the exercise, and at what particular stages?

2. As the cost-share mechanism is already a statutory requirement of the new LGPS, from 1 April 2008, consultees' views on how most effectively to take the process and delivery of the whole exercise forward would be welcomed.

3. It may be that some of the actual content of each of the above stages (and others) could be set in the regulatory framework, for example in a dedicated schedule to a statutory instrument or, alternatively, in statutory (or non-statutory) guidance prepared by CLG. Consultees' views would be welcomed on this aspect.

4. Do consultees envisage any problems in providing detail as set out in paragraph 20 (types of cost risk)?

5. Consultees' views on approaches to maintaining longer term sustainability are invited.

6. Consultees' views are invited on the three columns' contents (see pages 7 to 9 inclusive) and further suggestions and commentary will be welcomed.

7. It is suggested to consultees that surpluses or deficits which exist in the local funds at the commencement date of the model scheme would be excluded from the notional fund and should not form part of any cost-sharing envelope, as these are related to experience which occurred prior to the implementation date. Views on such an approach are therefore sought.

8. The current 2007 actuarial valuation average amortisation period could, at the outset, be adopted in the notional fund. Views are sought on whether this approach - or some other approach would provide stability (see paragraph 32).

9. Consultees are asked to consider if inter-valuation experience impacts on cost sharing calculations?

10. Consultees' views on ill health and related experience issues are sought (see paragraph 38).

11. Consultees' views on how best to achieve inter-generational balance are invited (see paragraph 39).

12. (a) The share need not necessarily be 50:50; consultees may wish to consider the range of possible alternatives and (b) to justify alternative ratios as part of this informal consultation exercise.

13. Consultees' views are invited on the principle of a notional cap within the cost share framework, and on its initial level going forward from April 2009.

14. (a) Consultees' views on the most appropriate and beneficial timetable position are invited, given the objectives set out in paragraph 18. (b) Consultees may also wish to comment on the timetable and process needed to establish the cost share arrangements, given the 31 March 2009 regulatory timetable and the earliest date from which the results of the first cost share (should one be needed) is implemented.

Please send your responses to the above consultation questions to Nicola Rochester, Workforce Pay and Pensions 2, 5th Floor, Eland House, Bressenden Place, London SW1E 5DU (email: Nicola.rochester@communities.gsi.gov.uk) no later 30 May 2008.

If you have any queries concerning the consultation, please contact Brian Town on either email: brian.town@communities.gsi.gov.uk / tel: 020 7944 6015 or Nicola Rochester: Nicola.rochester@communities.gsi.gov.uk / tel: 020 7944 6016.

Communities and Local Government
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Annex A

LGPS cost share – A broad guide to the process

A paper by the Government Actuary's Department

1 This note has been produced by the Government Actuary's Department at the request of CLG in connection with an informal paper issued by CLG in advance of a statutory, national consultation exercise on the basis for future cost sharing in the LGPS.

2 This note describes the cost share process, sets out some examples of how it might work in practice and describes the mechanism by which the outcome of the cost share process might feed through into contributions payable. It builds upon the approach to cost sharing explained in the accompanying CLG paper "Sustaining the Local Government Pension Scheme in England and Wales", setting out the principles and propositions for analysis and comment on how best to prepare for the cost share mechanism required to be in place no later than 31 March 2009.

3 For the purposes of this note it is assumed that:

(a) There are shareable and non-shareable elements of experience, where the shareable elements of experience are shared by members/employers on a 50%/50% basis and the non-shareable elements are effectively met entirely by employers.

(b) The shareable and non-shareable elements are as set out in the accompanying CLG paper.

(c) There is a cap on employer contributions of 14% of pensionable pay. It is noted that this cap applies to employer contributions in the model scheme and not actual employer contributions payable (as will be explained in this note).

(d) The cost share process lasts for two years starting one year before the "as at date" for the next cycle of triennial actuarial valuations of local funds, and ending two years later – ie one year after the local fund valuation date, coinciding with the date of implementation of recommended contributions rates arising from the valuations.

Calculations

4 As explained in the attaching CLG paper, a model scheme is established using membership data compiled from local funds and actuarial assumptions largely based on scheme experience. This model scheme represents the LGPS as a single combined unit but will not be equal to all the local funds added together, primarily for two reasons:

- Certain elements of experience (ie the non-shareable elements such as the impact of better/worse than expected investment returns) would have been excluded from the compilation of the model scheme, but will be included locally.

- The actuarial methodology and assumptions adopted to value the model scheme will differ from that used locally – eg local actuarial assumptions may include margins for prudence which are not replicated in the model scheme.

5 The model scheme includes a notional fund, analogous to the funds held locally. As with local funds, the notional fund is credited with notional investment return (see paragraph 15 below); model contributions are added to it, and benefits deducted from it.

6 The following model scheme calculations are then undertaken at each triennial assessment:

(a) A standard contribution rate (SCR) is calculated representing the annual cost of future benefits accruing to members, expressed as a level percentage of pensionable pay;

(b) The notional fund is compared to accrued scheme liabilities. The difference between the two is the notional surplus/deficit at the valuation date (an excess of assets over liabilities represents a surplus). At the first model scheme valuation the surplus/deficit will be zero – ie the notional fund will be set equal to the accrued scheme liabilities at that date; and

(c) The surplus/deficit from (b) is then spread forward as reduction/addition to the SCR from (a), to arrive at a model recommended contribution rate (RCR), also expressed as a level percentage of pensionable pay. At the first model scheme valuation there is no surplus/deficit so RCR will equal SCR.

(d) Based on the membership data provided, a projected employee contribution yield (ECY) is calculated using the tiered contribution either from the Regulations or as amended following an earlier cost share.

At the first model scheme valuation

7 At the first model scheme valuation ECY is subtracted from RCR to give a model employer rate. If the model employer rate is less than 14%, (see 3(c) above) then there is no change made to member contributions or scheme benefits, and local fund actuaries proceed to complete their valuations based on unchanged scheme benefits and the tiered contribution scale from the Local Government Pension Scheme (Benefits, Membership and contributions) Regulations 2007.

8 If the model employer rate exceeds 14% of pensionable pay, PRG will consider the position and make recommendations to the Secretary of State on the changes to member contributions and/or scheme benefits needed to bring the model employer rate down to 14%. Following consultation, the Secretary of State determines the necessary changes to employee contribution rates or benefits, and these changes are then incorporated into regulation and taken into account in local valuations.

9 The results from the first model scheme valuation also set the benchmark against which subsequent cost-share outcomes are determined. This can be seen from the examples set out below in paragraph 13.

10 Depending on local experience (including un-shareable items of experience), local assumptions and the profile of local membership it is possible for actual recommended employer rates (or even the average of all local employer rates) to be materially less than the model employer rate or to exceed 14% of pensionable pay.

At subsequent valuations

11 At subsequent model scheme valuations the RCR is compared to the RCR at the previous valuation to give a cost increase / decrease figure. (If, as a result of the previous valuation of the model scheme, scheme benefits were changed, then the RCR at the previous valuation is taken to be the RCR after the benefit changes).

12 Any reduction in cost is shared between employers and members. However, if members have lost value at previous valuations (through either increased contribution rates or reduced benefits) by more than employers have lost value through increased contributions, then the first chunk of any cost reduction goes to reduce member contribution rates or improve benefits. Only when members and employers are back on an equal footing with regard to their historic tally of gains and losses from the cost share process, are savings then shared.

13 Any increase in cost at successive valuations is shared up the employer cap of 14%.

Examples

14 Three examples are set out below. The examples are designed to give a broad outline of how the process might work, they are not designed to cover every possibility and considerable additional thought and possible legal input will be required if the detail of cost share is to be included within regulations. It is not envisaged that contributions will, in practice, fluctuate as significantly as shown in the examples.

Example 1

(a) At the first model scheme valuation:

RCR = 20.0%
ECY = 6.3%

The notional employer rate is: RCR – ECY = 13.7%, which is less than 14.0% so there is no need to invoke the cost share arrangements or to make changes to the benefits or contributions.

(b) At the second model scheme valuation:

RCR = 21.1%
ECY = 6.3%

The increase in the RCR since the previous valuation is 1.1% and this needs to be shared. However the notional employer rate already stands at 13.7% and cannot go above 14.0% so it increases by 0.3% to 14.0% leaving 0.8% of the increase in RCR to be picked up either through increased member rates or reduced benefits (or a combination of both).

Say that member rate rises by 0.8% so that ECY now equals 7.1%.

(Check: Member rate (7.1%) + model employer rate (14.0%) = RCR (21.1%))

(c) At the third valuation:

RCR =19.0%
ECY = 7.1%

The RCR has reduced by 2.1% since the previous valuation and this needs to be shared. However, at the last valuation member rates went up by 0.8% whereas the model employer rate only went up by 0.3%. Because the member rate went up by 0.5% more than the employer rate, the members receive the first 0.5% of the reduction in RCR, with the balance (1.6%) being shared.

The revised member rate becomes: 7.1% - 0.5% - half of 1.6% = 5.8%
The model employer reduces by half of 1.6%, from 14.0% to 13.2%.

(Check: Member rate (5.8%) + model employer rate (13.2%) = RCR (19.0%))

(Further check: The RCR at the third valuation is 1% less than the RCR at the first valuation, and both the member rate and model employer rate are 0.5% lower than at the first valuation – ie savings have been fully shared.)

Note: The model employer rate specified in this example is not the actual rate payable by scheme employers. The member rates will be set out in a tiered scale which, on the model scheme valuation data, is expected to yield the required 5.8%. This scale of member rates is then included within local valuations and the actual rates payable by employers are determined as a local balance of cost according to principles determined locally.

However, the member rate of 5.8%, the model employer rate of 13.2% and the RCR of 19.0% are all benchmark figures which are carried forward to the next model scheme valuation, to be compared against the outcome of that valuation.

Example 2

(a) At the first model scheme valuation:

RCR = 20.0%
ECY = 6.3%

(Same as Example 1.) The notional employer rate is: RCR – ECY =13.7%, which is less than 14.0% so there is no need to invoke the cost share arrangements or to make changes to the benefits or contributions.

(b) At the second model scheme valuation:

RCR = 21.1
ECY = 6.3%

(Same as Example 1.) The increase in the RCR since the previous valuation is 1.1% and this needs to be shared. However the notional employer rate already stands at 13.7% and cannot go above 14.0% so it increases by 0.3% to 14.0% leaving 0.8% of the increase in RCR to be picked up either through increased member rates or reduced benefits (or a combination of both).

In this example however, instead of member contributions going up by 0.8% as they did in Example 1, benefits are reduced in value by 0.8%. The RCR is now recalculated on the revised benefit structure as 20.3% (21.1% - 0.8%).

(Check: Member rate (6.3%) + model employer rate (14.0%) = RCR (20.3%))

(c) At the third valuation:

RCR =19.0%
ECY = 6.3%

At the third valuation the RCR is 19.0% (same as Example 1), but it has now only fallen by 1.3% (20.3% - 19.0%), not 2.1%. Again however the members' tally of loss of value is still 0.8% compared to the 0.3% increase in model employer rate, so members get the first 0.5% (the difference between 0.8% and 0.3%) of the 1.3% reduction in RCR, with the 0.8% balance (2.1% - 1.3%) being shared.

The revised member rate becomes: 6.3% - 0.5% - half of 0.8% = 5.4%
The model employer reduces by half of 0.8%, from 14.0% to 13.6%.

(Check: Member rate (5.4%) + model employer rate (13.6%) = RCR (19.1%))

(Further check: The RCR at the third valuation is 1% less than the RCR at the first valuation, but the value of benefits has also been reduced by 0.8% - giving a net experience saving of 0.2%. This saving has been shared through a reduction in the employer rate of 0.1% from 13.7% to 13.6%, and a reduction in member contributions of 0.9% less a reduction in the value of benefits of 0.8% (ie a net value to the members also of 0.1%)).

Example 3

(a) At the first model scheme valuation:

RCR = 21.3%
ECY = 6.5% (note that this is no longer 6.3% - perhaps there has been a change in the earnings profile of members)

The notional employer rate is: RCR – ECY =14.8%, which is greater than 14.0% so the model employer rate is capped at 14.0% and the member rate rises by 0.8% to 7.3%.

(Were it not for the employer cap, and assuming that the employer will pay 14% before costs are shared - see note at the end of this example - the model employer rate would have been 14.4% and the member rate would have been 6.9%.)

(b) At the second model scheme valuation:

RCR = 20.7%
ECY = 7.3%

The reduction in the RCR since the previous valuation is 0.6% and this needs to be shared. However at the previous valuation the member rate went up by 0.8% so all the reduction in RCR is allocated to members reducing their rate from 7.3% to 6.7%. The model employer rate remains at 14.0%.

It is also noted that members have only regained 0.6% of the 0.8% increase in their rate from the first valuation, so they carry forward a net tally of 0.2% to the next valuation.

(c) At the third valuation:

RCR =19.5%
ECY = 6.7%

The RCR has reduced by 1.2% since the previous valuation and this needs to be shared. However, the members are effectively carrying forward a tally of 0.2% from the previous valuation and so the first 0.2% of the 1.2% reduction in RCR is allocated to members, with the balance being shared between the member rate and the model employer rate.

The revised member rate becomes: 6.7% - 0.2% - half of 1.0% = 6.0%
The model employer reduces by half of 1.0%, from 14.0% to 13.5%.

(Check: Member rate (6.0%) + model employer rate (13.5%) = RCR (19.5%))

(Further check: The RCR at the third valuation is 1.8% less than the RCR at the first valuation, and both the member rate and model employer rate are 0.9% lower from what they would have been if there was no employer cap – see valuation 1 above.)

Note: In this example (and to some extent the other examples), not only is the first valuation used to set the benchmarks for future model valuations, but it also includes an element of cost sharing/capping itself. In effect, the "cost-share" at the first valuation is that the model employer rate bears the all shareable risks up to a maximum model employer rate of 14.0%, and the members bear all the shareable risks above the employer cap. At subsequent valuations, once the benchmarks have been set, the experience is shared 50%/50% (subject to the 14.0% employer cap).

How are elements excluded from the cost share and model scheme?

15 If, as proposed in the accompanying CLG paper, the cost impact of investment returns is to be excluded from the cost share, then this can be achieved by assuming that the model scheme earns an investment return in line with that assumed in the actuarial valuation. For example if the valuation discount rate for the model scheme was 3.5% in excess of prices (as per the LGPS benchmark review costings), then the notional fund is simply credited with an annual return of RPI + 3.5% (as are net cashflows to/from the fund).

16 Similarly, other elements of experience to be excluded from the cost share could be excluded by assuming that the experience of those elements is in line with expectations.

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