Non-Executive Report of the: **PENSIONS BOARD** **19 September 2019**	TOWER HAMLET
Report of: Neville Murton, Corporate Director, Resources	**Classification:**
LGPS Cost CAP Update, McCloud Case and Actuarial Valuation	

Originating Officer(s)	Miriam Adams, Pensions & Investments Manager
Wards affected	All

Introduction

This report provides the Board with a summary of the history of the LGPS cost cap in public service pensions and recent developments regarding judgement on the Judges and Fire Fighters cases generally referred to as McCloud case. This paper also covers proposed changes to triennial actuarial valuation process and recent developments to investment cost transparency.

Recommendations:

Members of the Pensions Board are asked to note the contents of this report.

1. REASONS FOR THE DECISIONS

1.1 The management of costs is key to the longevity of the LGPS and affordability for employers. Since the construction of the cost cap there has been unexpected slowdown in UK longevity improvement. This slowdown in longevity would mean pension payments would not be for as long as initially envisaged.

2. ALTERNATIVE OPTIONS

2.1 There are no alternative options to this report.

3. DETAILS OF REPORT

3.1 A new mechanism was introduced under the Public Service Pensions Act 2013 for HM Treasury (HMT) to control unexpected changes in the cost of public service pensions – this cost control mechanism is known as the 'employer cost cap'. This 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 public sector pension schemes were introduced in 2015 (2014 for

the LGPS). If the cost changes steps must be taken to return costs to the level set under the reforms.

3.2 The cap applies to significant unexpected increases in “member costs” i.e. increases in cost relating to assumptions about the profile of members, such as life expectancy, growth in salaries or career paths. Where costs rise above or fall below the cap, the legislation requires action to bring them back to the target. The LGPS in England and Wales also has a separate cost management process which is completed independently of the HMT public sector cost cap calculations. HMT calculations are on hold at present – see below.

3.3 On 21 December 2018, a cost management update on behalf of Scheme Advisory Board (SAB) was released with SAB proposing an improvement to benefits equating to 0.5% of payroll, taking the cost back up to the long term target of 19.5% of payroll.

3.4 On the same day it was reported that the Court of Appeal held that transitional protections that protected older judges and firefighters from the public sector pension scheme changes in 2015, were unlawfully discriminatory. This case is known as the ‘McCloud case’.

3.5 Following the judgment, on 30 January 2019 the Government published a written statement that paused the HMT cost management process for public service pension schemes, pending the outcome of the application to appeal the McCloud case to the Supreme Court.

3.6 On 8 February 2019, SAB confirmed it had 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 management process (either the LGPS process or HMT process) from 1 April 2019. This situation will be reviewed once McCloud is resolved which is not expected for some months.

3.7 On 15 July 2019, the Government issued a written ministerial statement and confirmed that as ‘transitional protection’ was offered to members of all the main public service pension schemes, the difference in treatment will need to be remedied across all those schemes, including the civil service pension schemes. The difference in treatment will need to be remedied across all those schemes, including the LGPS.
As the remedy will involve ‘levelling up’ member benefits, it is expected that any agreed outcome will increase the cost of LGPS pensions. However, at the time of writing, there is no certainty about how much this additional cost will be.

A copy of the statement is available via the link below:

Written Ministerial Statement – Public Service Pensions

3.9 The cost management page of the SAB website has been updated with all of the background information to the above. A Q&A which sets out potential timescales and possible outcomes of the McCloud case, and its impact on the cost cap process can be found at:

http://www.lgpsboard.org/index.php/structure-reform/costmanagment/ccmcloud

4.0 McCloud and risk to LGPS Funds

4.1 The uncertainty stems from the fact that no one currently knows what form any remedy will take in the LGPS.

4.2 For examples, decisions need to be made around areas such as:

- Eligibility – would it only apply to scheme members who were active in 2012? Or all those active when the scheme changed at 31 March 2014 (2015 in Scotland)? However re-joiners who choose to link up their benefits would need consideration?
- Operating period of the underpin – will the underpin only apply to service accrued up to 2022 i.e. 10 years after 2012? Or will it apply for all service accrued from 1 April 2014 until retirement?
- Retrospection- how will the benefits for members who have left service since 2014 (or 2015 in Scotland) be rectified? Will interest be applied to any payments that should have been made had an underpin been in place?
- Administration – any remedy needs to be relatively easy to administer to avoid placing administration teams under even more strain. What may seem an obvious remedy may actually be very complex to administer so an alternative approach may be more appropriate.

There are many more issues than just those listed above and each decision about the form of a remedy is likely to have a material impact on the overall cost depending on the assumptions used in each Fund valuation.

4.3 Impact on 2019 valuation

4.3.1 On 14 May 2019, the Scheme Advisory Board published an advice note covering the implications of the McCloud case on the 2019 valuation. The key points from the advice note were:

- For the purpose of the 2019 valuation, if no remedy is agreed by 31 August 2019, LGPS funds should value the benefits as per the current LGPS Regulations.
- Funds should consider how to factor in the uncertainty and risk associated with the McCloud case when setting employer contribution rates
- Once the McCloud case is remedied, funds should revisit employer contribution rates to ensure they remain appropriate in light of any additional costs.
- The Cost Cap process will be suspended until the McCloud case is resolved.

4.4 There are various possible and suggested approaches and options put forward by the Fund actuarial community that LGPS funds can take to managing the uncertainty around the cost of benefits due to the McCloud case such as:.

- Add an explicit loading onto employer contribution rates e.g. X% of pay – this could be in the form of the same loading across all employers or it could vary by employer based on factors such as membership profile. Funds would need to consider how to derive such a loading given the uncertainty around what form any remedy will take. Funds would also need to consider how to communicate this approach to employers given the final remedy could result in a cost that is very different from any loading.
- Increase the level of prudence in the funding plan – in the three-step approach we use to set employer contribution rates, this would involve increasing the likelihood of success e.g. from 66% to 70%. The result would be a higher employer contribution rate (compared to if no action was taken) in recognition that pension costs are likely to increase. As per the first approach, it is unlikely that any increase in rate as a result of this approach would match the actual cost increase once the McCloud case is resolved, so careful communication with employers would be required.
- Do nothing – as with any risk, one option is always to do nothing. Funds taking this route may justify it on the grounds that there is so much uncertainty currently associated with McCloud that making any allowance is not feasible at this stage. Funds taking this route would need to communicate this carefully with employers and Committees to avoid any issues around future contribution rate increases once the case is resolved.

4.5 The justification and reasoning for any decision would be documented in the Funding Strategy Statement, employer communications and final valuation

5. Investment Cost Transparency

5.1 The fee quoted by an Investment Manager for their services has always to be deducted from the gross return achieved by the Investment Manager to calculate the net return received by the Investor.

However, there are also other costs, necessarily incurred by the Investment Managers (which depending on the asset class might, for example, include transaction taxes, broker commissions, entry/exit charges, custody charges, audit fees) that reduce the return received by the investor. Traditionally there was no standard means by which investors could seek information on these charges to allow investors to scrutinise and challenge costs.

5.2 To improve transparency, reporting and understanding of investment management charges and costs by LGPS Funds the Scheme Advisory Board for England and Wales (SAB) working with major stakeholders including CIPFA, some LGPS Funds and most crucially the Investment Association (the main trade body representing UK Investment Managers) developed the LGPS

Investment Code of Transparency which was initially issued in May 2017. Under this voluntary Code participating Investment Managers will report their fees, costs and any relevant income (for example from stock lending) using standard templates issued by the SAB.

5.4 The approved templates cover only listed assets but where an asset class is not covered by the existing templates Investment Managers can still sign up to the Code and submit data agreed with each client that is *"substantially similar….to that covered by existing templates."* It was intended to expand the Code to cover unlisted assets but this was subsequently passed to the Institutional Disclosure Working Group (IDWG) established by the Financial Conduct Authority (FCA).

5.5 In September 2018 the SAB launched a tender for a process to validate the templates received from Investment Managers. As at 28 February 2019 approximately one hundred Investment Managers including four LGPS Asset Pools (Border to Coast, Brunel, Central, and the Local Pensions Partnership) had signed up to the Code.

5.6 The FCA proposed *that "both industry and investor representatives agree a standardised template of costs and charges"* and to *"ask an independent person to convene a group of relevant stakeholders to develop this further, for both mainstream and alternative asset classes"*. This resulted in the establishment of the Institutional Disclosure Working Group (IDWG).

5.7 The IDWG recommendations to the FCA may be summarised as follows:

5.7.1 Proposed the use of five templates – User, Main Account-Level (for most product types), Private Equity, Physical Assets, Ancillary Services (Custody).

The use of the templates should be voluntary but encouraged through other means such as pressure from institutional investors applied to providers. Typically, this would be by non-compliance resulting in de-selection from Requests for Proposal and the non-renewal of contracts. Investment consultants and other market participants (such as platforms) should adopt a similar selection approach. Industry representative organisations and trade bodies should be prepared to adopt the templates as their disclosure codes and to support the use of the templates by their members.

5.9 On 7 November 2018 a new body (as proposed by the IDWG) was launched which is known as the Cost Transparency Initiative (CTI). This is an independent group working to improve cost transparency and to progress the work of the IDWG and develop a pilot. The CTI is supported by the Investment Association, LGPS Scheme Advisory Board and the Pensions and Lifetime Savings Association.

5.10 Following the pilot, the CTI will roll out templates to the Investment Management and Pension Industries to encourage fully transparent and standardised cost and charge information for UK institutional investors.

6. COMMENTS OF THE CHIEF FINANCE OFFICER

6.1 This is a noting report and there are no direct financial implications as a result of the contents of this report.

6.2 Until the remedy for the case is established officers cannot speculate on what financial implications for this case will be.

7. LEGAL COMMENTS

7.1 On the 27th June 2019, the Supreme Court refused the government permission to appeal the Court of Appeal's Judgement in the McCloud case that transitional provisions introduced to the reformed judges and firefighters pension schemes in 2015 gave rise to unlawful discrimination. The outcome of this case is that the difference in treatment will need to be remedied across all of the main public service pension schemes including the LGPS to deal with any potential age discrimination. The administering authority will need to implement any changes required as a result of the judgement.

7.2 There are no immediate legal implications arising from this report.

8. ONE TOWER HAMLETS CONSIDERATIONS

8.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in costs management will reduce the contribution and increase the funds available for other corporate priorities.

9. BEST VALUE (BV) IMPLICATIONS

9.1 The effective and efficient management of scheme costs is key to the achievement of the funding strategy objectives and this is considered to be a good decision which can result in greater cost savings to the fund.

10. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

10.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

11. RISK MANAGEMENT IMPLICATIONS

11.1 The rigorous robust management of LBTH Pension Fund results in better quicker and more effective decision making which can lead to better Fund performance and reduction in the contribution required from the Council towards the Fund.

11.2 Ensuring good corporate governance and the adoption of sustainable business models at the companies in which the Fund invests should over the longer term ensure that they are able to deliver superior returns to the Fund.

12. CRIME AND DISORDER REDUCTION IMPLICATIONS

12.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- Written Ministerial Statement – Public Service Pensions
- http://www.lgpsboard.org/index.php/structure-reform/costmanagment/ccmcloud

Appendices

NONE

Local Government Act, 1972 Section 100D (As amended)

List of "Background Papers" used in the preparation of this report

- Hymans Robertson Sixty Second Summary

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