Summary
- Reforms come after public sector pension pricing confusion arose in 2016.
- The proposals are broadly welcomed as providing greater stability to cost control.
- Critics argue that there is still scope for improvement in how cost control is approached and calculated.
- There is 'disappointment' at the LGPS being included in the proposals, despite fundamental differences between it and other public setor schemes.

What's next for public sector pensions?

With the government consultation now concluded, the industry has broadly welcomed the proposed reforms for public sector pensions. However, concerns remain about how effective these measures will be

In early October, the government confirmed its intention to push ahead with reforms around public sector pensions and the cost control mechanisms used in them.

This was the culmination of a consultation first launched in June 2021, in response to the Government Actuary Department's recommendations for reform of this cost control mechanism. The industry's views were shared on three potential changes.

These included the adoption of a reformed scheme only design, widening the cost corridor to +/-1 3 per cent of pensionable pay, and the introduction of an economic check. The latter point would link schemes to long-term GDP figures.

From the outset, such reforms have been positively received by those in the industry. Broadstone actuarial director, Yvonne Wan, says: "The proposed reforms are welcome and provide a series of positive steps towards addressing the shortcomings of the current cost-control mechanism, which is not fit for purpose in its current guise."

A stabilised ship

The cost control mechanism is a result of Lord Hutton's proposals over a decade ago, introduced via the 2013 Public Service Pensions Act to ensure public service pensions cost would not rise or fall outside of a target rate.

Controversy arose in 2016 when valuations suggested scheme costs were lower than expected, with trade unions arguing this meant member contributions should not rise or pension benefits should increase. Providing greater security to this feature could help avoid controversy in future, according to AJ Bell head of retirement policy, Tom Selby.

"Given the aim of the cost control mechanism is to ensure fair, predictable outcomes both for members and taxpayers, this level of volatility was clearly far from ideal," says Selby. "The key test of the proposed reforms to the mechanism will be the extent to which they deal with the problems unearthed during 2016."

With greater rigour, it is hoped the cost control mechanism assigned to these pensions will provide members and trustees alike with more security and clarity. However, this comes at a cost, according to Hymans Robertson head of LGPS valuation, Robert Bilton, who argues there is no perfect solution.

"We welcome the fact that the cost control mechanism has been reformed as it was evident that the mechanism in its current form could be improved," says Bilton. "However, increasing stability does involve a trade-off – the government will end up exposed to more of any future cost variation (both costs and savings, so not all bad). This is the fine balancing act that is required when designing a cost control mechanism and there is no perfect solution and answer."

As a result, Bilton is dismayed to see a purely numerical solution being brought to the table.

Qualitative need

"It is disappointing to see that the reforms have not included any form of qualitative review for future cost cap valuation results," says Bilton. "This review would have further improved the mechanism by providing a 'common sense' check on what is still a very formulaic process."

Bilton is not alone in expecting a more common-sense approach.

Irwin Mitchell partner, Penny Cogher, welcomes the move toward stabilisation but says: "It had been expected that the government would introduce a qualitative review of future cost cap valuation results. As it stands, the process remains very formulaic and somewhat unpredictable save for the economic check."

Many experts agree that the current cost control mechanism requires correcting, and that the issues encountered in 2016 should not be repeated. Although these reforms may rectify this, some are concerned about the extent of the solution in contrast to the problem.

"The approach taken by the government to ensuring the mechanism bites less often goes too far, meaning that the cost control mechanism never actually gets to control any costs in the future," says LCP partner, Luke

Hothersal, who takes issue with the mechanisms' tolerance levels being increased.

"From a stability perspective, making the mechanism less likely to bite might sound like a good thing, but if the mechanism is functioning well 'more stable benefits' means 'less stable employer/taxpayer costs'. This therefore may well be a bad thing from the viewpoint of employers and the taxpayer."

Addressing unfairness

A securer and stronger approach to public service pension cost control was not the only priority for the government consultation. Analysis was made into points raised by respondents into allegations of intergenerational unfairness, with some members being made to pay higher costs over others.

The response is mixed, and Wan takes a pragmatic view.

"Whilst the move to a reformed scheme only design will have a positive impact as comparatively younger members will not see changes to their benefits based on legacy scheme costs associated with comparatively older members, the impact will likely fade over time as the proportion of past service benefits grows in the reformed schemes," she says. "The wider corridor may also cause intergenerational issues as there will be fewer benefit adjustments and when these do occur, they are likely to be larger step changes."

There are limits to what reforms can achieve on this front.

For one, benefits accrued before the new career average revalued earnings (Care) schemes were introduced are now outside the mechanism and any cost variations related to these fall beyond the mechanism. Furthermore, because any change to member benefits/contribution rates will only be forward-looking, it may be the case that the generation whose benefits caused the cost variation are not the ones who are paying for them.

"This issue will likely be further amplified by the widening of the corridor as it will delay when any benefit changes are enacted," adds Bilton. "There is no easy fix to the issue of intergenerational fairness, given the very long timeframes over which pension costs actually emerge and the preservation of accrued rights."

Overall, these reforms are viewed as a step in the right direction. Several shortcomings of the current system are being directly addressed and the issues of 2016 may be avoided in future given greater stability.

Criticisms still linger about where the costs will land, with questions raised about fairness. In particular, Cogher points out how the use of economic check effectively gives the government the ability to override the results of the cost control mechanism if it wanted to.

"There are concerns that the government needs more defined control on this ability to stop it becoming an unfettered power," she says, pointing to concerns expressed by the TUC that the state could be given licence to ignore breaches and override the intended objectiveness of the mechanism.

There are two sides to this issue though, and Cogher adds: "However, it also arguable that the government's override may allow more stability in years where the valuation takes unexpected turns."

Written by Jon Yarker, a freelance journalist

The LGPS issue

The Local Government Pension Scheme (LGPS) falls under these new reforms. However, the unique nature of the scheme means commentators argue it should be treated differently, with exceptions made for its own cost control mechanism.

"Like with other public sector pension schemes, the LGPS should welcome the degree of stabilisation that these reforms should bring in," says Irwin Mitchell partner, Penny Cogher. "There remains the question as to whether a wider root and branch reform is needed in relation to all public sector schemes and what is being proposed here is just tinkering around the edges."

As a funded scheme, many experts are questioning why the LGPS will answer to the same cost controls as other public sector pensions.

In particular, Hymans Robertson head of LGPS valuation, Robert Bilton, is disappointed the government has not adopted a different approach with the LGPS and criticises the use of long-term GDP growth as the metric of choice for this scheme's cost control mechanism.

"While we understand the government's desire for consistency and commonality with the unfunded schemes, this decision significantly weakens alignment of the cost control mechanism in the LGPS and could lead to further contrary outcomes," he says. "We think it would have been preferable that the LGPS cost control mechanism uses a discount rate that reflects the expected return from the overall asset allocation of LGPS funds."