ACTUARIAL VALUATIONS AND EMPLOYER COST CAPS

Issue

1. The Public Service Pensions Bill provides a common framework for valuations of the public service pension schemes. The detailed specifications underpinning how valuations will be taken forward will be set out in published HMT directions. The Bill also specifies that all schemes must set an employer cost cap, expressed as a percentage of pensionable pay, to provide backstop protection for the taxpayer.

2. In November 2012, HM Treasury published:
   - *Actuarial valuations of public service pension schemes*[1]
   - *Establishing an employer cost cap in public service pension schemes*[2]

3. The HMT papers set out further detail on how valuations and the employer cost caps will operate in public service pension schemes.

Valuations

4. Actuarial valuations are used to measure the future cost of the pension promises that are being made, today, to the workforce. They set the level of employer and employee contributions to be paid so that these reflect the value of the benefits being built up. This ensures that the full costs of employing and remunerating staff are accounted for by employers.

5. The output of valuations will also inform the operation of the employer cost cap. For the unfunded schemes, like the Firefighters' Pension Schemes, the initial cost cap will be set by reference to the 2012 valuation.

6. Subsequent valuations will be undertaken on a 4 year cycle and will be used to measure future costs against the employer cap. Valuations will also identify 'member' and 'employer' costs and will use the SCAPE methodology.

SCAPE - Superannuation Contributions Adjusted for Past Experience

7. In the unfunded schemes, there is no pot of assets which can be valued to determine if sufficient contributions have been paid to meet the costs of benefits accrued. Instead, valuations will create, and track, the value of a 'notional fund'.

8. A number of the unfunded public service pension schemes already operate under the SCAPE approach. However, this approach has not yet been adopted for the Firefighters' Pension Schemes, although the Government has previously set out its intention to do so. HMT directions

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[1] http://www.hm-treasury.gov.uk/d/actuarial_valuations_publicservicepension121112.pdf
[2] http://www.hm-treasury.gov.uk/d/establishing_employer_costcap121112.pdf

will specify how a notional fund will be created for the Firefighters' Pension Schemes.

9. Broadly, the SCAPE contribution rate is comprised of two elements:
   - the ongoing cost of benefits that members are accruing in the scheme (SC), and
   - adjustments for any differences between the historic contributions paid and the current assessment of the value of benefits that have been promised (APE)

SCAPE "assets" and liabilities

10. The intention is to set up a notional fund with notional assets. The notional assets are likely to be set so as to match the liabilities of the scheme at the baseline. Between valuations, the notional assets will:
    - increase in line with the amount of contributions made (employees and employers)
    - increase in line with notional returns in line with the discount rate (currently 3 percent per annum plus CPI), and
    - decrease when pension benefits (or other forms of scheme expenditure) are paid.

11. At subsequent valuations, scheme liabilities are calculated and compared with the notional assets. If scheme experience has followed previously adopted assumptions, then no surplus or deficit occurs.

12. If there is either a scheme deficit or a surplus, a decision has to be taken about how these are addressed. These are usually addressed via adjustments to contribution rates, spread over a 15 year period.

13. The following set out some examples of changes in assumptions or experience that can affect scheme costs:
    - past (real) salary increases were greater / less than expected
    - future promotional prospects
    - past and future mortality experience
    - past and future withdrawal, retirement, death rates
    - corrections / adjustments to data

Employer cost cap

14. The Proposed Final Agreement set out that there would be an employer cost cap introduced for the Firefighters' Pension Schemes to cover unforeseen events and trends that significantly increase scheme costs. The intention of the employer cost cap is to ensure the fair sharing of risk between pension scheme members and other taxpayers.

15. The employer cost cap will be informed by the 2012 valuation and will control all of the cost risks associated with the 2015 scheme, and active members in the current schemes. It is important to note that the employer cost cap is not the same as the employer contribution rate.

16. As mentioned above, future valuations will track changes in scheme costs and identify increased or decreased costs as either member costs or employer costs. Member costs include items such as increases in longevity, pay growth, and career paths; employer costs include items such as changes in the discount rate or valuation methodology.

17. If a valuation shows that the costs of a scheme have risen more than two percentage points above the cap, or two percentage points below the cap, action must be taken to return costs to the level of the cap. The Bill provides for a procedure for stakeholders to reach agreement on what adjustments should be required before any change is made.

FPC Secretariat