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Public service pensions: the cost control mechanism

Summary
1 Background
2 The cost control mechanism
3 2016 valuation
4 Review of the mechanism

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Contents

Summary		**4**
1	**Background**	**8**
1.1	The Labour Government's reforms	8
1.2	The Coalition Government's reforms	9
2	**The cost control mechanism**	**12**
2.1	The 25-year guarantee	12
2.2	The Public Service Pensions Act 2013	13
2.3	Directions and valuations	14
2.4	Application to the LGPS	19
3	**2016 valuation**	**22**
3.1	Initial results	22
3.2	Pause due to McCloud	23
3.3	Meeting the costs of the McCloud remedy	25
3.4	Public Service Pensions and Judicial Offices Bill	27
4	**Review of the mechanism**	**29**
4.1	Report – June 2021	29
4.2	Government consultation – July to Oct 2021	32
4.3	NAO and Public Accounts Committee reports	38

Summary

Following the reports of the Independent Public Service Pensions Commission, chaired by Lord Hutton of Furness, the Government legislated in the Public Service Pensions Act 2013 for a framework for new public service pension schemes, to be introduced from April 2015 (2014 for local government). The new structure is designed to manage some of the costs and risks to the Exchequer of providing public service pensions. For example, basing benefits on career average earnings rather than final salary, removes from the Exchequer much of the 'salary risk' and linking the normal pension age to the State Pension age (except for the 'uniformed services, where it is 60) removes much of the longevity risk.

As an added safety valve, the Commission recommended that the Government should set a "fixed cost ceiling: the proportion of pensionable pay that they will contribute, on average, to employees' pensions over the long-term. If this was exceeded then there should be a consultation process to bring costs back within the ceiling, with an automatic default change if agreement cannot be reached"(Interim report, recommendation 12).

The Government legislated in section 12 of the Public Service Pensions Act 2013 for a 'cost control mechanism', which would operate symmetrically, so that if valuations showed that costs had risen or fallen outside of a target rate, steps would have to be taken to bring them back to target. It applies to 'member costs', such as increases in life expectancy or salaries.

2016 valuations

In September 2018, the Government said initial results of the 2016 valuations indicated that members should get "improved pension benefits for employment over the period April 2019 to March 2023." There would be consultation on what this would mean for each scheme and changes would be implemented from April 2019. It also asked the Government Actuary (GA) to "undertake a review of the mechanism to check whether it is working as intended and delivering the Government's objective to protect taxpayers and workers from unforeseen changes in pension costs" (HC Deb 6 September 2018 c13WS).

The operation of the cost control mechanism in relation to the 2016 valuations was paused on 30 January 2019 due to uncertainty about scheme costs following the Court of Appeal judgement in McCloud v Ministry of Justice. This had held that the 'transitional protection' offered to some members as part of the 2013 Act reforms amounted to unlawful discrimination. Trade unions representing public servants objected to the pause. The TUC said the government should "stick to its own rules and deliver what it pledged." The 2016 valuation had showed public sector pensions to be cheaper than

expected. Under the agreed rules, this "should mean lower contributions or improved pensions for members."

On 16 July 2020, the Government lifted the pause, as progress in determining the McCloud remedy meant costs were now more certain. The cost of the remedy would count as a 'member cost' in the completion of the 2016 valuations.

In February 2021, the Government said that the inclusion of the cost of the McCloud remedy in the 2016 valuation would lead to higher costs than had been expected and in some schemes breaching the ceiling. While a cost ceiling breach would generally result in action having to be taken to return costs to target, the Government had decided that this would not be appropriate for the 2016 valuations. A review by the Government Actuary was ongoing and it would not be appropriate to reduce member benefits as a result of a mechanism that might not be working as intended. However, in the case of costs falling below target, member benefits would be increased to bring costs back to target.

Clause 80 of the Public Service Pensions and Judicial Offices [HL] Bill would allow ceiling breaches in the 2016 valuations not to be rectified by means of benefit reductions.

On 7 October 2021, the Government published amending directions for completion of the 2016 valuations. A letter from the GA confirmed that the amending directions reflected the Government's policy intention that the entire impact of the McCloud remedy should be taken into account at this set of valuations.

Trade unions representing public servants have objected to the inclusion of remedy costs as member costs in the 2016 valuation and argue that the benefit improvements originally expected from the 2016 valuations, before the inclusion of remedy costs, should be honoured.

Government Actuary review

Cost control policy will change for valuations from 2020 following a review of the mechanism conducted by the Government Actuary (GA), at the Government's request.

The main conclusions of the GA's report published on 15 June 2015 were:

- The older legacy schemes were the driver of the main changes in costs, but under the cost control mechanism, benefits could only be amended in the newer reformed schemes, which would seem to be tending towards intergenerational unfairness. Furthermore, the main changes in costs in the legacy schemes were in relation to assumed salary increases and life expectancy, two aspects which had largely been mitigated in the design of the reformed schemes.

- Costs could be expected to frequently fluctuate by more than two per cent, hence regular breaches of the corridor could be expected.
- Perverse outcomes could occur as benefit improvements could be granted at the same time as employer costs are increasing. Primarily this could occur due to the exclusion of changes to the long-term economic assumptions from the cost control mechanism.

The GA made five main recommendations as to how the mechanism could be improved, split between changes to the core mechanism and a validation layer to moderate the effects of the core mechanism.

On 24 June 2021, the Government launched a consultation on proposals to take forward three proposals, all recommended by the GA:

- Designing the cost control mechanism so that it considers only benefits built in the reformed schemes. This would ensure consistency between the benefits being assessed and those potentially adjusted;
- Widening the corridor from 2% to 3% of pensionable pay, thereby reducing the regularity of breaches; and
- Introducing an economic check, so that a breach of the mechanism would only be implemented if it would still have occurred had long-term economic assumptions been considered.

In response to this consultation on 4 October 2021, the Government said it had decided to proceed as proposed, although it would consult further with LGPS stakeholders on the application of an economic check in that context.

The majority of respondents to the consultation had supported the proposals to move to a ‘reformed scheme only' design and to widen the corridor (with a slight majority agreeing it should be set at 3%). In the case of the economic check, there was a division in opinion. Those supporting it said it would avoid the ‘perverse outcome' where benefits improved at the same time as employer costs were increasing. Others – including trade unions – were opposed on grounds that it may be a breach of the 25-year guarantee and previous government commitments regarding the types of cost the mechanism was intended to control.

The Government's proposed changes regarding the move to a ‘reformed scheme only' design and the incorporation of an economic check will require primary legislation. The wider cost corridor would be implemented to a longer timeline via secondary legislation.

Comment

In March 2021, the National Audit Office reported that “employee representatives told us that reviewing the mechanism because of what happened at the first valuation undermines trust between employees and the government.” Analysis by GAD in 2012 had suggested the mechanism could easily be triggered:

> HM Treasury's original intention was for the cost control mechanism to be activated only 'if extraordinary, unpredictable events' occur. HM Treasury told us it is concerned that the current design exposes taxpayers and members to short-term changes in assumptions rather than responding to long-term trends. GAD's analysis, performed in 2012, suggested the mechanism could easily be triggered if multiple factors were to move at the same time.

In June 2021, the Public Accounts Committee said recommended that HM Treasury should "prioritise work to quickly resolve the challenges presented by the McCloud judgment and cost control mechanism, in order to give certainty to scheme members and employers, and rebuild the trust lost through these issues."(Public Service Pensions, June 2021, para 5).

In its response, the Government agreed with the recommendation and said work was underway to complete the 2016 valuations and reform the cost control mechanism in time for the 2020 valuations.

For more on the reforms, see CBP 5768 Public service pensions – the 2015 reforms (July 2021).

1 Background

Public sector pension schemes are occupational pension schemes for employees of central or local government, a nationalised industry or other statutory body. Public service schemes are established by statute or by Ministers exercising statutory powers. [1]

Other than the Local Government Pension Scheme (LGPS), the main public service pension schemes are unfunded. They operate on a pay-as-you-go (PAYG) basis, which means there is no fund of assets which is invested and from which pension benefits are paid. Employer and employee contributions are paid to the sponsoring government department, which pays benefits to pensioner members, netting off the contributions received. [2]

The schemes are subject to regular actuarial valuations at which the value today of pension benefits that will be paid in the future is assessed. [3] For the unfunded schemes, the purpose of carrying out valuations is to ensure that contributions from employers and employees are set at a level to reflect the future value of benefits being earned. This is so that "the full costs of the scheme are taken into account when financial decisions are made by employers." [4] The employer contribution is normally expressed as a percentage of pensionable pay.

The LGPS is different in that it is made up of a number of different funds, administered at local level. Individual funds carry out valuations to determine the contributions to be paid by employers. Where a fund is in deficit, there will be a locally agreed recovery plan to fund the deficit. For more detail, see Local Government Pension Scheme: response to McCloud, CBP 9257, June 2021.

1.1 The Labour Government's reforms

The last Labour Government negotiated reforms to the main public service pension schemes. These had the aim of improving financial sustainability and reflecting changes in life expectancy, working practices and practice in the

[1] HM Treasury, Long-term public finance report: an analysis of fiscal sustainability, March 2008, Box 4.3; David Blake, Pension schemes and pension funds in the United Kingdom, 2nd Edn (2003), p686

[2] PPI, An assessment of the Government's reforms to public sector pensions, Oct 2008, p7

[3] Public Service Pensions Act 2013, s11

[4] HM Treasury, Public service pensions: actuarial valuations and the employer cost cap mechanism, March 2014

private sector. [5] Following consultation, new schemes were introduced for new entrants to the armed forces in April 2005 and for the police and firefighters in April 2006. Reforms to the local government scheme in 2006, applied to both new entrants and existing members. Reforms to the teachers', NHS and civil service schemes were introduced in 2007-08. The schemes all had different aims and different workforces, so the details of the reform are different in each case. However, common features of the reforms included: the modernisation of survivors' benefits, changes in member contribution rates and increases in the pension age, mainly for new entrants. [6] These reforms also included the introduction of a cost-capping and sharing mechanisms in the main public service schemes. HM Treasury explained:

> The cap and share policy is designed to ensure that the cost pressures associated with the rising cost of providing pension scheme benefits (such as improving longevity) are shared between employers and employees up to an agreed employer contribution cap, beyond which all further increases will be the responsibility of employees. This sets a maximum limit to employer contributions thus protecting the public finances and taxpayer. The costs will be assessed through the periodic scheme valuations that take place every 3 or 4 years. [7]

The National Audit Office (NAO) concluded that the reforms were "on course to deliver substantial savings" with long-term costs projected to stabilise around their current levels as a proportion of GDP. [8] However, opinion was divided on whether the reforms went far enough. [9]

1.2 The Coalition Government's reforms

Following the 2010 election, the Conservative Liberal Democrat Coalition Government set up the Independent Public Service Pensions Commission, chaired by former Labour Work and Pensions Secretary of State, Lord Hutton of Furness, to conduct a fundamental structural review of public service pension provision. [10] The Commission was invited to report in two stages, with an interim report looking at the potential for making savings in the short-term

[5] DWP, Simplicity, security and choice: working and saving for retirement, Cm 5677, December 2002, p106-7

[6] Public service pension reform 1997 to 2010, Commons Library Briefing Paper CBP 5298, November 2010

[7] HM Treasury, Long-term public finance report: an analysis of fiscal sustainability, December 2009, Box 6.A; For more detail, see Library Note SN 5252 Public service pension schemes – cost capping and sharing (21 December 2011)

[8] NAO, The impact of the 2007-08 changes to public sector pensions, HC 662, 8 December 2010, Executive

[9] See, for example, CBI, Getting a grip – The route to reform of public sector pensions, April 2010; TUC, Exploding Public Sector Pensions Myths: A Briefing for Trade Union Members, July 2009

[10] Independent Public Service Pensions Commission: interim report, 7 October 2010, p133

and a final report making recommendations for longer-term structural reforms.

The Commission's Interim Report was published on 7 October 2010. It recommended that the most effective way of making savings in the short-term was to increase member contribution rates and that there was a case for doing so. In response, the Government announced that it would increase member contribution rates by an average of 3.2 per cent across public service schemes, except for the armed forces. The increases were phased-in over the period 2012/13 to 2014/15. [11]

However, Lord Hutton said longer term structural reform was needed:

> It is my clear view that the figures in this report make it plain that the status quo is not tenable. I believe we need to adopt a more prudent approach to meeting the cost of public service pensions in order to strike a fairer balance not just between current taxpayers and public service employees but also between current and future generations. [12]

He said that although recent reforms would reduce costs over time, they did not "address the underlying issue of structural reforms, nor significantly reduce current costs to taxpayers." [13] The cost capping and sharing policy introduced by the Labour Government had limitations. In particular, it would only apply to increases in costs from a recent baseline:

> Cap and share reduces scheme costs only if scheme valuations reveal future additional cost pressures compared with a recent baseline (which is usually the preceding valuation). Therefore, although cap and share can reduce scheme costs below what they might have been, it would not at present deal with the very considerable increases in the costs of providing pensions, worth several percent of pay a year, that have resulted from increases in longevity in recent decades. [14]

In its final report, published in March 2011, the Commission said its aim was to design a structure that would share the risks and costs of public service pensions between employees and government fairly:

> For example, moving to [career average revalued earnings] from final salary removes much of the salary risk associated with public service pensions. Adjusting [normal pension age] in line with longevity increases through linking to [state pension age] will remove much of the risk to costs of future increases in longevity. [15]

[11] HM Treasury, Spending Review 2010, October 2010, para 1.94
[12] Independent Public Service Pensions Commission: interim report, Oct 2011, foreword
[13] Ibid, Box 2A
[14] Ibid, p47
[15] Independent Public Service Pensions Commission: Final Report, Mar 2011, para 4.25

However, it thought there would still be a need for an overriding mechanism to ensure public service pensions remained affordable and sustainable. This would act as a “safety valve in case costs within the new scheme increased due to factors not taken account of in the scheme design.” It recommended that:

> The Government on behalf of the taxpayer, should set out a fixed cost ceiling: the proportion of pensionable pay that they will contribute, on average, to employees’ pensions over the long-term. If this is exceeded, then there should be a consultation process to bring costs back within the ceiling, with an automatic default change if agreement cannot be reached. [16]

See Public service pensions: the 2015 reforms, Commons Library Briefing Paper CBP 5768, July 2021.

The Government accepted the recommendations of the Commission’s final report as the basis for negotiation with the trade unions. [17] It legislated in the Public Service Pensions Act 2013 for a framework for new public service pension schemes to be introduced from April 2015 (2014 for local government). Key features of the legislation included:

- Enabling the creation of new public service schemes, providing pensions based on career average rather than final salary (s 8);
- Linking the normal pension age to the State Pension age, except in the schemes for the firefighters, police and armed forces, which would have a normal pension age of 60 (s 10);
- Providing transitional protection for those 'closest to retirement.' People within 10 years of pension age on 1 April 2012 would remain in the existing schemes. Those within a further 3-4 years of normal pension age may have the option of a delayed transition to the new scheme (s 18).

The Government’s reforms overall [18] were expected to significantly reduce the cost of public service pensions to the Exchequer as a proportion of GDP. In 2017, the OBR said:

> 3.75 Gross public service pension expenditure (i.e. before offsetting member contributions) is projected to fall from 2.1 per cent of GDP in 2021-22 to 1.3 per cent of GDP in 2066-67. To a large extent, this decline reflects reforms that have been introduced since 2010 and the reductions to the public sector workforce associated with ongoing cuts to departmental spending (although these are less severe than were factored into our 2015 projections). [19]

[16] Ibid, p96-7
[17] HM Treasury, Budget 2011, para 1.132
[18] Including the switch to the CPI as the measure of prices for increasing pensions in payment and the increase in member contribution rates
[19] OBR, Fiscal sustainability report, 2017; See also, PPI, The implications of the Coalition Government’s public service pension reforms, 17 May 2013 (press release)

2 The cost control mechanism

2.1 The 25-year guarantee

In the course of negotiations on the reforms, the then Chief Secretary to the Treasury, Danny Alexander, said that reform along the lines the Government had proposed could endure for 25 years:

> It will be a sustainable deal that will endure for at least 25 years, and an affordable deal that will ensure that taxpayers are asked to make a sensible contribution, but will keep costs sustainable and under proper control. [20]

On 20 December 2011, he undertook to ensure a high bar was set for the design of schemes to be changed:

> I have made the commitment that these reforms will be sustained for at least 25 years. The Government intend to include provisions on the face of the forthcoming public service pensions Bill to ensure that a high bar is set for future Governments to change the design of the schemes. [21]

Section 22 of the Act therefore provides for enhanced consultation arrangements in the event of certain changes being made to "protected elements of the scheme within the protected period" (25 years from 2015). "Protected elements" refers to:

- the extent to which the scheme is a career average revalued earnings scheme;
- members' contributions under the scheme;
- benefit accrual rates under the scheme. [22]

However, as discussed below there are different procedure for changes resulting from the operation of the cost cap.

[20] HC Deb 11 November 2011 c929

[21] HC Deb 20 December 2011 c1203

[22] Section 22

2.2 The Public Service Pensions Act 2013

The Government accepted the Independent Public Service Pensions Commission's recommendation for a ceiling on employer costs and provided for it in the Public Service Pensions Act 2013:

> 1.3 The Independent Public Service Pensions Commission recommended that the Government establish a mechanism to control future spending on public service pensions, by setting a fixed proportion of pensionable pay that public service employers would contribute to the schemes in the long term. The Commission also recommended that if this cost were exceeded then the Government should consult on how to reduce costs, with an automatic default to be applied if agreement could not be reached.
>
> 1.4 In response to this recommendation, the Government has committed to putting in place an employer cost cap to protect against unforeseen changes in scheme costs. The cost cap will provide backstop protection to the taxpayer, to ensure that the risks of increased costs are shared between scheme members and public service employers. The cap arrangements will be symmetrical, so that if costs fall below a certain threshold, the savings will be used to the benefit of scheme members [...]. [23]

Section 11 (valuations) provides that schemes must be actuarially valued in accordance with Treasury directions – to ensure the approach is transparent and consistent. [24] This applies to the new schemes introduced under the Act and 'connected schemes' under s4 (6). [25] The Treasury is required to consult the Government Actuary before making, revoking or amending directions. [26]

The Government explained that in future, valuations of the funded schemes would have a dual purpose. As well as being used to set employer contribution rates, they would inform the operation of the cost cap:

> 1.6 For the unfunded schemes, the initial level of the employer cost cap will be set with reference to the 2012 scheme valuations, with subsequent valuations being used to measure future costs against this cap. If valuations show that there have been unexpected changes in costs, action will be taken to mitigate these. This may be via an adjustment to the benefits accruing in respect of future service, an adjustment to member contributions, or via some other means. [27]

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[23] HM Treasury, Establishing an employer cost cap in public service pension schemes, November 2012, Executive summary
[24] HM Treasury, Actuarial valuations of public service pension schemes, November 2012, para 1.7
[25] Public Service Pensions Act 2013, Explanatory Notes, para 73
[26] Public Service Pensions Act 2013, Explanatory Notes, para 74
[27] HM Treasury, Actuarial valuations of public service pension schemes, November 2012

In the case of the Local Government Pension Scheme (which is made up of different funds administered locally) a model fund would be used to measure assets and liabilities across the scheme as a whole:

> 1.12 The pension schemes for local government employees differ from the other large public service schemes as they are funded schemes, comprised of a number of individual local funds. These individual funds will continue to carry out their own valuations to determine the contributions to be paid by employers using the fund. However, to allow an employer cost cap to operate, a model fund will be used to measure assets and liabilities across the local government scheme as a whole. The outcome of the model fund valuation will be used to assess whether costs remain at sustainable levels. For the remainder of this paper, references in this document to valuations of the local government schemes will relate to these model funds, unless otherwise stated. [28]

Section 12 provides for an **employer cost cap** to be set in accordance with Treasury directions. Under subsection 5, Treasury regulations must make provision for a target cost for the scheme:

> (a) provision requiring the cost of a scheme (and any connected scheme) to remain within specified margins either side of the employer cost cap, and
>
> (b) for cases where the cost of a scheme would otherwise go beyond either of those margins, provision specifying a target cost within the margins.

Under subsection 6, where costs would otherwise go beyond these margins, regulations may provide for a procedure for the scheme manager, employers and members (or their representatives) to reach agreement on steps required to achieve the target cost.

2.3 Directions and valuations

A Treasury paper published in November 2013 explained how the cap was intended to work. In the event of the floor or ceiling being breached, there would be:

> 1.12 [...] a process of consultation to allow the responsible authority, the scheme managers, employers and members (or their representatives) to reach agreement on how the scheme costs will be returned to the level of the cap. The adjustment to the employer contribution rate may be brought about via a change in the benefits members accrue going forward, a change to member contributions,

[28] HM Treasury, Actuarial valuations of public service pension schemes, November 2012

> or some other adjustment. There is no intention to make changes to benefits already accrued via the cost cap mechanism. Treasury consent will be required before the changes are implemented, in line with the general requirement for Treasury consent for scheme changes.
>
> 1.13 White the Government expects that agreement would be reached via this process, the Bill sets out that there may be a default action if this is not the case. Scheme regulations will therefore set out what should be changed if there is no agreement within a specified period. This will have the effect of adjusting members' future benefit accruals or contribution rates so that the costs of providing the revised pension scheme are in line with the cap. [29]

The initial level of the cap would be set at a level "deemed to be sustainable in the long-term," based on valuations using 2012 data, which would be completed before the reformed schemes were introduced in April 2015. [30]

These directions and regulations providing for the employer cost cap are on Gov.UK. Correspondence between the Government and the Government Actuary's Department which took place as part of the statutory requirement to consult under section 11 (4) of the Act is on Gov.UK.

Scope and timing of valuations

The Treasury explained that scheme valuations, which had not been completed for a number of years, would now be carried out in accordance with the Directions. They would inform employer contribution rates from 2015 and the setting of cost caps:

> For the unfunded schemes, these valuations will inform the schemes' employer contribution rates to be paid from 2015 onwards. For all of the schemes, including the funded schemes for local government workers, these preliminary valuations will also set the level of the employer cost cap, with future valuations comparing scheme costs against these caps. [31]

Directions provide for old and new schemes for similar categories of employees to be valued together. This is because the cost cap will control the costs associated with the new schemes and some of the costs associated with the existing schemes. [32] Treasury directions require valuations to be carried out every four years (for the unfunded schemes), every three years for the

[29] HM Treasury, Establishing an employer cost cap in public service pension schemes, November 2012

[30] Ibid, para 1.24-7

[31] HM Treasury, Public service pensions: actuarial valuations and the employer cost cap mechanism, March 2014, para 1.6

[32] Ibid para 1.8

LGPS. [33] As discussed below, in September 2018, the Government proposed that LGPS valuations for cost cap purposes should also be four-yearly.

The cost of unfunded schemes is measured using a SCAPE approach – whereby a notional pot of assets that is set equal to the scheme's total past service liabilities. [34] The Directions set some central assumptions to be used in scheme valuations. [35] Others will be set on a scheme specific basis by the responsible authority. The intention is to introduce greater consistency in the way costs are measured across different schemes. [36]

Costs controlled by the cap

The cap is designed to control changes in "member costs" (those relating to assumptions about the profile of scheme members) not to changes in "employer costs" (those relating to assumptions that are financial or technical in nature):

> 1.22 Many of the assumptions that must be made to carry out a valuation relate to the profile of scheme members – for example the expectations about their life expectancy, growth in salaries, or career paths. These will be defined as "member costs". Other decisions and assumptions that must be made to carry out a valuation are financial or technical in nature – for example the discount rate that is used to assess the present costs of future benefits, or the actuarial methodology to be used. These will be defined as "employer costs".
>
> 1.23 The Government has stated that adjustments will only be made via the cost cap mechanism if they arise from changes in the "member costs". Changes that arise solely from changes in "employer costs" will not be controlled by the employer cost cap and will not trigger changes in member contributions or benefits. Public service employers, and ultimately the Exchequer, will bear the risks of changes in these costs. [37]

It will apply to all increases in member costs, except those associated with deferred or pensioner members of the existing schemes:

> 2.24 [...] As only active members will see their future benefits or contributions adjusted if the ceiling or floor is breached, the government considers that it would be unfair to control all of the

[33] Ibid para 1.11

[34] Ibid chapter 3

[35] Public service pensions – employer contributions, Commons Library Briefing Paper CBP-7539

[36] HM Treasury, Public service pensions: actuarial valuations and the employer cost cap mechanism, March 2014, p24

[37] HM Treasury, Establishing an employer cost cap in public service pension schemes, November 2012; HM Treasury, Public service pensions: actuarial valuations and the employer cost cap mechanism, March 2014, para 2.33

> costs associated with pensioner and deferred members of the existing pension schemes.
>
> 2.25 The cost cap will control all other member cost risk, including the past and future cost risks associated with:
>
> - Active members of the reformed schemes, including any service they have in the existing schemes*;
> - Deferred and pensioner members of the reformed schemes; and
> - Transitionally protected active members of the existing schemes.
>
> *The cost risks arising from active members' service in the existing schemes will be controlled by the cap where there has been no break in service of longer than five years between membership of the existing and new schemes. This is in line with the retention of the final salary link for members that rejoin active service within five years.
>
> 2.26 Public service employers, and ultimately taxpayers, will bear the additional risk associated with pensioner and deferred members of the existing schemes, rather than the members themselves. [38]

Past and future service costs for the purposes of the employer cost cap will be different from those used to calculate the contribution rate, in that past service costs relating to deferred and pensioner members of the existing schemes will be excluded. In order to achieve this, the Directions establish the concept of a "cost cap fund", which will measure all costs relating to members of the new schemes, but only costs relating to members of the existing schemes while they remain in active service. [39]

Mechanisms for keeping the costs to target

The operation of the cap will allow for minor fluctuations in cost:

> 2.28 There may be fluctuations in scheme costs between valuations. So that these do not lead to frequent changes in the scheme design after each valuation, Treasury regulations (made under section 12(5) of the Act) specify that there will be a two-percentage point margin above and below the cap. The upper margin will form a "ceiling" on the employer contribution rate, with the lower margin forming a "floor". For example, if the employer cost cap is set at 14% of

[38] HM Treasury, Public service pensions: actuarial valuations and the employer cost cap mechanism, March 2014, para 1.19

[39] Ibid, para 4.66-4.71

> pensionable pay, the ceiling and floor will be set at 16% and 12% respectively. [40]

Scheme regulations would set out the process to be followed in the event of the cap or floor being breached:

> 2.29 As set out above, at future valuations the "cost cap cost of the scheme" will be compared to the employer cost cap. If there is a change in costs, and this measure of scheme costs rises above the ceiling or falls below the floor, the Act requires action to be taken to bring costs back to a "target cost". The Treasury regulations define this target cost as being the same as the employer cost cap. Bringing costs back to the level of the cap will ensure that there is no long-term increase or decrease in the costs of the scheme – a long-term increase would not be fair to taxpayers, whereas a long-term decrease would not be fair to scheme members.
>
> 2.30 Costs may be rebalanced by amending scheme benefits for future accruals to alter the overall cost of the scheme, or by altering the level of employee contributions so that a higher or lower level of employer contributions is required. Scheme regulations will set out a process for agreeing the necessary action with stakeholders, and a default action to be taken if agreement cannot be reached within a reasonable time limit. [41]

The Government said that the directions would be kept under review. This was because there might be future changes in scheme costs which the government would not wish to affect members via the cost cap. [42]

Setting the level of the employer cost cap

HM Treasury directions set out the details of how the initial level of the cost cap should be set, based on the assessment of future service cost from scheme valuations:

> 2.17 Preliminary valuations of the schemes, valued "as at" 31 March 2012, will form the basis for the new cost control framework and will be used to set the cost cap. The preliminary valuations will be conducted subject to an assumption that the schemes will be reformed in line with agreed proposals from 2015 (2014 for LGPS in England and Wales). The level at which that cap will be set will be based on an assessment of only the future service costs of the new schemes – the costs of the benefits being accrued by current members. It will not take into account any past service costs that have arisen in the existing schemes due to previous over- or under-estimation of costs before those schemes closed. This means that

[40] Ibid

[41] Ibid

[42] Ibid para 2.36-41

> when the level of the cap is set, it is likely to be different from the employer contribution rate actually paid. This is because the rate paid from 2015 will also reflect past service costs associated with members of the pre-2015 schemes.
>
> 2.18 The preliminary valuation of the new schemes will calculate a cost cap based on the costs of providing the new scheme benefits from 2015-19, using assumptions relevant to that period. This is consistent with the approach to calculating the future service element of the employer contribution rate in the preliminary valuation, except that there will be three adjustments made in the way that these costs are calculated. These adjustments will take account of changes in scheme costs which the government expects to take effect after 2019. [43]

This preliminary valuation would use assumptions relevant to the 2015-2019 period, with adjustments to take account of changes in scheme costs which the government expected to take effect after 2019. These adjustments would relate to: the transitional protection arrangement for those closest to retirement; the fact that the retirement decisions of members would change as members accrued more of their rights in the new scheme; and earnings forecasts for the longer term. [44] Future valuations for the unfunded schemes will take place every four years, with the 'first valuation' showing the position of the scheme as at 2016. [45]

2.4 Application to the LGPS

Unlike the other main public service schemes, the LGPS operates on a funded basis. Its rules are in regulations set at national level, but the scheme is made up of different funds, operated and governed at local level. Each fund is subject to periodic valuation to ensure it has sufficient assets to meet its liabilities and to set the employer contribution rate accordingly. The assumptions for these valuations are set locally:

- Each LGPS pension fund is required to appoint their own fund actuary, who carries out the fund's valuation and setting the assumptions for this. Liabilities are split between those that relate to the past, and those that relate to the future. The results of the valuation may lead to changes in employer contribution rates for both future and past service costs.
- The portion of the total employer contribution which relates to the past service cost is known as the deficit contribution and is often payable in cash terms. The portion of the total employer contribution which relates

[43] Ibid

[44] Ibid para 2.19 to 2.23

[45] Ibid para 4.16

> to the future service cost is known as the future service rate and is normally payable in percentage of pay terms. [46]

There is an additional valuation conducted at national level, based on a model fund, for employer cost cap purposes:

> Under the new cost management process, the costs of the LGPS will be reviewed every three years from 31st March 2016 to ensure that they remain in line with agreed targets. The process includes additional valuations that will be carried out at national level. The purpose, assumptions and output from these cost management valuations are all different from the local valuations carried out by LGPS funds. This cost management process can only lead to changes in benefit levels and/or employee contribution rates that will be made at national level. [47]

Before the cost cap mechanism is tested, the LGPS Advisory Board (SAB) for England and Wales runs an additional cost control process with the aim of "providing greater control over the contribution rates actually paid by employers participating in the scheme." [48] The agreed target future service rate for the LGPS (England and Wales) in the 2016 valuations19.5% of pay:

- In the national cost management process, the costs of the LGPS will be assessed in line with the agreed target future service rate for LGPS benefits of 19.5% of payroll (made up of an average yield of 6.5% in employee contributions and an average yield of 13% in employer contributions). A movement of two percentage points or more from the target in either direction must result in agreed recommendations for action to move back to the target or a default process to move back to the target will be triggered. Recommendations for action may be made following changes of less than two percent.
- The cost management process will (when changes in cost become apparent) only lead to changes in benefit levels and/or employee contribution rates and these changes will apply to all employees in the LGPS. Any changes to benefit levels and/or employee contribution rates will be made at national level and so will impact on all participating employers. These changes will only impact on the actual contributions that employers pay when they are allowed for in the local valuations. [49]

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[46] SI 2013/2356 reg 62; LGPS SAB – Triennial valuations in the LGPS (England and Wales) in detail

[47] LGPS (England and Wales) Scheme Advisory Board; HM Treasury, Public service pensions: actuarial valuations and the employer cost cap mechanism, March 2014 para 5.2; Public service pensions (valuations and employer cost cap) (amendment) directions 2018 – amending directions 5 and 6 and technical annex

[48] Ibid para 5.3-12

[49] LGPS Scheme Advisory Board – 2016 valuations - summary

In September 2018, the Government proposed bringing LGPS cost cap valuations onto the same quadrennial cycle as for the unfunded schemes. It said this would minimise complications and assist with comparison. [50]

On 10 October 2018, the Scheme Advisory Board for the LGPS in England and Wales said that the total cost was 19% and that it would look at ways to return costs to the target 19.5%. [51] However, on 8 February 2019, it announced that this work had been put on hold pending the outcome of legal proceedings in relation to the transitional protection arrangements for the 2015 schemes (see below). [52] In November 2019, the SAB said it did not expect to "see any remedy implemented before the end of financial year 2020/21." Cost cap calculations would be "re-run once the McCloud remedy had been agreed." [53]

LGPS Scotland

The first valuation of the LGPS (Scotland) under these arrangements was based on scheme data as at 31 March 2014 and was completed on 4 January 2016. It proposed an employer cost cap of 15.5% of pensionable pay. [54] The next valuation, based on scheme data as at 31 March 2017 would begin in 2017-18. Any changes arising from it would apply from April 2020. [55]

[50] Information about the cost management process is here.

[51] LGPS Advisory Board/Board updates/October 2018

[52] LGPS Advisory Board cost management process

[53] LGPS Advisory Board/McCloud

[54] SPPA website -valuations; GAD, Actuarial valuation as at 31 March 2014, March 2016

[55] SPPA website -valuations

3 2016 valuation

3.1 Initial results

On 6 September 2018, the Government said that initial results of the 2016 valuations showed that “the protections in the new cost cap mechanism mean public sector workers [would] get improved pension benefits for employment over the period April 2019 to March 2023.” Breaches of the cost floor would require steps to be taken to return costs to their target level:

> The outcome of the valuations and the cost control mechanism will be confirmed later this year. Secretaries of State, and Scottish and Welsh Ministers, will then consult the appropriate Scheme Advisory Board, which consist of member and employer representatives for each of the pension schemes, to reach agreement on the steps to be taken to return costs to their target level. Where it is not possible to reach agreement, the legislation provides that remedy will be delivered by increasing the rate at which pension benefits accrue. Changes will be implemented with effect from April 2019. [56]

Following consultation, HM Treasury published amending Directions on 23 November 2018 to ensure that the 2016 valuations of the public service pension schemes could be completed using the latest assumptions. [57]

Discussions were held in Scheme Advisory Boards on what action should be taken to return costs to target. To take the Civil Service Pension scheme as an example of the process to date, based on the initial valuation results, the Scheme Advisory Board [58] agreed a package of reforms to implement the cost control mechanism. These included a reduction of member contributions; reform of the current contribution rate structure; and increased death benefits. [59] As discussed below, this was not implemented due to the pause. [60] Unions representing civil servants objected. [61]

[56] HCSW945, 6 September 2018

[57] Public Service Pensions (Valuations and Employer Cost Cap) (Amendment) Directions 2018; Gov.UK, Public service pensions 2016 valuations: suppl. docs, 6 Sept 2018

[58] Set up under section 7 of the 2013 Act to advise on rule changes to the scheme

[59] FDA pensions update, June 2019

[60] Cabinet Office, Report on proposed amendments to the Public Service (Civil Servants and Others) Pensions Regulations 2014, 2019

[61] FDA pensions update, June 2019

3.2 Pause due to McCloud

In December 2018, the Court of Appeal ruled in McCloud that the 'transitional protection' offered to some members as part of the reforms amounts to unlawful discrimination. [62]

For more detail, see Commons Library Briefing Papers: Public service pensions: response to McCloud, CBP 9117, August 2021

On 30 January 2019, the then Chief Secretary to the Treasury, Elizabeth Truss, announced that the cost control element of the 2016 valuations had been put on hold pending the outcome of the McCloud litigation. This was because if the Government was unsuccessful in appealing the judgement, it would be required to remedy the discrimination:

> However, given the potentially significant but uncertain impact of the Court of Appeal judgment, it is not now possible to assess the value of the current public service pension arrangements with any certainty. The provisional estimate is that the potential impact of the judgment could cost the equivalent of around £4 billion per annum. It is therefore prudent to pause this part of the valuations until there is certainty about the value of pensions to employees from April 2015 onwards. [63]

The part of the valuations which set employer contributions would continue:

> In order to ensure employers are meeting the increased costs of providing pensions, the part of the valuations of the unfunded pension schemes which sets employer contributions (which existed before the 2015 reforms) will continue. Employers in unfunded schemes have been planning for these changes in employer contributions to be implemented in April 2019, and the Treasury is in the process of allocating funding to departments to help with these costs. [64]

The delay in implementing the cost cap was met with concern by unions representing public sector workers. TUC said the government should "stick to its own rules and deliver what it pledged":

> Public sector pension schemes have been cheaper than expected. Under the agreed rules, which the government committed to for 25 years, this should mean lower contributions or improved pensions for members. But halting the valuation process leaves this in jeopardy. [65]

On 15 February 2019, HM Treasury published amending valuation directions which formally put the pause into effect and confirmed the basis for the

[62] Lord Chancellor and Secretary of State for Justice v McCloud and Mostyn, Home Secretary and Welsh Ministers v Sargeant [2018 ECWA Civ 2844]

[63] HCWS 1286 30 January 2019

[64] HCWS 1286 30 January 2019

[65] Government must not break public sector pensions pledge says TUC 30 January 2019; See also Public sector pension improvements paused by age discrimination cases ruling, Prospect, 5 Feb 2019;

calculation of employer contributions from 1 April 2019 by public service schemes. [66] The Government Actuary had agreed this approach was reasonable. [67]

Results of the 2016 valuations

The results of the 2016 valuations, published in February 2019, reflected the Government's decision to pause the operation of the cost control mechanism pending the outcome of McCloud and to implement employer contribution rates from 1 April 2019 as if it had not done so. [68] In relation to the cost cap, it assumed an increase in member accrual rates due to the cost cap mechanism, resulting in an increase in the employer contribution rate:

> Direction 43A requires the corrected employer contribution rate to be calculated assuming that the accrual rate set in scheme regulations for the 2015 Scheme has been adjusted from 1 April 2019 to the extent necessary for the employer contribution correction cost to be set equal to the target cost of the scheme. If the accrual rate of the 2015 Scheme is increased to 2.82% from 1 April 2019 this will result in the employer contribution correction cost being equal to the target cost of the scheme. The addition to the uncorrected employer contribution rate for providing this level of accrual in the 2015 Scheme from 1 April 2019 is 4.6% of pensionable pay. This is lower than the difference between the employer contribution correction cost and the target cost of the scheme (which is shown as 5.4% in the table above) as a proportion of the membership will continue to accrue benefits in the pre-2015 schemes over the implementation period and their cost of accrual will not change. The resulting corrected employer contribution rate is 27.0% of pensionable pay. [69]

The result was an increase in the average employer contribution rate (relating to all the civil service schemes, not just the 2015 Scheme) from 21.1% to 27.3% with effect from 1 April 2019. [70] Actual employer contribution rates vary, depending on members' salaries. [71]

On 25 April 2020, a group of public service trade unions – the Fire Brigades Union (FBU), the Prison Officers' Association (POA), the Public and Commercial Services Union (PCS) and the GMB – said it had launched a legal challenge to the pause, saying that 2016 valuation had demonstrated that the costs of the scheme were below the predetermined level and that from April

[66] The Public Service Pensions (Valuations and Employer Cost Cap) (Amendment and Savings) Directions 2019, Feb 2019

[67] Ibid

[68] GAD, Principal Civil Service Pension Scheme. Actuarial valuation as at 31 March 2016, Feb 2019, Executive summary, para 1.1

[69] GAD, Principal Civil Service Pension Scheme. Actuarial valuation as at 31 March 2016, Feb 2019

[70] Civil Superannuation Account 2018-19, December 2019, p48

[71] Ibid, para 1.5-1.7

2019, the benefits for thousands of scheme members should have been improved. [72]

3.3 Meeting the costs of the McCloud remedy

In July 2020, the Government said that, progress having been made in determining a remedy to the McCloud discrimination, there was now enough certainty to proceed with the valuations. The cost of the remedy would count as a 'member cost.' Chief Secretary to the Treasury, Steve Barclay explained:

> When the mechanism was established, it was agreed that it would consider 'member costs': i.e. costs that affect the value of schemes to members. As the proposals in the consultation published today will increase the value of schemes to members, this falls into the 'member cost' category. As a 'member cost', this will be considered as part of the completion of the cost control element of the 2016 valuations process. Current employer contribution rates will not be affected. [73]

HM Treasury would set out in the Directions the technical detail of how the remedy costs should be taken into account in the cost control element of the valuations process. [74]

Announcing its response to the remedy consultation in February 2021, the Government said given the ongoing review by the Government Actuary (discussed in section four below), there should be no reduction in benefits as a result of ceiling breaches for the 2016 valuations. However, any floor breaches would be honoured, via increases in benefit accrual and/or reductions in member contributions in respect of service from 1 April 2019:

> Whilst the directions are yet to be finalised, and will be published as soon as possible, early estimates indicate that some ceiling breaches are likely. If normal statutory procedure were followed, any ceiling breaches would lead to a reduction in member benefits in order to bring costs back to target. The government is aware that the occurrence of ceiling breaches may support concerns that the mechanism is not working appropriately and in line with the original policy intentions. The GA's review of the mechanism is currently underway and will examine these concerns. Any changes that the government decides are necessary following the review will take effect ahead of the next (2020) valuations and so will not impact on the 2016 valuations process.

[72] POA press release 24 April 2020; See also, 'Firefighters to take government to court over 'pensions robbery'', FBU press release, 25 April 2020

[73] HCWS380 16 July 2020

[74] HM Treasury, Update on the Cost Control Element of the 2016 valuations, July 2020

> The government has decided that there should not be reductions to member benefits as a result of completing this process for the 2016 valuations, particularly based on a mechanism that may not be working as originally intended. The government has therefore announced that, should results identify ceiling breaches, the impact of these will be waived. This means that the benefit reductions that would be expected following such ceiling breaches will not be implemented. Where results show that a scheme is in the 'corridor' or above the ceiling, benefit levels will not be changed as a result of the 2016 valuations.
>
> The government has, however, decided to commit to delivering the impact of any floor breaches that occur. This means that when results have been finalised and implemented, any benefit improvements that are due will be delivered, via increases in benefit accrual and/or reductions in member contributions in respect of service from 1 April 2019. [75]

In evidence to the House of Commons Public Accounts Committee, HM Treasury officials said the cost of the McCloud remedy would be included in the 2016 valuation and borne by member costs going up. The Government had decided to waive ceiling breaches where target costs were exceeded so that members would not be in a worse position as a result of McCloud:

> Ultimately—this is where it gets a bit complicated—the impact of the McCloud remedy will be included in the 2016 valuation and will be borne by member costs going up. We then have to apply the cost control mechanism to the 2016 valuation. The reason why we announced that we would, in effect, waive ceilings where target costs are exceeded is that we do not want members to be put in a worse position than they would have been prior to the McCloud remedy being implemented. Ultimately, the costs will be borne by members, but the cost control mechanism will manage that cost. The ultimate logic from that is: who pays for the costs of the waiver? That will need to be considered as part of the valuation process, which then sets the employment contribution rate. [76]

This is confirmed in the Delegated Powers memorandum for the Public Service Pensions and Judicial Offices Bill:

> The cost control element of the 2016 valuations (the first time the cost control mechanism will be tested) is due to be completed for all public service pension schemes. The increased value of schemes to members following the legislative remedy will be taken into account. As a result, once the 2016 results are finalised, early estimates indicate that some schemes may breach the ceiling. This would ordinarily trigger the procedure set out in scheme regulations to

[75] HM Treasury, Update on the 2016 and 2020 valuations, February 2021; HCWS 757, 4 February 2021

[76] Oral evidence to Public Accounts Committee, 22 April 2021, Q71-2

> reduce member benefits and bring those schemes back to the target cost. [77]

The costs of removing the discrimination will "feed into future employer contribution rates once the 2020 scheme valuations are completed." However, it would be "only one of many factors that could impact employer contribution rates in the next valuations." [78]

Trade unions representing public servants have objected that including all the cost of the remedy in the four-year period covered by the 2016 valuation, when in fact they would be spread over many years, was unjustified and would result in less favourable figures and no obligation to reduce contributions for scheme members. [79]

In a circular of 23 August 2021, the Fire Brigades Union said the effect would be that scheme members would not benefit from improvements that had been recommended by the Scheme Advisory Board, following the initial publication of results of the 2016 valuation. [80]

Directions for completing the 2016 valuations

On 7 October 2021, the Government published amending directions for completion of the 2016 valuations. A letter from the Government Actuary confirmed that the amending directions reflected the Government's policy intentions which included the fact that the entire impact of the McCloud remedy should be taken into account at this set of valuations.

3.4 Public Service Pensions and Judicial Offices Bill

The Public Service Pensions and Judicial Offices Bill [HL] had its First Reading in the House of Lords on 19 July and is scheduled to have its Second Reading on 7 September.

The supporting information produced by HM Treasury states that although the 2016 valuation process is not yet complete, early estimates indicate that some schemes may breach the cost cap ceiling, which would ordinarily

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77 Public Service Pensions and Judicial Offices Bill – Memorandum on Delegated Powers, July 2021, para 169

78 Public Service Pensions and Judicial Offices Bill [HL], Assessment of Impacts, p6 and para 2.14

79 Treasury threatened with court over civil service pensions theft, Civil Service World, 4 May 2021; Government backs BMA proposal to tackle unlawful discrimination, BMA, 5 Feb 2021; Judges and firefighters age discrimination pension case, NEU, Feb 2021; FBU, Pensions Update, 23 August 2021

80 FBU, Pensions Update, 23 August 2021

trigger the procedure set out in the scheme regulations to reduce member benefits and bring those schemes back to target cost. [81]

Clause 80 (3) of the Bill would waive any ceiling breaches of the cost control mechanism that arise from the 2016 cost control valuations. [82]

Clause 80 (2) would expand HM Treasury's existing power to make directions about the cost control mechanism, to include a certification process. Under that, the scheme actuary must issue a certificate that states the cost of the scheme measured in the cost control mechanism in accordance with Treasury directions), allowing for steps to be taken by a scheme (whether in agreement with employers/members and their representatives or not) to bring costs back to target. This power would "formalise the planned processed needed to give stakeholders confidence that rectification actions were suitable to meet the aim of returning the costs back to the target costs and to ensure consistency across schemes regarding the process by which actions to bring cost back to target are assessed as suitable." [83]

[81] Public Service Pensions and Judicial Offices Bill – Delegated Powers Memorandum, July 2021, para 169

[82] Public Service Pensions and Judicial Offices Bill – Assessment of Impacts, July 2021, p3 and para 2.14

[83] Ibid, para 172

4 Review of the mechanism

The Government has announced changes it intends to make to cost control policy for valuations from 2020 onwards. It announced these changes on 4 October 2021, following a review by the Government Actuary (GA) and subsequent consultation.

This GA undertook its review on request from the Government in September 2018. The purpose was to "check whether [the cost control mechanism] is working as intended and delivering government's objective to protect taxpayers and workers from unforeseen changes in pension costs." [84]

Responding to the announcement, the trade union, Prospect, said that "any fundamental changes to the cost cap mechanism could breach the agreement on pension reform that public sector workers voted for in 2012." [85]

The terms of reference for the review were to assess whether, and to what extent, the mechanism was working in line with the original policy objectives:

- To protect taxpayers from unforeseen costs;
- To maintain the value of pension schemes to the members;
- To provide stability and certainty to benefit levels; and
- That the mechanism should only be triggered by 'extraordinary, unpredictable events.'

The GA could also consider the impact of the mechanism on intergenerational unfairness and on the ability of government to respond to future relevant developments." [86]

4.1 Report – June 2021

The final report of the review was published on 15 June 2021. It noted that preliminary results for the 2016 valuations, prior to the McCloud remedy, of all the schemes for which results were assessed, showed a breach of the cost

[84] HCWS945, 6 September 2018

[85] Prospect warns no good reason to review public sector pension cap, 7 September 2018

[86] Cost control mechanism: Government Actuary's Review – final report, June 2021, Executive Summary, para 3 and 4

cap floor. The key reasons were a reduction in the assumed future pay increases and a reduction in assumed life expectancy. [87]

The GA said that the mechanism had performed in line with how it was constructed but with what could be considered a "somewhat perverse outcome," when considered against its objectives. In particular, "60% of the cost reduction leading to the breach arose in the legacy schemes (which account for nearly all the past service as at 2016), yet the cost control mechanism can only amend benefits in the reformed schemes…This disproportionality in the application of benefit change would seem to be tending towards intergenerational unfairness." Furthermore, the main factors contributing to the reduction in costs related to risks that the 2015 schemes had been designed to mitigate (salary risk through the CARE design, and longevity risk through the link to the State Pension age). [88]

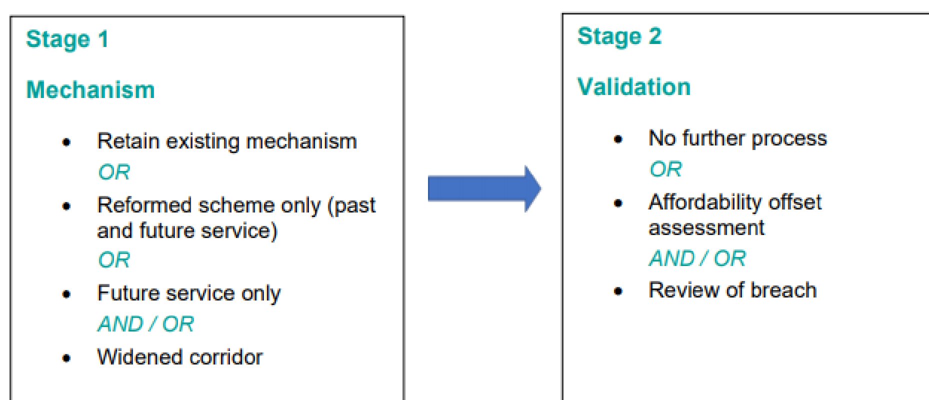
A further issue was that if benefits were increased to bring costs back to target, this would further increase employer contribution rates, on top of the increases already implemented following the 2016 valuation:

> 11. At the 2016 valuation, employer contribution rates increased by up to 9% of pensionable pay before the impact of the cost control mechanism. But the preliminary cost cap results for all schemes showed a floor breach which would further increase the employer contribution rates and cost to the taxpayer. It is hard to reconcile such an outcome with the stated objective of protecting taxpayers. The cause of this apparently perverse outcome is the exclusion from the cost control mechanism of the primary reason for the increase in employer contributions in the unfunded schemes, being the change in the SCAPE discount rate, because this is not considered to be a "member cost." [89]

The GA commented that "based on this experience, it does not seem possible for the mechanism to be able to protect taxpayers unless it takes into account more of the factors affecting the actual cost of providing a pension." [90]

The report recommended retaining a cost control mechanism, as this could set out how risks were to be managed and provide a degree of security and certainty around costs. It recommended improvements to the core cost control mechanism and the introduction of a second stage, where the effects of the core mechanism could be moderated: [91]

[87] Ibid, para 7
[88] Ibid para 9-10
[89] Ibid
[90] Ibid para 12
[91] Ibid para 13-15



The report recommended the potential changes to the core mechanism:

- **Consider the costs of the reformed schemes only,** both past and future service. The legacy schemes continued to have a bearing on costs because of the nature of accrued rights. However, these costs could not be directly controlled by the mechanism and the legacy schemes would be closed to future service from 2022. Removing them from the cost control mechanism would "improve short to medium term stability and intergenerational fairness of the mechanism." However, it would "mean that fewer costs are captured by the mechanism, and that the government (and ultimately the taxpayer) take on all the risk (both upside and downside) associated with the legacy schemes."
- **Consider future service only.** Given that the mechanism "can only adjust future benefits it would be reasonable for it to only consider the cost of those future benefits in its assessment." This would "further increase stability and intergenerational fairness as well as producing a much more simple and easier to understand mechanism." However, it would also "reduce the strength of the cost control, with no effective risk management of any past service costs, for both the reformed and legacy schemes, other than those inherent in the benefit design."
- **Widening the corridor from +/-2% of pensionable pay**. This would reduce the volatility of the mechanism and the risk of breaches without an "extraordinary, unpredictable event" occurring. It would reduce the ability to protect the taxpayer or maintain value to members and lead to larger changes in benefits and/or member contributions when breaches did emerge, as well as exacerbating the impact of the "cliff edge" nature of the cost control outcomes." [92]

For the second stage of the process, the report recommended two possible options:

- **An affordability offset assessment,** where a floor or ceiling breach would "only be implemented if it would still have occurred had the long-term economic assumptions (such as the SCAPE discount rate) been

[92] Ibid para 17-19

considered within the mechanism." This would reduce the risk of benefit improvements (or reductions) being implemented at the same time as employer contributions were increasing (or reducing). This change would introduce into the cost control mechanism changes in economic assumptions, which were not originally designated "member costs", into the mechanism, albeit in a limited way. Because these factors would not be part of the core cost control mechanism (stage 1), it would still be possible for costs to the taxpayer to increase without any corresponding reduction in benefits. [93]

- **Review of the breach** – allowing a reasoned judgement to determine whether or not to apply the results of the cost cap valuation. This could "take different formats, varying from an independent specialist panel to solely the government making the decision." [94]

Consideration should also be given to whether changes in life expectancy should be considered as part of the cost control mechanism, given that they could have a substantial bearing on it and longevity risk was already mitigated in the reformed schemes through the link to the SPA. [95]

4.2 Government consultation – July to Oct 2021

The Government launched a consultation on 24 June 2021, to run to 19 August, on proposals for three changes to the cost control mechanism, all of which were recommendations by the Government Actuary:

- **Moving to a reformed scheme only design:** to remove any allowance for legacy schemes in the cost control mechanism, so the mechanism only considers past and future service in the reformed schemes. This ensures consistency between the set of benefits being assessed and the set of benefits potentially being adjusted;

- **Widening the corridor**: to widen the corridor from 2% to 3% of pensionable pay. This aims to achieve a better balance between stability and responsiveness to the cost control mechanism; and

- **Introducing an economic check:** currently the mechanism does not include changes in long-term economic assumptions and therefore cannot consider the actual cost to the Government of providing the pension benefits. The Government proposes introducing an economic check so that a breach of the mechanism would only be implemented if it

[93] Ibid para 20
[94] Ibid para 21
[95] Ibid para 22

> would still have occurred had the long-term economic assumptions been considered. [96]

In its response to the consultation published on 4 October 2021, the Government said it would proceed with the proposed changes – while giving some further consideration as to how the economic check would apply in the case of the Local Government Pension Scheme. In terms of next steps:

> The Government is aiming to implement all three proposals in time for the 2020 valuations. It is necessary to implement the reformed scheme only design and the economic check through expanded powers in primary legislation, when parliamentary time allows, and then by making Treasury Directions under those powers in due course. The wider cost corridor will be implemented to a longer timeline via secondary legislation. [97]

Reformed scheme only design

In its June 2021 consultation, the Government identified a number of advantages in focusing the cost control mechanism on the reformed schemes only:

> A reformed scheme only design would mean that the risk of a change in the cost of providing legacy schemes would be borne by the Government rather than members. This risk diminishes over time and could be either beneficial or detrimental to the government, depending on how the economic picture develops, as well as the nature of any wider demographic changes. The Government believes that in general it is right to transfer this risk to the Exchequer to minimise intergenerational unfairness as the legacy schemes close to future service. It would not seem fair for those who have only ever been members of reformed schemes to bear risks relating to the legacy schemes going forward. [98]

It did not think the mechanism should focus on future service only as this would reducing the strength of the cost control mechanism, placing all the risks of past service costs, including those in the reformed schemes, onto the Exchequer. [99]

In its response to consultation on 4 October 2020, the Government said the majority of respondents had agreed that the move to a reformed scheme only design was "necessary to ensure the right balance of risks between members and the Exchequer and to improve stability." Many respondents "noted that

[96] HM Treasury, Public Service Pensions: cost control mechanism consultation: Proposal to reform the mechanism, 24 June 2021; HCWS 24 June 2021, c41

[97] HM Treasury, Public Service Pensions: cost control mechanism consultation. Government response to the consultation, October 2021, p5

[98] HM Treasury, Public Service Pensions: cost control mechanism consultation: Proposal to reform the mechanism, 24 June 2021, para 5.6

[99] Ibid para 5.8

benefits from the reformed scheme can be adjusted by the mechanism and therefore it is reasonable for the mechanism to only assess the costs of the reformed scheme." It would mean transferring the risk of costs associated with legacy schemes to the Exchequer. However, the Government's intention was that no-one would be accruing further benefits in the legacy schemes from April 2022 and it was "right for the Exchequer to bear this risk in order to reduce intergenerational unfairness and ensure the mechanism is fairer to younger members who did not previously have access, or had access for a shorter term, to the legacy schemes."[100] This approach had the support of the TUC, among others, which said it would "lead to a more stable mechanism, which could potentially increase confidence in the system for both members and employers." Furthermore, it seemed "reasonable to ensure that only those benefits that can be adjusted by the mechanism are considered in the assessment of cost."[101]

The proposal to move to a 'future service only' design would not be taken forward. Although it would further reduce intergenerational fairness and increase stability, the Government did not believe the Exchequer should bear the entire risk of costs associated with past service in the reformed schemes.[102]

Several respondents pointed out that that there were particular issues that needed to be considered in the case of the Local Government Pension Scheme (LGPS), given the nature of the scheme and the fact that the risk of legacy benefit would fall almost entirely on LGPS employers. The Government said it would work with stakeholders to consider the most appropriate way to implement the proposal in that context.[103]

Widening the corridor

The Government proposed widening the 'corridor' for the cost control mechanism, so that movements in cost of +/- three per cent of pensionable pay would be ignored, rather than two percent at present. This wider corridor would mean a breach of the floor or ceiling might be expected once every ten years compared to once every five years under the current arrangements. Introducing an even wider corridor would increase stability even further but would not "effectively control costs." The Government had considered the option of a proportional cost corridor (i.e. wider corridors for schemes with higher costs) but decided this would be overly complex and difficult for scheme members to understand.[104]

In its response to the consultation on 4 October, the Government said that

[100] HM Treasury, Public Service Pensions: cost control mechanism consultation. Government response to the consultation, October 2021, p16
[101] Ibid p14
[102] Ibid p16
[103] Ibid para 2.12 and 2.17
[104] HM Treasury, Public Service Pensions: cost control mechanism consultation: Proposal to reform the mechanism, 24 June 2021, p19

> In line with the majority of respondents with the proposal to widen the corridor, and a slight majority agreed that the corridor should be set at +/-3% of pensionable pay. They welcomed the fact that widening the corridor would lead to a more stable mechanism by minimising the frequency of breaches, which will lead to fewer changes in benefits or member contributions. They felt that a corridor size of +/-3% was appropriate, and will strike the right balance between stability and effective cost control.[105]

Economic check

The Government agreed with the Government Actuary that there should be a "validation layer":

> ...whereby breaches of the cost control mechanism only lead to a change in benefits where this is in line with the long-term economic outlook. In simple terms, benefits would not be reduced if the country could afford to continue paying the current level of benefits. Similarly, benefits would not be increased if the country could not afford to pay these increases. [106]

As regards what form the economic check should take, the Government said that using the SCAPE discount rate would be consistent with the approach used for setting employer contribution rates. However, whether that was appropriate would depend on the outcome of a separate consultation on the SCAPE discount rate methodology. [107] The Government Actuary had raised the option of introducing a review, or qualitative assessment to the mechanism. However, the Government took the view that it would be preferable to allow the mechanism to continue operating as a "purely technical process." [108]

This is the most controversial change. The Government's response to the consultation in October 2021, states that those who supported it did so on the basis that it would "lead to a more stable mechanism and also help avoid benefit reductions if the wider economic outlook improved but individual scheme costs rose." Those objecting – in particular, unions representing public servants - were concerned that the proposal may be a breach of the 25-year guarantee and that it had been agreed when the mechanism was set up that changes in the SCAPE discount rate would not impact member benefits:

> 3.7 Many respondents expressed concerns that this proposal may be a breach of the 25-year guarantee. They argued that the economic check is a significant departure from the process for the cost control mechanism originally agreed between the Trade Unions and the

[105] HM Treasury, Public Service Pensions: cost control mechanism consultation. Government response to the consultation, October 2021

[106] HM Treasury, Public Service Pensions: cost control mechanism consultation: Proposal to reform the mechanism, 24 June 2021, p21

[107] Ibid para 5.27

[108] Ibid para 5.34

> Government and that, during discussions at the time, it was strongly suggested by the Government that the originally agreed cost control processes were covered by the guarantee. A related concern was the Government has previously made explicit promises that employers would meet any costs arising from changes to the SCAPE discount rate, and that such impacts would be excluded from the cost control mechanism as they were not member costs. Relatedly, some also questioned the concept of 'perverse outcomes' presented in the GA's report and noted that the exclusion of SCAPE from the CCM [cost control mechanism] was an intentional decision and that there were no expectation that employer rates that the results from the CCM would move in the same direction.[109]

Many also raised concerns that the economic check would not be transparent or objective and would make the mechanism subject to government interference.[110]

In relation to the measure of economic growth that should be used, many expressed a strong view that it should match that used to set employer contribution rates and that in both cases it should be the Social Time Preference Rate (STPR) – the measure used to assess other government investments.[111] Some respondents highlighted that using a methodology based on expected long-term GDP growth to set the SCAPE discount rate had contributed to volatility in employer contribution rates.[112]

In its response, the Government said the "main purpose of the economic check was to ensure consistency between benefit changes and changes to the wider economic outlook." This would ensure "a higher bar for benefit increases to be awarded if the country's long-term economic outlook has worsened." The Government did not believe that the STPR would be an appropriate measure for the economic check as it was an estimation of society's preference for consumption sooner rather than later. It was not intended to provide an estimate of the economic outlook. It would respond shortly to the consultation on the appropriate methodology for setting the SCAPE discount rate used to calculated employer contribution rates. It had asked for views on two methods – one based on long-term economic growth and the other based on STPR.[113]

While acknowledging concerns, the Government's view was that the introduction of an economic check was "justified and proportionate" in the circumstances:

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109 HM Treasury, Public Service Pensions: cost control mechanism consultation: Proposal to reform the mechanism, 24 June 2021, para 3.7

110 Ibid p4

111 Ibid, para 3.9; For an explanation of STPR, see HM Treasury, Green Book, 2020, Annex 6

112 See Public service pensions: consultation on the discount rate methodology, HM Treasury, June 2021

113 HM Treasury, Public Service Pensions: cost control mechanism consultation: Proposal to reform the mechanism, 24 June 2021, para 3.22

> 3.24 The Government recognises that the addition of the economic check is introducing a new step into the process, and that political statements were made to the effect that the 25-year guarantee would mean that there should be no changes to scheme design, benefits or contribution rates outside of the processes agreed for the CCM. However, the Government does not believe that the proposal for the economic check necessarily breaches the 25-year guarantee. The elements protected by the 25-year guarantee in law are set out in section 22 of the Public Service Pensions Act 2013 and include i) the CARE nature of schemes, ii) member contribution rates and iii) benefit accrual rates. The cost control mechanism is not one of the protected elements. Furthermore, the Government is proposing this change following a thorough and independent review of the mechanism by the GA. As the GA's report makes clear, the CCM processes are not operating properly to serve its objective to sufficiently protect taxpayers. The Government is now seeking to implement the economic check to improve the CCM process and ensure the mechanism is better able to meet this objective, while also ensuring that the mechanism equally continues to protect members.[114]

Local Government Pension Scheme

Respondents with a link to the Local Government Pension Scheme (LGPS) argued that if an economic check were applied, linking it to expected long-term GDP would not be appropriate for that scheme:

> The LGPS, as a funded scheme, looks to achieve investment returns to ensure a minimum call on future local taxpayers by maintaining a pension fund able to meet all future liabilities. They argued that this is a fundamentally different situation to the unfunded schemes, where taxpayers are directly responsible for paying the cost of public service pensions.[115]

The Government said it remained of the view that an economic check should apply to the LGPS. As for the unfunded schemes, the purpose was to "ensure consistency between benefit changes and changes in the wider economic outlook." However, it recognised the different nature of the LGPS and the value of the cost control process developed by the LGPS (E&W) Scheme Advisory Board in that it could take account of LGPS specific assumptions to provide a recommendation to the Government as part of the cost control valuations. It would work with stakeholders to consider whether this process could be adapted in line with the principles of the economic check.[116]

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[114] Ibid

[115] Ibid p4

[116] Ibid para 331

4.3 NAO and Public Accounts Committee reports

In a report published in March 2021, the National Audit Office (NAO) said HM Treasury had been advised by the Government Actuary in 2012 that, the cost control could easily be triggered even in normal circumstances. The review of the mechanism at the first valuation had undermined trust between employees and the Government:

> 3.13 HM Treasury took the provisional results of the 2016 actuarial valuations as an indication that the cost control mechanism is not working as intended and exposes the taxpayer to affordability risks. HM Treasury's original intention was for the cost control mechanism to be activated only 'if extraordinary, unpredictable events' occur. HM Treasury told us it is concerned that the current design exposes taxpayers and members to short-term changes in assumptions rather than responding to long-term trends. GAD's analysis, performed in 2012, suggested the mechanism could easily be triggered if multiple factors were to move at the same time.
>
> 3.14 HM Treasury has asked the Government Actuary to review whether the mechanism is working as it should. The review will consider the operation and effectiveness of the mechanism as it is currently set out in legislation governing the valuation of public service pension schemes. In 2019, HM Treasury paused the review at the same time as it paused the mechanism. Employee representatives told us that reviewing the mechanism because of what happened at the first valuation undermines trust between employees and the government [...] [117]

In May 2021, the Public Accounts Committee recommended that:

> HM Treasury must prioritise work to quickly resolve the challenges presented by the McCloud judgment and cost control mechanism, in order to give certainty to scheme members and employers, and rebuild the trust lost through these issues. The Department should write to us with an update in six months' time. [118]

In its response in September 2021, the Government said it agreed with the recommendation and that work was underway to complete the 2016 valuations and the review of the cost control mechanism in time for the 2020 valuations. It would write to the Committee with an update by February 2022. [119]

[117] NAO, Public service pensions, HC1242 2019/21, 19 March 2021

[118] Public Accounts Committee, Public Sector Pensions, 6th report of 2021-22, HC 289, June 2021, para 11

[119] Government response to the Public Accounts Committee's 6th report of 2021-22, September 2021

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