

Briefing

Teachers' Pension Scheme: 2020 valuation consultations could be game-changers

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The Government has recently published two consultations, the outcomes of which could have a big impact on the results of the 2020 public sector pension scheme valuations, including the Teachers' Pension Scheme ('TPS') and Scottish Teachers' Pension Schemes (collectively referred to as 'STPS').

Both consultations are open until 19 August 2021 and we would encourage all schools to consider responding to them.

RECAP – THE KEY DRIVERS FOR THE COST OF PENSION SCHEME BENEFITS

Pensions are long-term arrangements and if we want to know how much to pay today to provide a pension decades from now, we have to make a series of assumptions about how that pension might look when today's workforce comes to retire.

Given a particular pension scheme structure (in other words, the formula for calculating benefits), assumptions are needed to determine the costs:

- How long will that pension be paid for?
- How will the amount of pension change over the course of an individual's life both before and after retiring?
- How much money is needed today to provide that pension in the future?

This calculation can become hugely complex, with assumptions covering life expectancies, population demographics, price inflation and salary growth key, but the assumption that converts all of this complexity into a final answer – "what is the cost today?" – is the discount rate.

Consultation 1: the Cost Control Mechanism¹

The first consultation looks at proposals for reforming the Cost Control Mechanism. This mechanism was introduced following a review of public sector pension provision carried out in 2011, and its impact was first felt following the 2016 round of valuations.

As we saw, while the TPS and STPS valuations showed that the cost of benefits needed to increase, largely as result of changes in financial conditions, the Employer Cost Cap determined that the value of benefits had actually fallen and so required benefits to be improved.

¹ www.gov.uk/government/consultations/public-service-pensions-cost-control-mechanism-consultation

This counter-intuitive outcome was a result of a number of factors, the most significant of which were that:

- The two key assumptions driving the fall in the value of benefits were reductions in future salary growth and in life expectancy. The mechanism looked at both the cost of benefits accruing in the future and the impact on members' past benefits but the impact of these assumption changes was greatest on benefits earned under the pre 2015 (final salary) benefit structures.
- The Cost Control Mechanism ignores changes in the discount rate used in the valuation calculations. In 2016, the discount rate fell, meaning that benefits cost more and so contributions needed to rise. At present, the cost of benefits can rise even when the mechanism has determined that the level of benefits needs to increase. Perhaps more importantly, at least politically, the current mechanism can require benefits to be cut even while employer contribution levels are reduced (for example, if life expectancy increased at the same time as a significant increase in the discount rate).

Under the proposals being put forward by the Government, based on recommendations from the Government Actuary, three aspects of the Mechanism would change:

1. It would only consider the impact of assumption changes on benefits earned after 2015, excluding final salary benefits from the calculation.
2. The threshold needed for the mechanism to be triggered would be widened from 2% of pay to 3%.
3. An economic check would be applied using the discount rate, such that the mechanism would only be triggered if it would still have done so after allowing for the economic cost of the change.

How would these have affected the outcome in 2016?

It's not hard to see why these changes are being proposed – if the Cost Control Mechanism had included these features in 2016, the outcome we saw would have been avoided.

Removing the impact of changes in assumptions on pre-2015 benefits is a sensible proposal in our view. The Cost Control Mechanism considers what is affordable to the country today, so it is reasonable that this decision is based on the cost of benefits accruing today. What isn't fully clear at this stage is how the McCloud judgement might play out into these calculations.

With the effect of assumption changes on pre-2015 benefits included, a 3% corridor would still have been hit, but removing pre-2015 benefits from the equation would have brought the overall impact down to under 2%.

Either way, if a discount rate economic 'sense check' had been available within the mechanism in 2016 these would not have led to a required change in the level of benefits.

Clearly, if these reforms are brought in then it is far less likely that the mechanism will be triggered in future. The economic check in particular will mean that in future, benefits will only be reduced if they cannot be maintained at the current contribution level, nor would they be increased if that would require an increase in contributions.

What is being consulted on?

The Government is asking for comments on all three proposals, as well as the fundamental aim of this review, which is to "achieve the right balance of risk between scheme members and the Exchequer (and by extension the taxpayer)" and to create a more stable mechanism for Employers over time.

Consultation 2: the Discount rate²

The assumption that can have the largest impact on the cost of pension benefits is the Superannuation Contributions Adjusted for Past Experience (SCAPE) discount rate. In 2016, this was set by reference to long-term projections for UK GDP growth, but this is the subject of the second consultation now underway.

The discount rate used to assess TPS and STPS pension costs has been steadily falling since 2011. In 2011 it stood at 3.0% above CPI inflation, but was reduced to 2.8% in 2016 and then 2.4% in 2018. The consultation states that a 0.25% pa change in the SCAPE discount rate could change employer contribution rates by between 4% and 11% of salary.

² www.gov.uk/government/consultations/public-service-pensions-consultation-on-the-discount-rate-methodology

The Government is considering moving away from this approach and instead using what is known as the Social Time Preference Rate, ('STPR'), a rate used when appraising projects that involve spending money in the short term to deliver future welfare benefit. STPR was also used to assess public sector pension costs prior to the 2011 review.

Long term GDP growth

In March 2020, the Office for Budget Responsibility published its latest economic outlook forecasts³, which the consultation notes could imply a discount rate of just 1.8% above inflation if the same methodology were adopted for the 2020 valuation.

The consultation makes it clear that this is not currently the case, and that a separate consultation will be carried out in due course to assess the level of the discount rate that will be adopted for the 2020 valuations.

However, it is worth noting that if the discount rate did reduce from 2.4% to 1.8%, the 2016 valuation report⁴ suggests this, all other things being equal, could lead to an employer contribution rate in the mid 30%.

STPR

STPR is currently 3.5% above inflation, and has been since it was first introduced in 2003⁵. At first glance, this suggests that the discount rate used for the 2020 valuation could be substantially higher than at present potentially meaning a lower employer contribution rate arising from the 2020 valuation. However, the consultation proposes that this rate is adjusted downwards, for two reasons:

- Standard STPR includes an element that represents the riskiness of the endeavour (and the returns generated by taking more risk). Given that public sector pensions are considered lower risk, removing this element would reduce STPR to 2.5% above inflation.
- STPR is appropriate for assessing projects over a period of up to 30 years, but a lower rate should be used for very long term projects, with the standard 3.5% reducing to 3.0% after 30 years and then to 2.5% after 75 years. The consultation does not illustrate exactly how this would affect the discount rate used to assess public sector pension costs, but it is reasonable to assume that it would reduce the basic 2.5% rate slightly given the long-term nature of pensions.

Timing of future reviews

Alongside the methodology consultation, the Government proposes that the discount rate review will move to a new 4-yearly cycle that would coincide with public sector pension scheme valuation dates.

This would avoid a repeat of the situation we saw in 2018 when the rate was revised (downwards) during the valuation process, which led to an unexpected rise in pension costs, although the Government would retain the ability to conduct out-of-cycle reviews if circumstances changed.

Why does this matter?

On one level, this is a theoretical discussion about a technical issue where the impact cannot be assessed until further down the line. Alternatively, this proposal is introducing an option for setting the discount rate that could allow a much more flexible approach. No longer wedded to the OBR's long-term GDP forecasts, if adopted the STPR appears to offer more room for qualitative arguments to influence the outcome. It could even pave the way for the 2020 discount rate to be almost unchanged from the rate used in the 2016 valuation, which could mean little or no change in employer contribution rates – an option we have noted in previous briefing notes.

Alternatively, the next phase of the consultation process could result in a discount rate that does indeed follow OBR projections and lead to a substantial contribution rate increase. What this consultation appears to be offering is the option for flexibility of approach combined with a more predictable review timetable.

Finally, to link back to the Cost Control Mechanism, if the economic sense check is introduced to this process, as the Government proposes, then the new discount rate methodology will be fundamental in deciding when that check is applied, again giving more flexibility and control to the Government and potentially offering more stability and predictability to Employers around TPS and STPS contribution rates in the future.

³ obr.uk/efo/economic-and-fiscal-outlook-march-2020/

⁴ [Teachers' Pensions Valuation Report | 04 | 2019 \(teacherspensions.co.uk\)](https://teacherspensions.co.uk/Teachers-Pensions-Valuation-Report-04-2019/)

⁵ assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938046/The_Green_Book_2020.pdf

What next?

The outcome of the 2020 valuations is still some time away, but these consultations will form a key part of the roadmap towards regaining more certainty in the cost of pensions for independent schools, and across the public sector.

Following completion of this exercise, we expect to see a further consultation on the level at which the valuation discount rate should be set, and more on the Cost Control Mechanism and McCloud remedy. Once these points have been resolved the outcome of the 2020 valuations will be easier to predict.

Both consultations are open until 19 August 2021 and we would encourage all schools to consider responding to them.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch with Tim Williams, Associate and FIA or Martin Willis, Partner and APFS via the following:

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