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Public Service Pension Schemes: valuations update

On 6 September 2018, the Chief Secretary to the Treasury, Elizabeth Truss, provided an update to Parliament on the actuarial valuations of the public service pension schemes. Her statement included an indication of the likely consequences of the valuations for member benefits and employer contribution rates. This bulletin provides an overview of that statement and associated publications issued by HM Treasury.

Valuing the public service pension schemes - background, purpose and emerging results

Following the final report of the Independent Public Service Pensions Commission in 2011, reforms were made to public service pension schemes (PSPSs). New career average re-valued earnings schemes were put in place, typically with effect from April 2015. A new framework for actuarial valuations was established, allowing for greater risk-sharing between members and taxpayers. The four-yearly valuations have two key purposes:

Public service pension schemes: the two purposes of the actuarial valuations

a) To measure certain costs of the scheme against a target rate; the "employer cost cap": This implements the cost cap mechanism which shares the risks of unexpected costs between members and taxpayers.

b) To set the employer contribution rate: When combined with member contributions, contributions are expected to meet the full cost of pension benefits being earned, including past service effects.

The first valuations conducted under this framework generally had an effective date of 31 March 2012, with different dates applying for the local government schemes. You can find more information about these previous valuations in this GAD Technical Bulletin and HM Treasury (HMT) policy paper, both from 2014.

The next round of valuations typically has an effective date of 31 March 2016. GAD has been working with schemes on these valuations and whilst final results are not yet available, the Chief Secretary to the Treasury's (CST) statement notes that early indications show that:

- for some schemes the cost cap (or cost control) mechanism will lead to improved pension benefits for members in respect of employment between April 2019 and March 2023
- the contribution rate that employers pay towards their schemes will need to increase

Understanding the cost cap mechanism and how it relates to employer contributions

The previous valuations calculated a figure for each scheme known as the 'employer cost cap'. Expressed as a percentage of pensionable pay, this is a target rate reflecting the cost of benefit accrual in the reformed scheme. The current valuations measure certain costs of the scheme relative to the cost cap mechanism for the first time. If these costs are more than 2% of pensionable pay above or below the scheme-specific target rate then a breach has occurred and steps must be taken to return costs to the level of the employer cost cap. This can be achieved either by adjusting future benefits or member contributions, or a combination of both.

The employer cost cap is not directly comparable to the employer contribution rate. This is because the cost cap mechanism does not calculate the full cost of the scheme, as members do not share in all scheme risks. Various elements needed to capture the full cost of the scheme are excluded from the cost cap mechanism - for example, the cost cap mechanism is not affected by changes in actuarial methodology or changes to the discount rate used and does not measure costs associated with deferred or pensioner members of the pre-reformed schemes.

Initial valuation results

The cost cap mechanism: Early indications in some schemes show that the costs measured by the cost cap mechanism have decreased by more than the 2% of pensionable pay threshold. If the cost cap floor is breached, this measure of scheme costs will need to be returned to its target value. For each scheme which experiences a breach, discussions will be required between those responsible for the scheme and the Scheme Advisory Board introduced by the Public Service Pensions Act 2013 and the Public Service Pensions Act (Northern Ireland) 2014. If no agreement can be reached following a cost cap breach, legislation generally requires that the rate at which benefits accrue will be amended. A breach of the floor of the cost cap would, for future accruals, lead to an increase in the accrual rate in the reformed schemes.

New information, which affects some key valuation assumptions, helps to explain the fall in the costs of the scheme measured in the cost cap mechanism:

- the Office for Budget Responsibility (OBR) has reduced its forecasts of short-term pay growth and updated the period over which these apply, meaning accrued final salary pensions are now expected to be less costly
- the latest population projections from the Office for National Statistics (ONS) show forecasts of future life expectancy have reduced, so pensions will typically be paid for a shorter period than previously expected

These factors mean that schemes are now expecting lower costs to pay future pension payments. Whilst these factors are also reflected in expected changes to employer contribution rates, these downward cost pressures can be more than offset by upward cost pressures outside the cost cap mechanism, such as changes to the discount rate.

The employer contribution rate: The CST stated that early indications suggest that the amount employers pay towards the schemes will need to increase. This increase is largely driven by a decrease in the discount rate used to assess the current cost of future payments from the schemes. Known as the SCAPE rate, this discount rate is based on the OBR's long-term projections of GDP growth (and is not captured within the cost cap mechanism). Budget 2016 announced a reduction in the annual rate from 3.0% above the Consumer Prices Index (CPI) to 2.8% above CPI. The CST has now proposed a further reduction, to take effect from April 2019, to 2.4% above CPI. This figure that will be confirmed in due course and formally announced at a later date.

Updated Treasury Directions

The Directions specify how to carry out the valuations, including what information to disclose in the valuation reports, so that all the schemes' valuations are carried out consistently and transparently. The Directions instruct schemes how to set various assumptions. Some are specified explicitly whilst others must be determined by each scheme as a best estimate (so with no margin for prudence or optimism).

The HMT Directions were originally published in 2014 and are effectively an instruction manual to calculate valuation results and operate the cost cap mechanism. This instruction manual must now be updated so that it is suitable to calculate the current valuation results. Alongside the ministerial statement, HMT has published draft amending directions, intended to deliver the required changes.

- **Change in SCAPE discount rate:** The draft amendments propose to change the value of the SCAPE discount rate used in the valuations to 2.4% above CPI, with effect from April 2019.
- **Rectification of cost cap breaches:** Since some schemes are expected to breach the cost cap, details have been added to the Directions on the process of how to rectify a breach. If a scheme breaches the cost cap mechanism, the scheme actuary has to provide a certificate confirming that the proposed changes to benefits and/or contributions bring the costs of the scheme back to the target level. The certificate must also provide the revised employer contribution rate, allowing for these changes.
- **Other amending directions** include: updates to assumptions to allow for recent scheme experience and the latest OBR and ONS projections; requirements for additional disclosures in the valuation report; bringing the cycle of local government valuations into line with the other schemes and various changes to address certain scheme-specific issues.

HMT has also published a technical annex outlining the reasons behind the amendments and a letter to the Trades Union Congress. The Northern Ireland Department of Finance published equivalent Directions in 2014 and will shortly issue corresponding draft amending directions.

Next steps

The Directions will be finalised once key stakeholders have had time to comment on the draft and a statutory consultation with the Government Actuary has been completed. The final valuation results are expected later this year.

The UK government is committed to implementing the results of the valuations but also to keeping the cost cap mechanism under review. Accordingly, the Government Actuary will be asked to review the mechanism to check whether it is working as intended and delivering the government's objectives. This review will conclude before the next round of four-yearly actuarial valuations - which will be undertaken as at 31 March 2020 with provisional results perhaps emerging during 2022.

If you would like to discuss any of these issues in more detail or have any questions please get in touch with your usual GAD contact.

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