

## The Draft Public Service Pensions (Valuations and Employer Cost Cap) (Amendment) Directions 2018

### Milne v GAD – Amending directions 3, 15 & 16

- These directions ensure that the costs of the additional lump sums paid out as a result of the Milne v GAD litigation (including interest) are reflected in ongoing employer costs.
- This ensures that employer costs adhere to the completeness principle which underpins the directions framework – “the directions should ensure that for each unfunded scheme, taken together, employer and employee contributions reflect the full expected costs of benefits provided by the scheme. These costs should include any past service effects that have arisen since previous valuations”.
- The “Milne” costs relate to members who retired before the 2015 schemes came into force, so have no impact on the employer cost cap mechanism. These were payments that were always due from the relevant schemes, and as such Treasury believes they are a relevant employer cost.
- Payments relating to compensation for taxation effects have been excluded.

### Security Services – Amending directions 4, 31, 32, 33, 34, 35 & 36

- The reformed pension scheme for employees of the Secret Intelligence Service and the Security Service was established from 1 April 2016. Accordingly, the preliminary valuation took place later than those for the other schemes.
- The implementation period for the initial employer contribution rate has been agreed as 6 years from 2017 rather than 4 years from 2015; and the effective dates for their first two valuations will be 2015 and 2020. These changes enable future scheme valuations to align back to the cycle of the other major schemes.
- Amending directions 34-36 insert relevant amendments to the schedules to include the new scheme for the security agencies.

### Local Government Pension Scheme (LGPS), timing of scheme valuations – Amending directions 5 & 6

- LGPS fund valuations, used to determine local employer contributions, are governed by the scheme’s regulations and currently take place on a triennial basis. However, the national scheme valuations, used to test the employer cost cap mechanism, are governed by HMT’s valuation directions.
- The valuation directions originally aligned the LGPS national scheme valuations with their triennial local fund valuation cycle, as the 2016 valuations coincided with local fund valuations. The other major public service schemes undertake quadrennial scheme valuations.
- Having considered the matter further, HMT believes that bringing the LGPS scheme valuations onto the same quadrennial cycle as the other public service scheme valuations should minimise complications, and will assist with comparisons. The outcome of the employer cost cap mechanism test may have significant implications and it is difficult to justify why the valuation cycle should differ for the LGPS.
- Because the local fund valuations for the Scottish LGPS are on a different cycle to the England and Wales LGPS (falling 1 year later) the 2017 Scottish LGPS national cost cap valuation will go ahead when due; and align its quadrennial valuations from 2020.

### Pension increase assumptions – Amending directions 7 & 24

- This will remain fixed as the annual increase in CPI as at the September preceding the start of the tax year; as used by DWP to uprate social security benefits.
- Future annual increases in CPI are taken from the relevant Office for Budget Responsibility (OBR) forecast – in this case the Economic and Fiscal Outlook (EFO) published in March 2018. Because of the need for certainty and finality in relation to valuation results calculations, these provisions will not be updated to reflect any further EFO published by the OBR in the next 12 months.

### Earnings assumptions – Amending directions 8, 9, 18, 19, 21, 25, 27 & 28

- The assumptions in amending direction 8 specified for general/national earnings growth until 2023 are taken from the relevant OBR forecast – in this case the EFO published in March 2018.
- The assumptions in amending direction 9 specified for public earnings growth are also taken from the March 2018 OBR forecast – and are the growth in paybill per head for government employment.
- The exception to this is the figure for 2016/17 in amending direction 9(a) of 1.2%. 2016/17, as a year in the past, is an exception as an outturn (actual increases reported in data) figure rather than an assumption. The measure provided for 2016/17 in OBR's March 2018 EFO was 3.6%. This is considered to be too high to constitute a plausible figure by schemes and the Government Actuary's Department (GAD), especially in the context of the 1% average increase in public sector pay policy, which applied until 2017.
- Alternative measures were considered, and following advice from HMT's GAD advisory team, the 2016/17 outturn in ONS's Average Weekly Earnings (AWE) (1.2%) was deemed the most appropriate alternative. This is ONS's 3-month average, as at March 2017, seasonally-adjusted regular pay for the public sector excluding financial services.
- The OBR forecasts incorporate both announced pay policy, and drift in paybill per head, arising from other changes such as shifts in workforce composition. It is government's view that it is appropriate to set these assumptions centrally, as all workforces are subject to broadly the same announced pay awards, and pay drift is an observed trend but is difficult for schemes to forecast where specific workforce plans are not available in future years.
- Beyond 2023, the directions specify a general long-term earnings growth assumption of 4.2% per annum. This is derived from the OBR's long-term central earnings growth forecast for the whole economy, as the OBR does not disaggregate long-term pay growth between increases due to pay awards and pay drift, or between government and non-government employment.
- The numerical value of 4.2% reflects the proposed SCAPE rate of 2.4% (see below). The equivalent figure which matches the current SCAPE rate of 2.8% is a long-term earnings growth assumption of 4.5%. These figures are consistent with the underlying economic forecasts used to set the respective discount rates, since the long-term earnings assumption is correlated to the forecast of long-term GDP growth at the time. This ensures that the earnings assumption used to project the cost of future payments continues to be consistent with the discount rate used to express those earnings in current terms. To use a different assumption would lead to asymmetries in the methodology.
- Amending direction 28 simply reflects the extension of the OBR's forecasts with the passage of time since the directions were last updated.
- As above, because of the need for certainty and finality in relation to valuation results calculations, these provisions will not be updated to reflect any further EFO published by the OBR in the next 12 months, or any relevant updates from the ONS.

#### SCAPE rate change - Amending directions 10, 17, 18, 19, 20, 22, 23, 26 & 27

- These amendments make the technical changes required to ensure that the change in the SCAPE rate announced at Spring Budget 2016, from 3% to 2.8%, is factored into valuation calculations.
- These amendments ensure that, for employer contribution rate calculations, the costs of this change to the SCAPE rate are fully reflected. They also ensure that the commitment to exempt such changes from the cost cap mechanism is honoured.
- These amendments also ensure that the subsequent, proposed reduction in the SCAPE rate from 2.8% to 2.4% (a figure that will be confirmed in due course and formally announced at a later date) will be factored into the 2016 valuations.
- The use of the date 1 April 2019 for the rate reduction from 2.8% reflects that the valuation modelling is generally based on annual (rather than monthly, weekly or daily) cash-flows so allows simplicity in the valuation calculations; and assumes that the SCAPE rate change will occur by that date.

#### Assumed mortality rates – Amending direction 11

- As per previously stated policy, this amending direction aligns assumptions for future improvements in life expectancy to those in the Office for National Statistics (ONS)'s principal population projections published in October 2017.
- There are some indications that public service pension scheme life expectancy changes may not fully align to the general population experience but at this stage there is no clear trend and so we have decided to continue to use the latest ONS principal population projections.
- We intend to monitor public service pension schemes' mortality data during future inter-valuation periods to inform the setting of this assumption at subsequent valuations.

#### Commutation – amending direction 12

- In 2014, it was decided that the assumption about the level of commutation in the schemes that don't provide an automatic lump sum should be centrally directed rather than scheme-specific. This was because the majority of experience of retirements in the public service schemes is from schemes which do have automatic lump sums and there was relatively limited evidence available to determine how much pension people are likely to commute in the new schemes. It was also felt desirable to have consistency across the schemes.
- There was (and remains) no obvious reason why, in the long run, experience of commutation for schemes with the same commutation rate and no automatic lump sum should differ significantly across schemes. In 2014, 15% was therefore determined as an appropriate level based upon an examination of the available data across a number of the schemes by HMT's GAD advisory team.
- Having considered the updated experience data from 2012-2016, there appears to be evidence now that levels of commutation are higher. However, there are still outliers and a lack of consistency across the schemes.
- Again, based on cross scheme 2016 valuation data and advice from HMT's GAD advisory team, HMT have determined that 17.5% is an appropriate assumption for the 2016 valuations.

#### Disclosure (contents of valuation report) – Amending directions 13 & 14

- These amending directions provide for additional disclosures in the valuation reports on certain aspects of the valuations process. These additional disclosures will assist all users of the report to, for example, identify cross-scheme trends, and when considering various policy matters.

#### Fee-Paid Judges Pension Scheme – Amending directions 15 & 16

- The retrospective introduction of the pension scheme for Fee Paid Judges in 2017 needs to be reflected in this valuation. As per the completeness principle mentioned earlier in respect of the Milne v GAD cost, this needs to be done in a way that ensures that the relevant additional costs of the scheme (including retrospective payments and interest) are met by the employer; and included in the post-valuation employer contribution rate.
- It will also be necessary to recalculate the employer cost cap for the 2015 Judges Pension Scheme; to include the costs of the relevant Fee Paid Judges (who since 1 April 2015 have been members of the JPS 2015). This will be done by recalculating the employer cost cap determined in the preliminary valuation. Amending direction 30, referred to below, ensures that this can be done appropriately.
- Payments relating to compensation for taxation effects have been excluded.

#### Cost cap net leavers liability – Amending direction 21

- This amendment provides a technical actuarial correction to the way in which one component of the cost cap mechanism is calculated. This ensures that the various different component calculations in the cost cap mechanism are carried out using consistent assumptions.

#### Process for scheme actuaries following notification of cost cap breach – Amending direction 29

- Given the indication that at least some, if not all, schemes will breach the cost cap floor in the 2016 valuation; it is necessary to include in the directions a process for scheme actuaries to follow as a result of the additional “step” that this will add to the valuations.
- The amendments enable and direct scheme actuaries to provide “certification” to the responsible authority (RA), once certain conditions have been met, that the RA’s decision on how the cost cap breach will be rectified will bring scheme costs back to the required level (the “cost cap cost” set in scheme regulations; also known as the target cost).
- The “certification” element of the process will also enable the scheme actuary to set out the re-calculated employer contribution; as the employer contribution rate contained in the valuation report will need to change, to reflect the implementation of the cost cap remedy.

#### Preliminary Valuations – Amending direction 30

- Amending direction 30 ensures that any preliminary valuation taking place after the 2014 directions have been amended, or after the passage of time, would be carried out using the same assumptions as other schemes used to conduct preliminary valuations; and/or the same assumptions used in any of their own previous preliminary valuations. As mentioned above, this latter scenario arises as a result of the retrospective introduction of the pension scheme for Fee Paid Judges in 2017.
- These amendments ensure consistency across the schemes in the calculation of the employer cost cap figure.

#### Correction relating to the Civil Service Pension Scheme 2012 valuation – Amending direction 35

- This amending direction updates the notional assets for the civil service scheme; this is necessary after analysis of the 2016 valuation data revealed a discrepancy in the 2012 valuation data.
- This approach is consistent with the treatment of data issues of similar materiality which arose during the 2012 valuation in respect of a number of schemes, including the Armed Forces Pension Scheme, the Firefighters Pension Scheme in England and the NHS and Teachers’ Pension Schemes in Scotland.