Public Service Pensions: Long-term financial management and reform of benefits

Mike Scanlon and Paul Butcher

Agenda

- Mike

    – Public service pension reform 2010-15

    – Fiscal impact

- Paul

    – Financial management of unfunded pensions

    – Actuarial methods and assumptions

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Why is this important

- 14 million members

- Benefit expenditure (unfunded): £38 billion per year
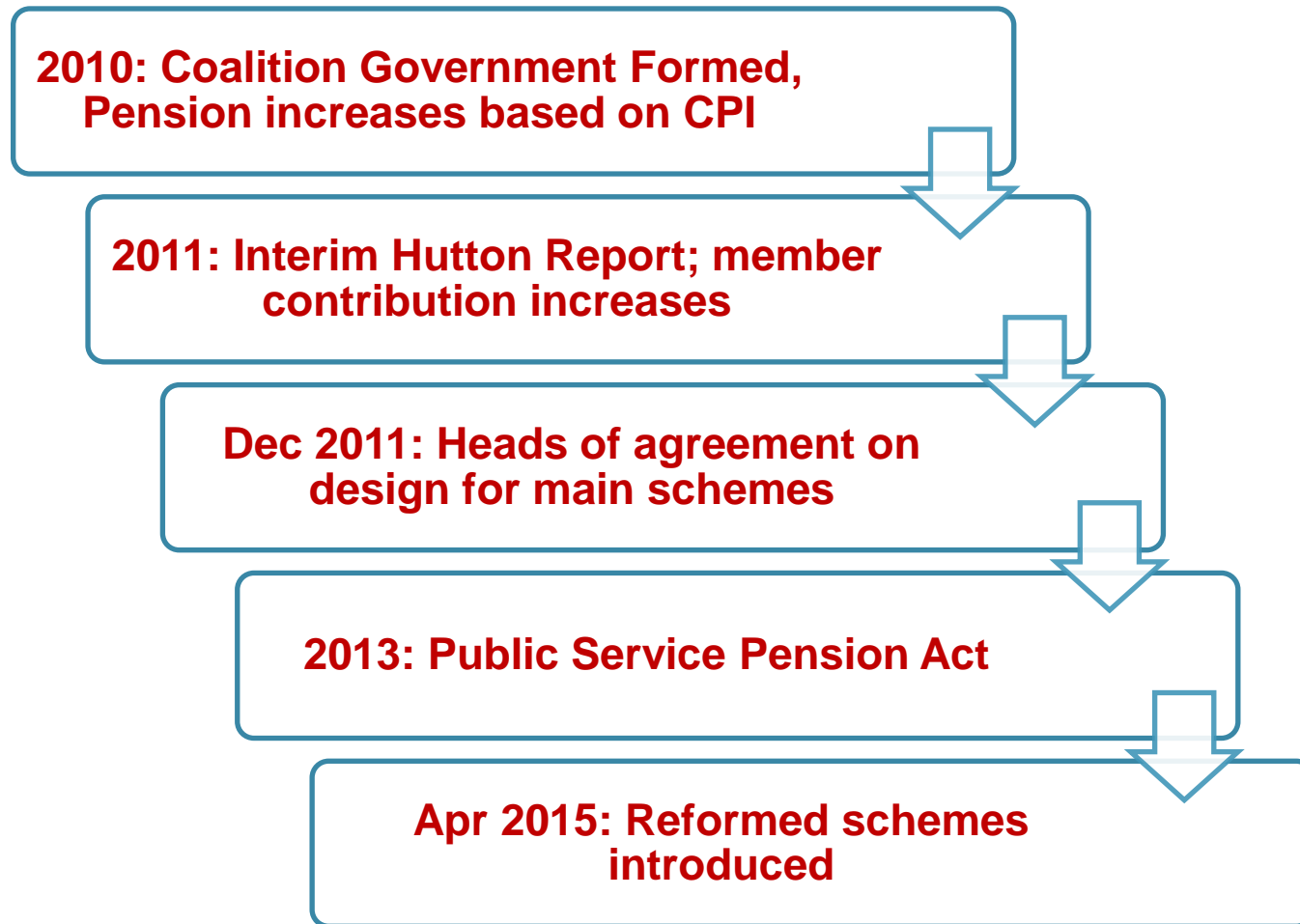
- Total liabilities (unfunded): £1.2 trillion

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Private vs Public sector

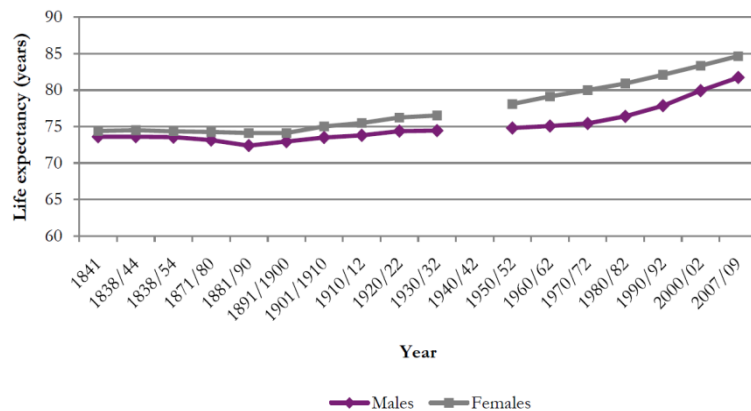| Pension schemes	Private Sector	Public sector
Set up by	Trust deed and rules	Legislation
Typical scheme designs	Historically – Defined benefit Now – Defined contribution	Defined benefit
Financing	Funded in advance	Typically unfunded (pay as you go)
Membership	16 million	14 million

Public service pension reform: timeline

2010: Coalition Government Formed, Pension increases based on CPI

2011: Interim Hutton Report; member contribution increases

Dec 2011: Heads of agreement on design for main schemes

2013: Public Service Pension Act

Apr 2015: Reformed schemes introduced

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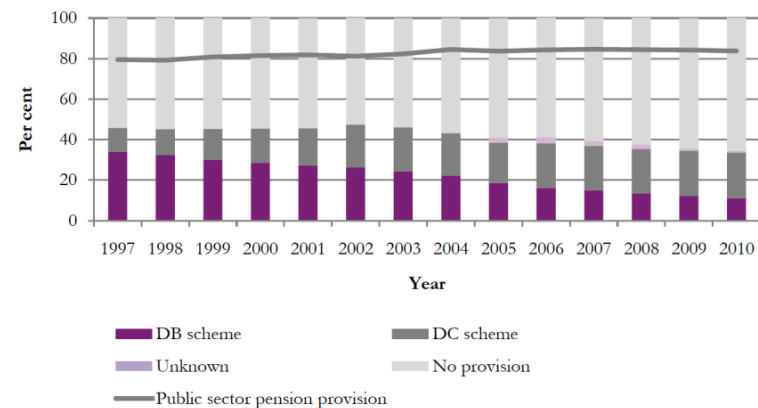
Case for reform

Demographic changes

Chart 1.A: Period life expectancies for those reaching age 60 – general population

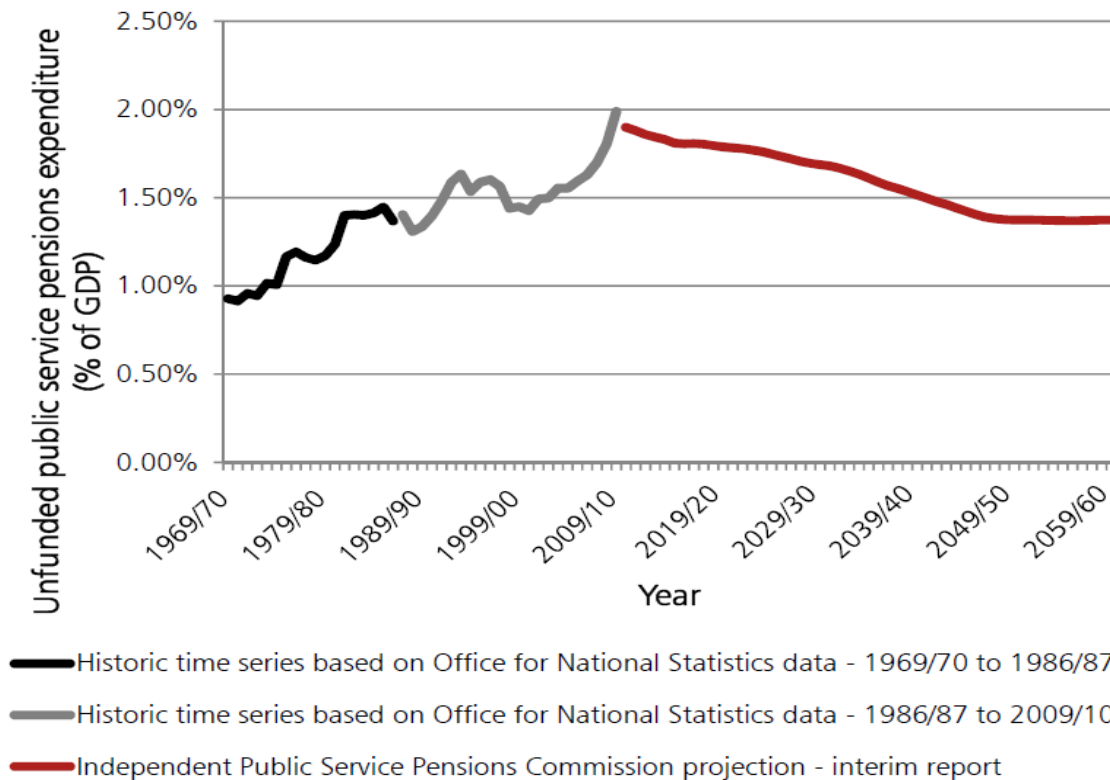## Private sector provision

Chart 1.D: Membership of employer-sponsored pension schemes among UK employees

Case for reform

Cost to taxpayer

Chart 1.A: Historic and projected unfunded public service pensions expenditure as a proportion of GDP
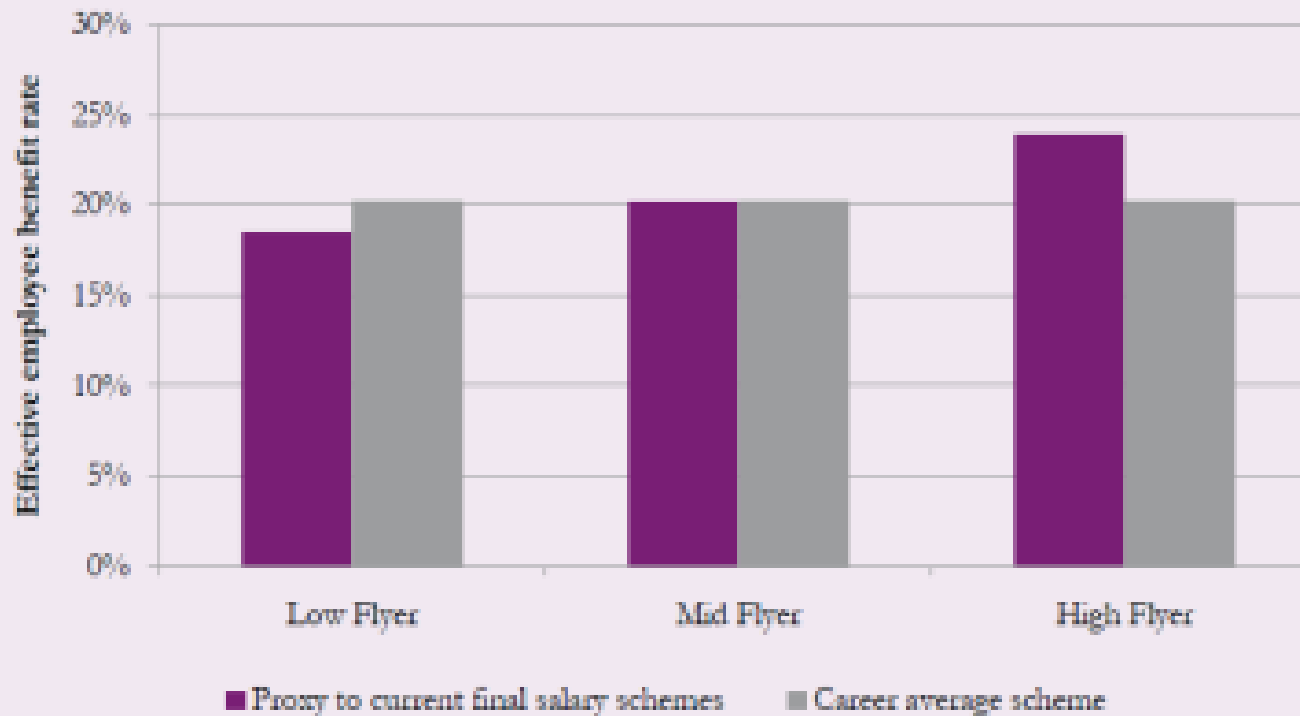
Historic time series based on Office for National Statistics data - 1969/70 to 1986/87

Historic time series based on Office for National Statistics data - 1986/87 to 2009/10

Independent Public Service Pensions Commission projection - interim report

Source: HM Treasury

Case for reform

'Fairness'

The distributional impact of moving from final salary to CARE

(Chart: Effective employee benefit rate, 0% to 30%)

- Low Flyer: Proxy to current final salary schemes ~18%, Career average scheme ~20%
- Mid Flyer: Proxy to current final salary schemes ~20%, Career average scheme ~20%
- High Flyer: Proxy to current final salary schemes ~24%, Career average scheme ~20%

Legend: ■ Proxy to current final salary schemes   ■ Career average scheme

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Major reforms

- Benefit changes

  - The inflation index changed

  - Member contributions increased

  - Changes to future service benefits

- Other reforms

  - Revision of governance arrangements

  - Introduction of a cost cap mechanism

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Major reforms

Changes to future service benefits

| Key Hutton recommendations	Implementation
Pension promises that have been made must be honoured.	• Final salary link maintain • Protection for members close to retirement to remain in existing schemes
Career average defined benefit schemes with earning revaluation	• Career average defined benefit schemes with revaluation varying by scheme
NPA linked to SPA (exceptions for uniformed services - NPA 60)	• Future service benefits linked to SPA • NRA 60 for uniformed services

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Reference scheme

The benefits

- CARE pension scheme,

- Normal Pension Age linked to State Pension Age

- Accrual rate of 1/60ths

- Earnings revaluation in service

- CPI increases in payment and deferment

- 12 for 1 commutation

- Protection for those within 10 years of retirement

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Yes, but …
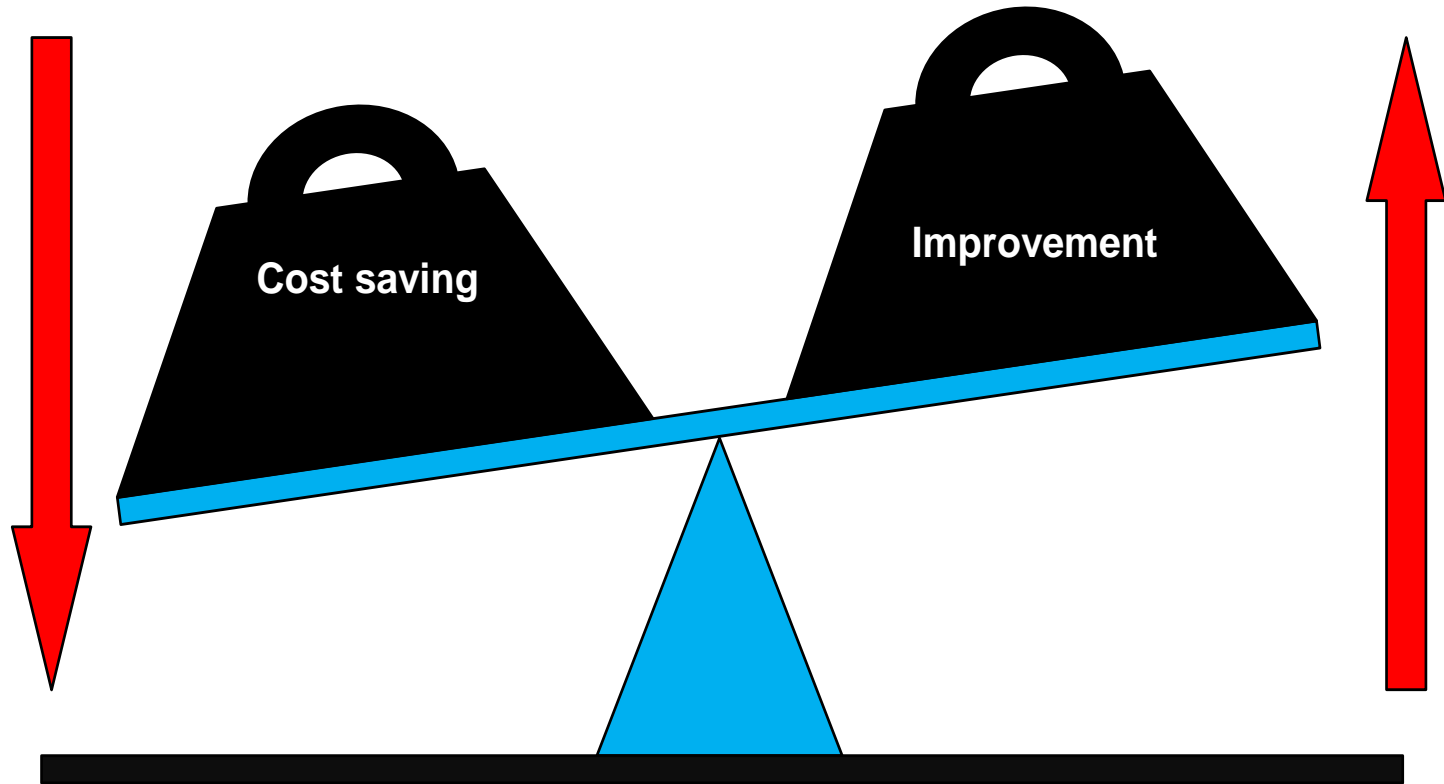
Summary of 2015 schemes

	NHS	Teachers	Civil service	Police	Armed forces	Fire	Local Govt *
NPA	SPA	SPA	SPA	60	60	60	SPA
Accrual	1/54	1/57	1/43.1	1/55.3	1/47	1/59.7	1/49
Reval	CPI+1.5%	CPI+1.6%	CPI	CPI+1.25%	Avg earnings index	Avg earnings index	CPI

*scheme came into force in 2014

Major reforms

The inflation index changed

- RPI to CPI

Source: OBR, GAD
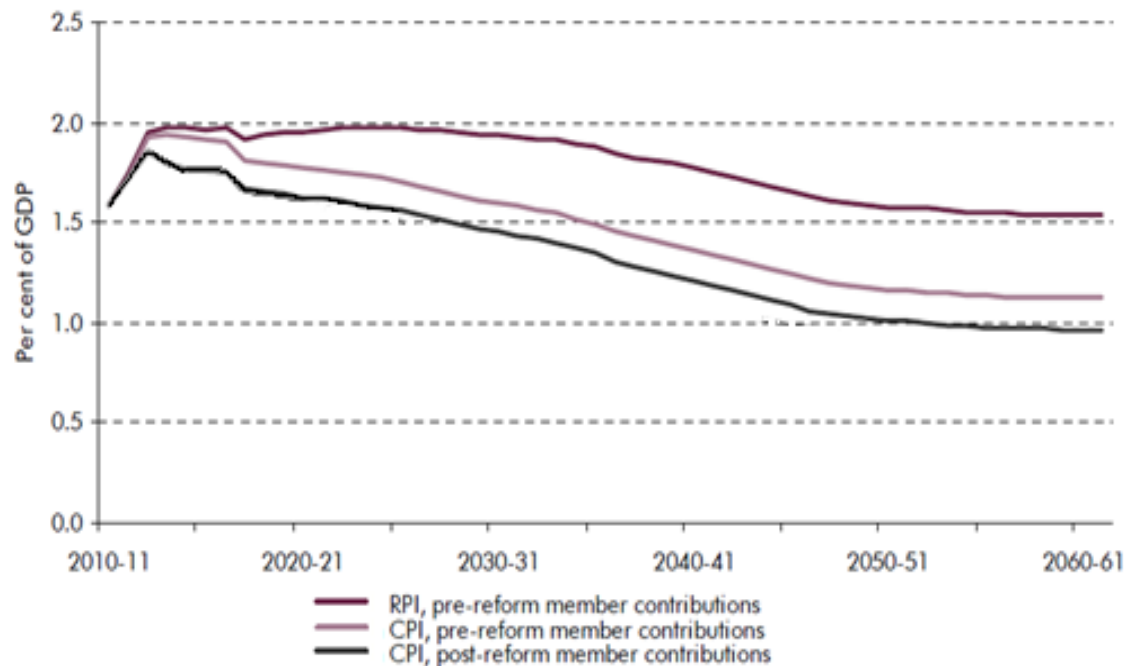
Major reforms

Member contributions increased
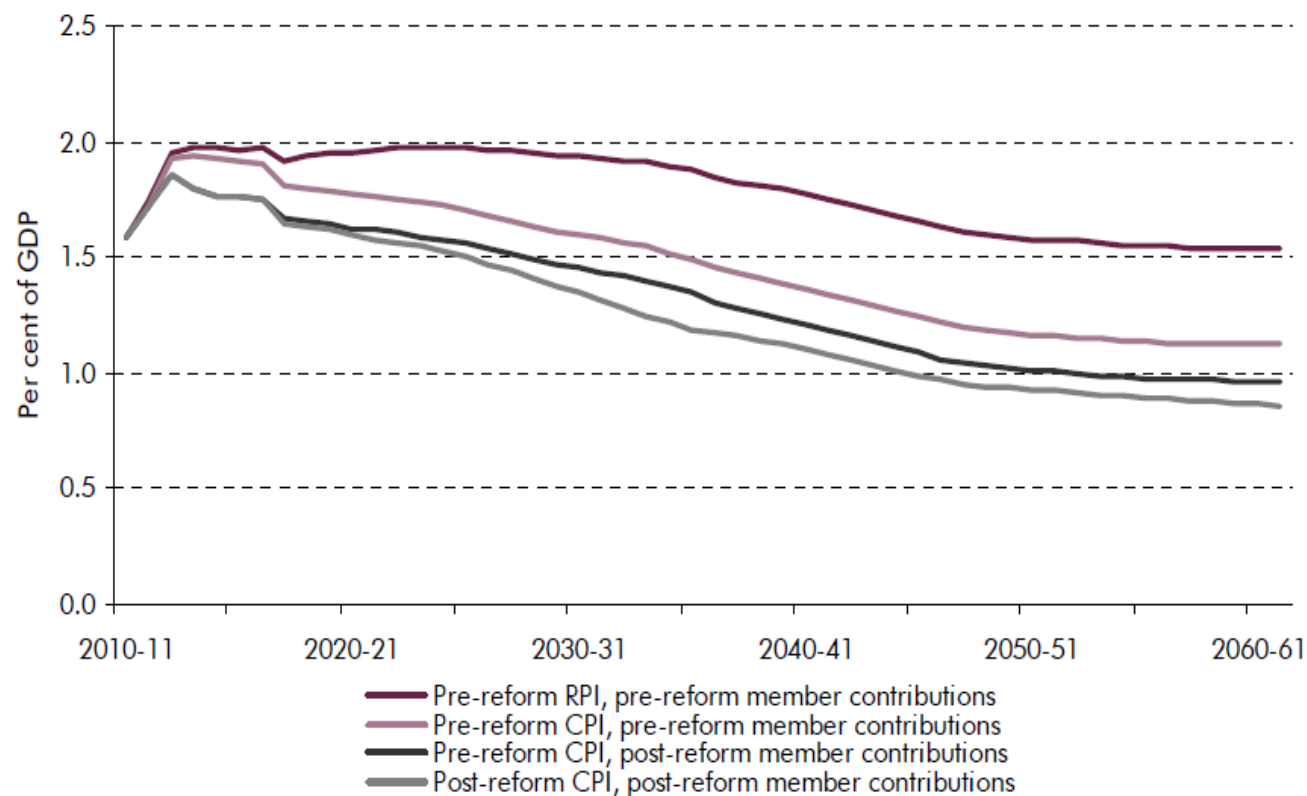
- Average increase of 3.2%
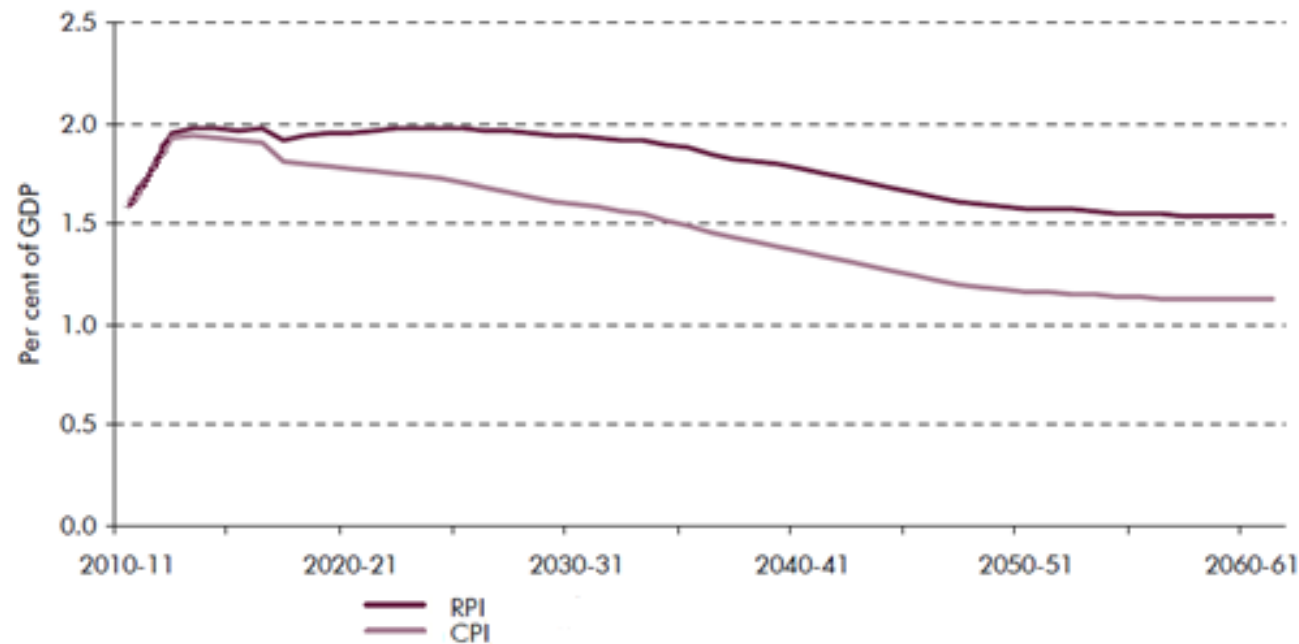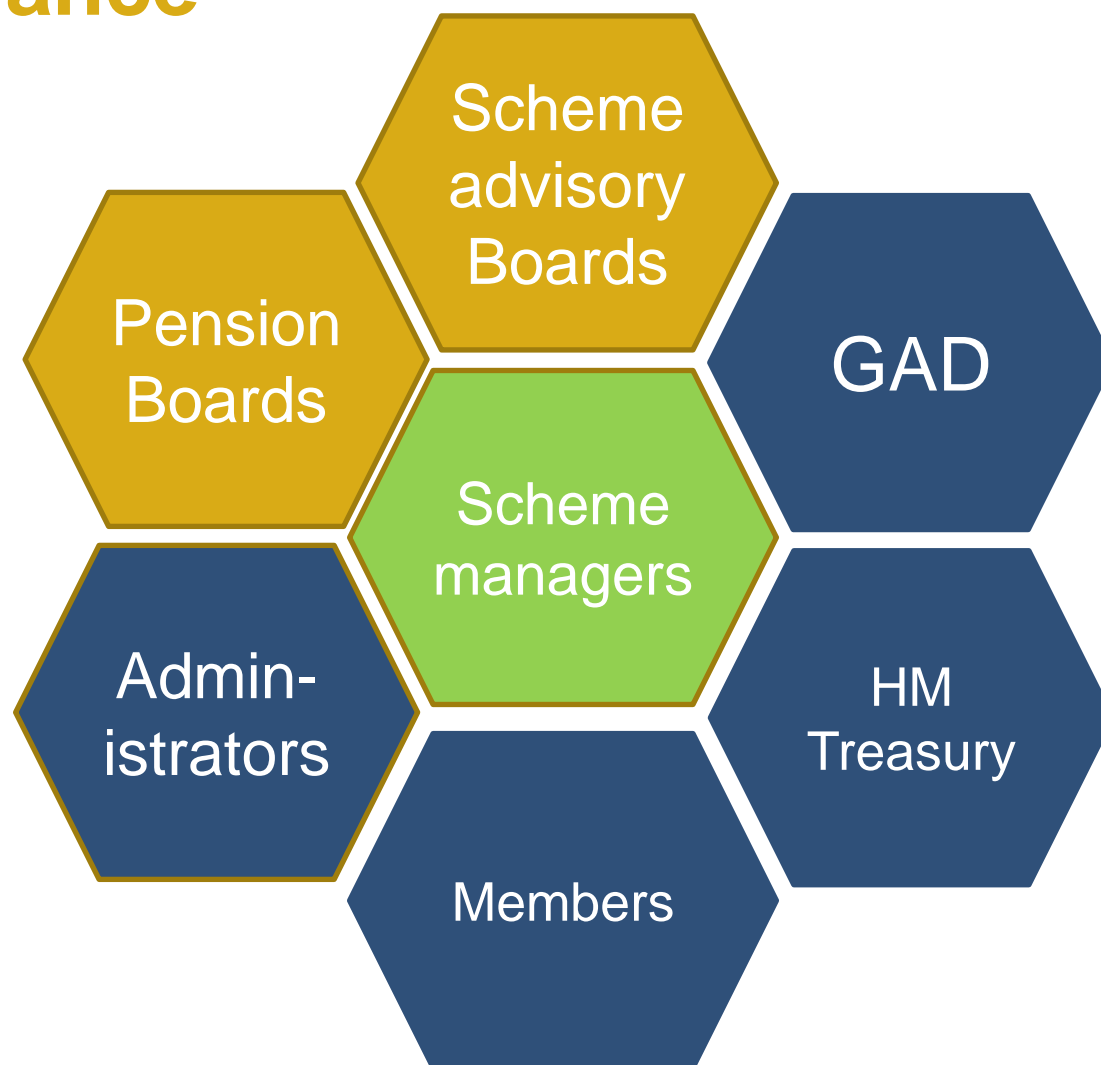

Source: OBR, GAD

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Major reforms

Combined impact

Source: OBR, GAD

Governance

Financial management of unfunded pensions

Liability	Expenditure
Off balance sheet	Cash flow (benefits paid less employee contributions)
On balance sheet	Accrual (cost of new benefits accruing to current workers)

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Balance sheet – National Accounts

	PAST	FUTURE
ASSETS/INFLOWS	Physical assets	Future assets
	Illiquid financial assets	Future revenues
	Liquid financial assets	
LIABILITIES/OUTFLOWS	All liabilities accumulated to date	Future liabilities incurred in the future
		Future liabilities incurred from past activities
		Contingent (i.e. potential) liabilities

Source - OBR

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Balance sheet – Whole of government accounts

Source - OBR

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Balance sheet reconciliation

	2013-14 £bn
Net liabilities (WGA)	**1,852**
Net public sector pensions liability	*(1,301)*
Provisions	(142)
Non-current assets	1,063
Asset Purchase Facility	45
Other	(115)
Public sector net debt (National Accounts)	**1,402**

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WGA liability breakdown

	2013-14 £bn
Unfunded schemes (gross)	
Teachers (UK)	288.1
NHS (UK)	391.6
Civil Service	193.2
Armed Forces	129.6
Police and Fire	148.5
Other unfunded	54.8
	1,205.8
Funded schemes (net)	
Local government	85.6
Other funded	10.5
	96.1
Total	**1,301.9**

Pension cash flow

Payments and contributions in pay-as-you-go pension schemes

Public Sector

Funding → HM Treasury ← Balancing figure

£12bn

£17bn

Public service employers — Employer contributions → Pension schemes

Pay

Employee contributions

£9bn

Public service employees

Payments

£38bn

Public service pensioners
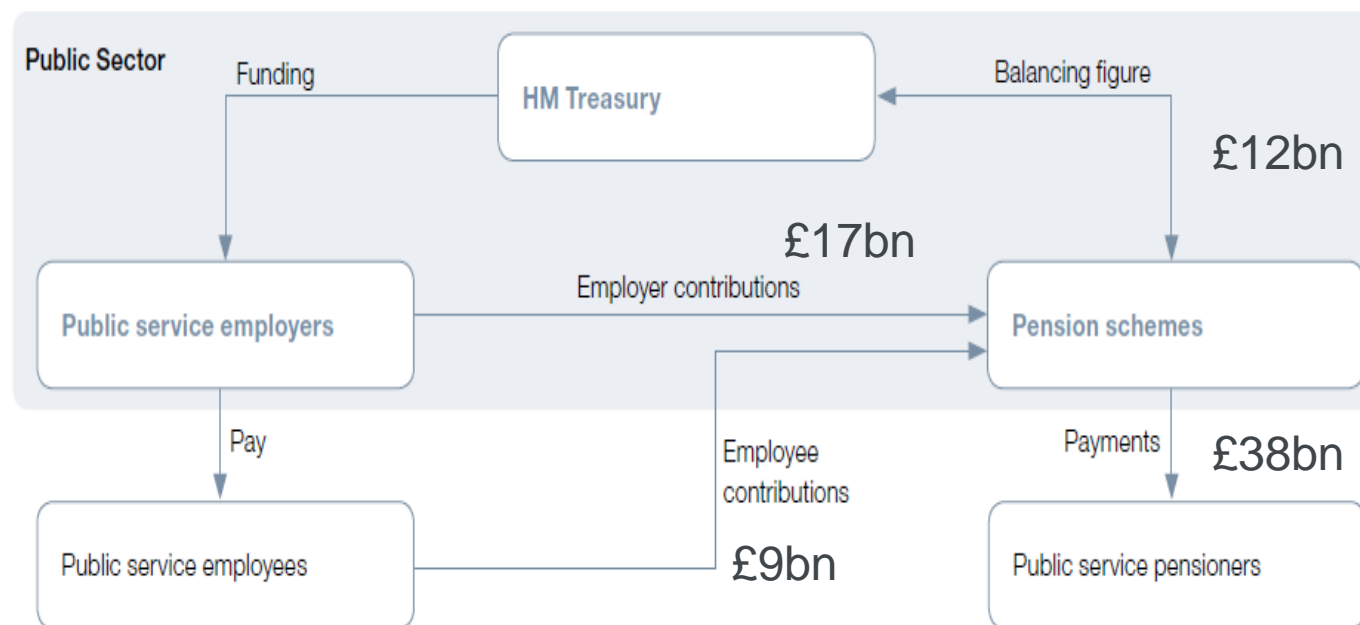
Source: National Audit Office

Government's spending rules

- **the fiscal mandate:**

    - **"a forward-looking aim to achieve cyclically adjusted current balance by the end of the third year of the rolling, 5-year forecast period".**

- **the supplementary target:**

    - **"an aim for public sector net debt as a percentage of GDP to be falling in 2016-17"**

- **The Deficit (PSNB):** (2014/15 estimate: **£89.2bn**)

    - **Deficit on current budget: £58.3bn** + Net investment: £30.9bn

        - **Current expenditure** (PSCE): **£668.6bn** + Depreciation: £36.0bn – Current receipts: £646.4bn

            - RDEL[1,2]: £317.4bn + **AME: £351.2bn**

                - Various items including **Net public service pension payments: £12.1bn**

[1]Employer contributions are showing up as positive DEL and negative in public sector pensions
[2]Employee contributions could be netted off against staff salary costs
OBR Economic and fiscal outlook July 2015

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Pension accrual

- Accrual measures of cost
  - Fund accounts reflecting IAS 19
  - A supplementary table to the national accounts
  - Management charge (via actuarial valuation)

Actuarial methods and assumptions

- Actuarial valuation

  - Management charge

  - Cost cap mechanism

- Discount rate

- Process of valuation

Cost cap mechanism

- Set as the 'long term' employer contribution rate of the new scheme

- At future valuations, compare the cap with:

  - the new future service cost,

  - past service costs

- Return costs to the level of the cap, if change by 2% of pay

  - Future accruals of benefits; or

  - Members contributions

Discount rate

- Discount rate methodology options

  – Consistent with private sector and other funded plans

  – Yield on index-linked gilts

  – Expected GDP growth

  – Social time preference rate

- Consultation process

- Government decided to select a rate based on expected long-term GDP growth

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Valuation process

- Valuation Directions (prescribed methods) set by HM Treasury

- Financial assumptions set by HM Treasury

- Demographics based on scheme specific experience

- Notional assets to track the impact of actual demographic experience relative to that expected

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Practical challenges, updates and wrap-up

- Observations about capturing saving

- Questions about pension design for the future

- Practical challenges

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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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