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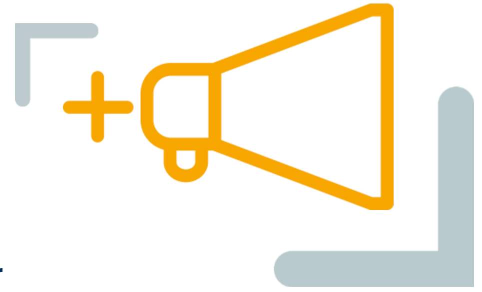

News Alert 2018/06

12 September 2018

Public Service Pension Schemes: Treasury statement points at surprising mix of higher contributions plus benefit improvements from April 2019

At a glance

On 6 September 2018, the Chief Secretary to the Treasury, Elizabeth Truss, provided an update to Parliament on the latest quadrennial actuarial valuations of the public service pension schemes. It indicated that:

- **Future service member benefits in several unfunded public service schemes will need to be improved significantly from 1 April 2019.** The affected schemes are those with a cost-cap mechanism and are as yet unnamed but are likely to include the pension schemes for NHS employees, civil servants and teachers.

- **The valuations are also going to show significant increases in contributions from April 2019 for employers in the NHS, Civil Service and Teachers schemes** due primarily to a reduction in the "SCAPE" discount rate.

- In the absence of further legislation, both the improvements to members' benefits to be earned in the future and the increase in contributions **will need to be funded entirely by employers** since employee contribution rates were protected for a period of 25 years from April 2015.

- **The Government is proposing to change the cost-cap mechanism to stop this happening again**, and has written to the TUC to explain what and why.

- **The Local Government Pension Scheme (LGPS) is subject to an additional review process** with the LGPS Advisory Board before the outcome is known. Any changes are likely to be felt a year later when the 2019 funding valuations take effect.

This is on the face of it a perverse outcome, but at the same time a natural consequence of the cost-capping mechanism agreed between the Government and the Unions as part of the review of public service schemes that took place in 2014 (under which the impact of certain changes, including changes to the discount rate, are stripped out when the cost-capping calculations are made).

Key Actions

Employers who participate in unfunded public sector pension schemes (eg for the NHS, civil service and teachers):

- Expect significant increases in pension costs from 1 April 2019, and factor these into budgets from 2019/20 onwards. Further substantial increases can be expected from April 2023.
- Those employers who regularly take on public service contracts with employees who TUPE transfer across but remain in these schemes need to consider possible increases in costs when pricing new contracts.
- Employers *who are able to do so* should review their participation in certain schemes and could consider any alternatives available.

Employers who participate in the Local Government Pension Scheme:

- Wait and see, but be aware of the potential for significant changes in costs following the 31 March 2019 actuarial valuations.

The Detail

On 7 September 2018 the Government Actuary's Department issued a bulletin on the likely results of the 31 March 2016 actuarial valuations of certain Public Service Pension Schemes (PSPSs) following a Written Ministerial Statement by Elizabeth Truss, Chief Secretary to the Treasury, published the previous day. The schemes are unnamed but we expect them to include most if not all of the unfunded public sector pension schemes, including the NHS Pension Scheme, Teachers' Pension Scheme, and Civil Service Pension Scheme – as well as those for the police, armed forces and firefighters.

Purpose of the valuations

There are two purposes of the valuations for the unfunded public service schemes:

1. To determine whether there has been a change in the expected costs of the benefits being earned, in order to assess whether benefits need to be adjusted in line with the **cost-cap mechanism**; and

2. To set an **employer contribution rate** which is expected to meet the full cost of benefits (both those being earned, and those already earned).

The actuarial assumptions used to assess (1) and (2) are different, and these differences are expected to have a material impact on the valuation outcomes.

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Our viewpoint

The lack of consistency between the assumptions used to fulfil the two purposes of the valuation was recognised as a potential pitfall when Public Service pensions were significantly reformed in 2015.

It is unfortunate that these differences have come back to bite quite so soon.

The cost-cap mechanism

The cost-cap mechanism was implemented in order to ensure that should there be some major unanticipated change in the profile of scheme members (for example changes in life expectancy or the age profile of the members, termed "member costs") which affected the cost of benefits being earned, the benefits to be earned in the future would be adjusted, **either up or down**, to return them to broadly the same long-term cost.

Importantly, the cost-cap mechanism excludes most financial assumptions, including the discount rate – these are considered "employer costs".

Early indications are that decreases in members' life expectancies and short-term pay growth expectations will have **reduced** the expected cost of benefits being earned by more than the trigger point for a change to be made, which is +/- 2% of salaries.

All else being equal, if the long-term cost of benefits has reduced by at least 2% of salaries, **we would expect that members' benefits to be earned in the future would need to be improved by at least 10%**.

If employer contributions were determined in the same way that the cost-cap mechanism calculations are carried out, increasing benefits for members should not result in an increase in the contributions required by employers (because the expected cost has reduced). However, this is not the way employer contributions are calculated – we discuss this in the next section.

Our viewpoint

Whilst an increase of 10% or more in pension benefits may be appreciated by some members, we wonder whether more "deferred pay" (in the form of increased pensions after they retire), is what many public sector workers want or need at a time when they are receiving limited or no pay increases and potentially struggling to make ends meet.

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Employer contribution rates

The employer contribution rate is set to cover the cost of benefits as they are earned from year to year, and to reflect any notional surplus or deficit that has arisen in respect of benefits already earned (eg due to changes in financial conditions).

Although decreases in members' life expectancies and short-term pay growth expectations will have reduced the value placed on the liabilities and the expected cost of benefits being earned, this will have been more than offset by a reduction in the discount rate used to place a value on the benefits accruing (the "SCAPE" discount rate). In particular, the SCAPE discount rate has been reduced following the 2016 Budget from 3.0% pa above inflation, to 2.8% pa above inflation and is proposed to be reduced even further to 2.4% pa above inflation from April 2019, reflecting lower long-term economic growth expectations. The rapid fall in the SCAPE discount rate will result in substantial increases to employer contributions from 2019.

In the absence of further legislation, both the "all else equal" increase in costs (due to using a lower discount rate) and the improvements to members' benefits (under the cost-cap mechanism) will need to be funded entirely by employers since employee contribution rates were protected for a period of 25 years from April 2015.

These costs could be significant – the Government estimated in March 2016 that the reduction to the discount rate alone (ie the "all else equal" impact) could increase total employer costs by around £2bn pa across all of the unfunded public service pension schemes.

Our viewpoint

It is an unfortunate consequence of adopting the different assumptions for different valuation purposes that employers are facing a "double whammy" of:

- *having to pay higher contributions for the benefits as they currently stand,*

and

- *having to fund an increase in the benefits members are earning due to improvements under the cost-cap mechanism.*

Which schemes are affected and how will the increase be funded?

The ministerial statement has not yet named which pension schemes are affected by increases to benefits under the cost cap mechanism, although it is likely that most, if not

all, of the unfunded public service pension schemes are likely to be affected, including the NHS Pension Scheme, Teachers' Pension Scheme, and Civil Service Pension Scheme – as well as the schemes for the police, armed forces and firefighters.

The funded Local Government Pension Scheme (LGPS) funds may also see an impact following their 31 March 2019 valuations, but the additional cost-cap mechanism that applies under the LGPS Advisory Board process means that the outcome could be different. In any event, each LGPS Fund has more autonomy to choose its own funding assumptions and so contribution changes from 2020 could vary significantly by Fund. Any changes to LGPS benefits being earned would, however, be universal.

It is expected that any increases in costs anticipated in the 2016 Budget (ie up to £2bn) will be funded by individual government departments and employers. The Treasury has stated that it will support departments with "any unforeseen costs for 2019/20". It is not clear whether any longer-term support will be available.

Our viewpoint

Passing costs on to individual departments and employers looks like budget cuts by another name. Increasing contributions means that the balance of the cashflows required and met by the Treasury will be directly reduced.

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