FPS Coffee Morning

First Actuarial LLP

28 September 2021

Who we are?

- Independent actuarial advisors to the Scheme Advisory Board.
- Appointed in 2017.
- Not GAD!

Craig Moran

James Allen

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What are we talking about today

- Valuation process
- The 2016 valuation & cost cap
- Sergeant / McCloud
- Recent consultations
- Next steps – 2020 valuation

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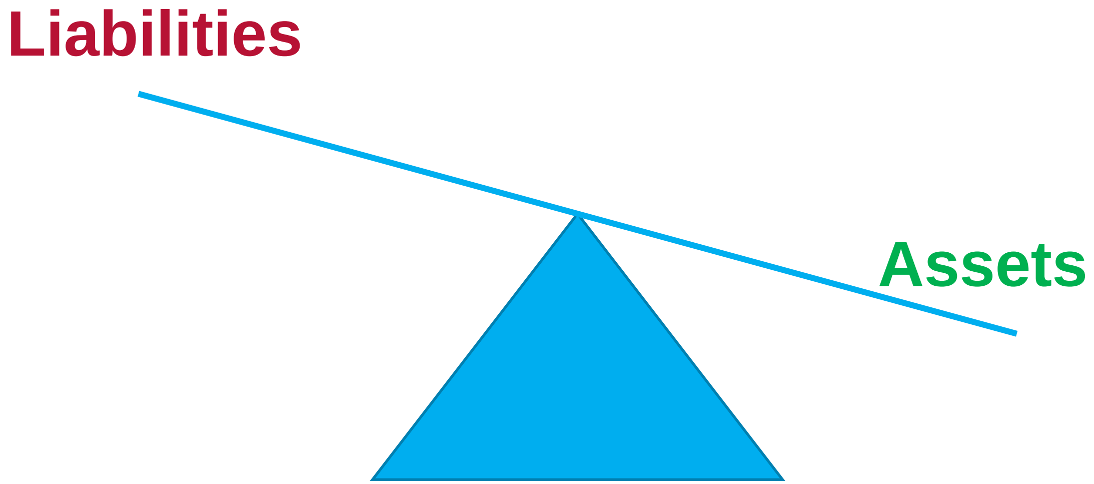
Valuation process

Purpose of a valuation

- Calculate the liabilities and the notional assets.
- Any surplus or shortfall is typically spread over 15 years.
- Calculate cost of new benefits being built up going forwards.



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Notional assets

- Fire Schemes are “unfunded schemes”.
- No actual investments, uses “notional” assets.
- Calculated using cashflows in/out of the scheme, plus notional investment returns.
- Takes account of whether past contributions were enough to pay for benefits provided

Liabilities

- As the timing and amount of future payments are unknown, GAD must use assumptions to project into the future.

- Some assumptions are set by HM Treasury for all schemes:
  - Discount rate, inflation, future mortality improvements.

- Others are scheme specific and set by the Home Office:
  - Baseline mortality, promotional salary scales, retirement ages.

Discount rate

- The discount rate is one of the key assumptions in a valuation.
- Used to “discount” future cashflows. In a funded scheme, broadly equal to expected return on assets.
- Unfunded schemes used the SCAPE rate (Superannuation Contributions Adjusted for Past Experience).
- More on this later…

Two different valuations

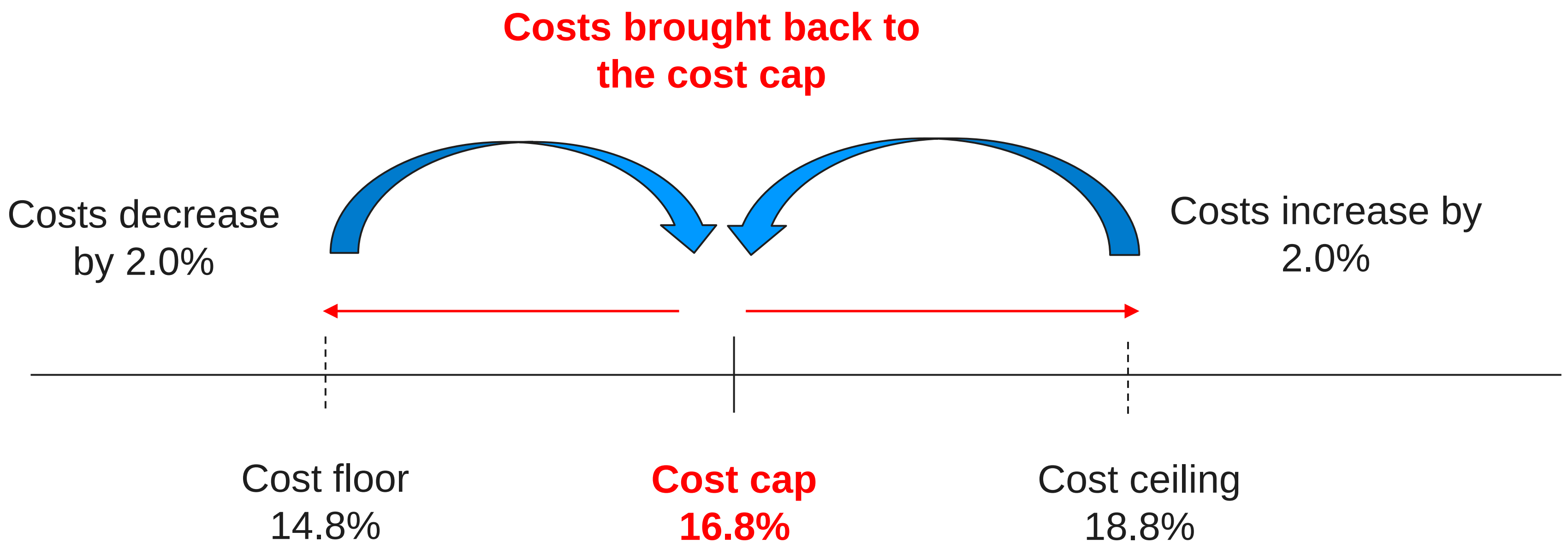
- Every four years, there are two valuations carried out for the Fire Schemes.
- The “main” valuation
  - Determines the employer contribution rate (cost of future pension being built up adjusted for any surplus/deficit)

- The ‘employer cost cap’ valuation
  - Aims to protect members and the taxpayer against changes in the value/cost of the scheme.
  - Excludes changes to most financial assumptions.

FPS 2016 valuation

How does the Cost Cap work?

- Action needed if costs exceed 2% margin
- 16.8% set for Firefighters Pension Scheme in 2012 valuation



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So what happened?

- In the 2016 valuation:
  - Main valuation – costs went up – so higher contributions needed
  - Employer cost cap valuation – costs went down and breached the cost-cap floor – so benefit improvements and higher contributions needed
- Described by GAD as a “perverse outcome”.

Next steps – benefit changes

- SAB consulted with to reach an agreement on returning costs to target level.
- This could be via improving future benefits or reducing member contributions.
- Regulations allow for a default option where accrual rates are amended.

Pause

- Changes should have been implemented from April 2019
- In January 2019 Government paused the cost cap mechanism (and benefit improvements) because of a legal case around age discrimination
- Potential cost of losing the case could involve compensation that could reverse the cost cap breach
- Government would resume benefit improvements if they won the case
- In June 2019 they lost …

Transitional Protection and Age Discrimination (Sergeant / McCloud)

Recap: Public Service Pensions Act 2013

- Affected many public service pension schemes.

- Changes generally included:
  - Future service based on career average rather than final salary
  - Increases in retirement age
  - **Transitional protection for those closest to retirement**

What Hutton said

“The Commission’s expectation is that existing members who are currently in their 50s should, by and large, experience fairly limited change to the benefit which they would otherwise have expected to accrue by the time they reach their current scheme NPA. This would particularly be the case if the final salary link is protected for past service, as the Commission recommends. This limitation of impact will also extend to people below age 50, proportionate to the length of time before they reach their NPA. ***Therefore special protections for members over a certain age should not be necessary****. Age discrimination legislation also means that it is not possible in practice to provide protection from change for members who are already above a certain age.”*

Transitional Protections

- The government agreed to exempt older members from the 2015 pension scheme changes.
- In most schemes this meant that members within 10 years of Normal Pension Age stayed in their existing schemes (known as transitional protection)
- Members between 10 and 13.5 years of Normal Pension Age could stay in their existing schemes for a period ranging from a few months to several years after 2015 (known as tapered protection).

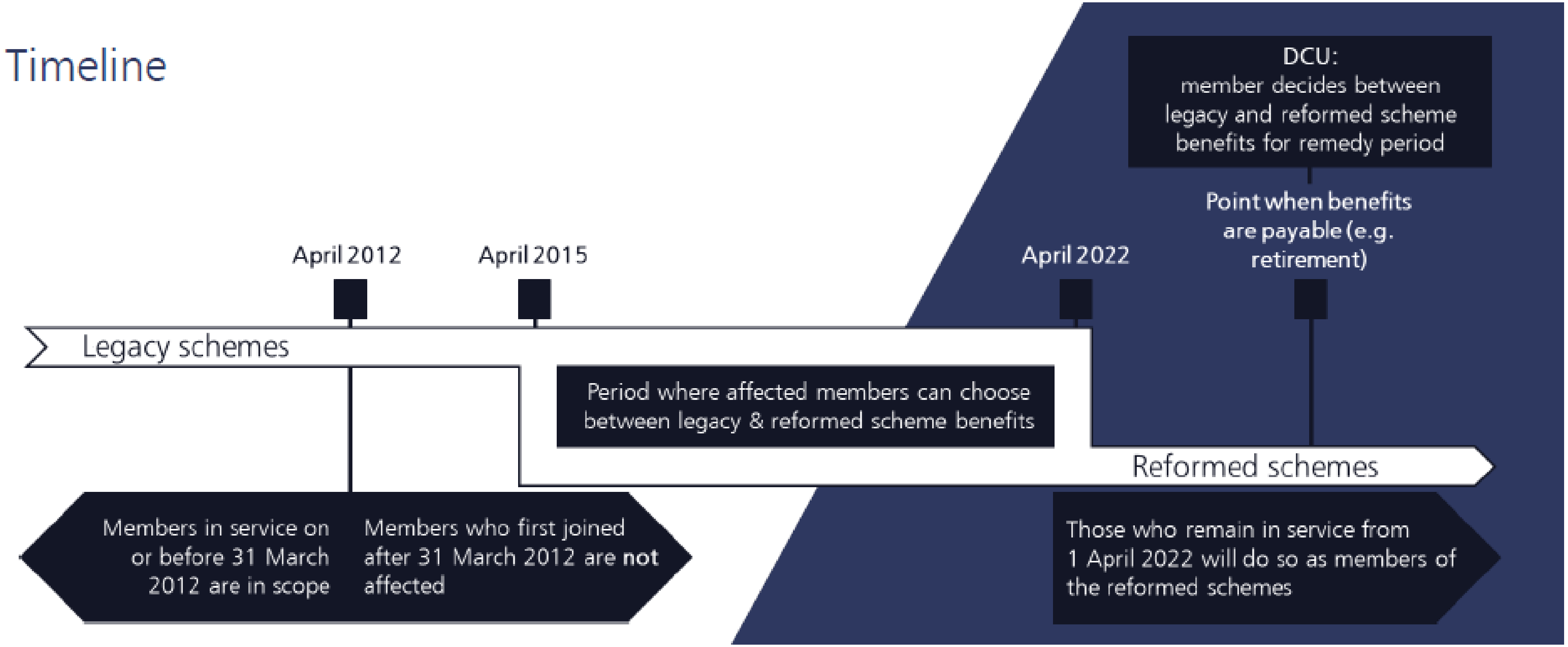
Firefighters and Judges Case

- Legal cases against Government, ruled on together due to similarities
- Argued that transitional protections were directly discriminatory on grounds of age
- Government lost the case in Court of Appeal (December 2018) and denied permission to appeal to Supreme Court (June 2019)

Remedy

- Government will need to:
  - Compensate younger members for less favourable treatment they received since transitional protections came into force
  - Remove any discriminatory elements going forward
- Estimated cost across all public service schemes is around £17bn.
- HM Treasury consulted on remedy approach, and elected for Deferred Choice Underpin: Members will choose between old scheme and new scheme for 2015 to 2022 service at the point of retirement (or when benefits become payable)

Remedy Timeline



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Who pays for it?

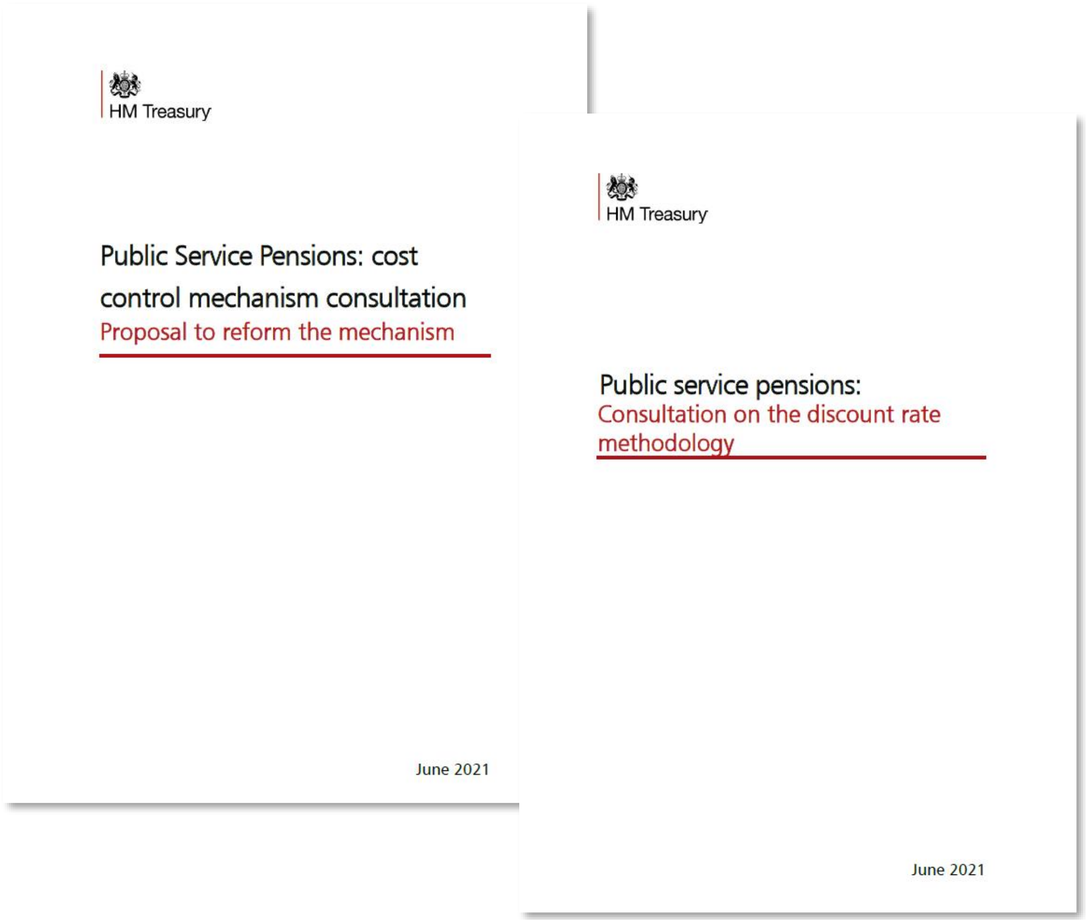
- July 2020: Cost cap unpaused.
- HMT said the costs associated with the increased value of schemes to members as a result of ‘McCloud remedy’ will be taken into account in the completion of the process, as these are ‘member costs’.
- 2016 cost cap valuation to be revisited, which will show greater costs than before.

Recent consultations

Consultations

- In June 2021, HM Treasury issued two consultations affecting public service pension schemes:
  1. Cost control mechanism; and
  2. Discount rate methodology

- Consultations closed on 19 August 2021


HM Treasury

Public Service Pensions: cost control mechanism consultation
Proposal to reform the mechanism

June 2021

HM Treasury

Public service pensions:
Consultation on the discount rate methodology

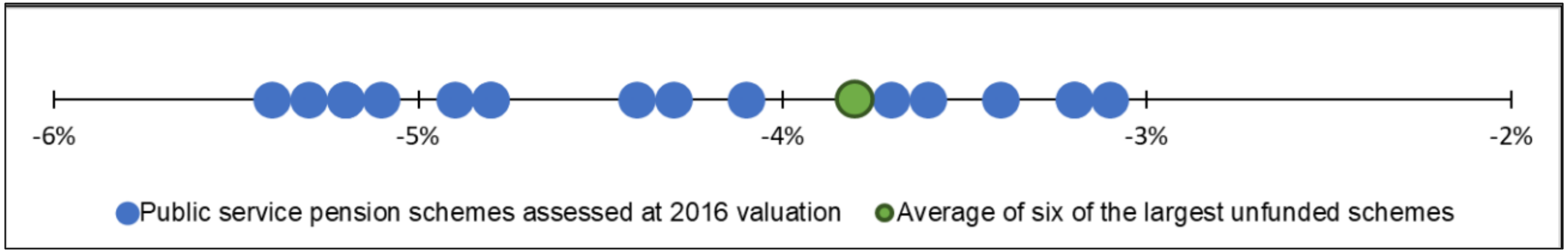
June 2021

Cost cap - Government Actuary review

- The Government Actuary published his review into the cost control mechanism in May 2021.
- Assessed that the current cost cap was failing to meet the objectives for **stability & certainty**, **protecting the taxpayer** and **intergenerational unfairness**.
- This review contained a number of recommendations for change.

Rationale for change

- All public service schemes saw significant breaches in 2016.
- Majority of this was due to legacy scheme benefits.
- Questions on whether 2% is a reasonable corridor.
- Benefit improvements arose alongside changes to the SCAPE rate that increased costs for employers "*a perverse outcome*".



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GAD’s recommendations

The Government Actuary made two groups of recommendations:

Stage 1

Mechanism

- Retain existing mechanism

  OR
- Reformed scheme only (past and future service)

  OR
- Future service only

  AND / OR
- Widened corridor

Stage 2

Validation

- No further process

  OR
- Affordability offset assessment

  AND / OR
- Review of breach

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HMT's Proposals

HMT put forward 3 of these recommendations in its consultation:

Stage 1

Mechanism

- Retain existing mechanism

  OR
- Reformed scheme only (past and future service)

  OR
- Future service only

  AND / OR
- Widened corridor

Stage 2

Validation

- No further process

  OR
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- Review of breach

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HMT's Proposals

Reformed Scheme only

- Consistency between benefits that are <u>assessed</u> by mechanism with those that can be <u>adjusted</u> by mechanism
- Improved short/medium term stability

Widened corridor

- Currently set at +/- 2%, which GA concludes that could be breached by non-extraordinary/unpredictable events (every 20 years if reformed scheme only is considered).
- Change to +/- 3%, combined with a Reformed Scheme only design, would mean a breach is expected once every 40 years.

Economic Check

- GA said that mechanism cannot protect taxpayer unless it has some allowance for affordability in relation to long-term economic outlook
- Would be based on SCAPE discount rate (or other suitable measure) and long-term earnings assumption.
- Intended to prevent other "perverse outcomes"

Impact of the proposals

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

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SCAPE Consultation

- The SCAPE discount rate is mainly used to set employer contribution rates to unfunded public service pension schemes (also used to set some factors in the Fire Schemes).

- It is currently 2.4% above price inflation. There have been several reviews over the past decade:
  - Pre 2011 — RPI + 3.5% pa
  - 2011: — CPI + 3.0% pa
  - 2016: — CPI + 2.8% pa
  - 2018: — CPI + 2.4% pa
  - *Future:* — *Potentially CPI + 1.8% to CPI + 3.5%??*

- Pensions have become more expensive.

Rationale for change

- The SCAPE discount rate has been reduced twice since 2011, including an “out-of-cycle” review.
- Frequent changes make it difficult for employers to budget.
- Retaining the current approach (GDP) would result in a further reduction based on current GDP projections.
- GDP projections are set by the Office for Budget Responsibility. The proposed approach is prescribed by Treasury guidance.

The consultation

The consultation sought views on:

- Two approaches to setting the SCAPE discount rate:
    - Retaining GDP (potentially with tweaks); and
    - Based on the Social Time Preference Rate* (potentially with tweaks).
- Aligning the review of the SCAPE discount rate with valuation cycles.

*The STPR is a relatively fixed rate used by government to appraise long-term investment projects.

What happens next?

What happens next?

2016 valuation	2020 valuation
HMT drafting amended valuation directions	Waiting for outcome of cost-cap and SCAPE consultations
Consultation with SAB on draft directions	HMT draft valuation directions. Consultation with SAB.
Directions and results of cost control valuation finalised	Initial results prepared using updated directions
	Any change to employer contributions effective from April 2024

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Any questions?

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