HM TREASURY

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Executive summary

One of the key objectives of public service pension reform is to ensure a fair balance of risks between scheme members and the taxpayer. To achieve this, the Independent Public Service Pensions Commission recommended that the Government establish a mechanism to control the future costs of providing public service pensions.

The Government intends to take forward this recommendation by putting in place an employer cost cap in the new public service schemes. This will provide backstop protection to the taxpayer, to ensure that risks associated with pension provision are shared between employers and scheme members. The Public Service Pensions Bill provides the necessary legislative framework for this cap to operate.

The Bill specifies that all schemes must set a cap, expressed as a percentage of pensionable pay. If a valuation shows that the costs of a scheme have risen more than two per cent above the cap, or have fallen more than two per cent below the cap, action will be taken to return costs to the level of the cap. This may be achieved via adjustments to member benefits accruing in respect of future service, adjustments to member contributions, or via some other method. The Bill provides for a procedure to allow stakeholders to reach agreement on the adjustments required before any change is made, and the Government intends that there will be a period of consultation before a decision is made on this.

The cost cap will control all of the cost risks associated with the new pension schemes, and the risks associated with active members who have service in the existing, pre-reform schemes (including those with transitional protection). Changes in costs which arise from technical or financial changes will not affect the cost cap. Only those which directly relate to members – such as changing expectations about life expectancy, salary growth or career paths – will be included in the cap mechanism.

The cost cap will operate in all of the large unfunded schemes and in the local government schemes.

1 Establishing an employer cost cap in public service pension schemes

Introduction

1.1 The Government is committed to ensuring that the future costs of public service pensions remain sustainable, and that cost risks are shared fairly between members and taxpayers. The Public Service Pensions Bill includes provisions for an employer cost cap mechanism to provide backstop protection against any unexpected changes in costs.

1.2 This note sets out how the employer cost cap will work in practice for the main public service pension schemes.

A mechanism to control costs

1.3 The Independent Public Service Pensions Commission recommended that the Government establish a mechanism to control future spending on public service pensions, by setting a fixed proportion of pensionable pay that public service employers would contribute to the schemes in the long term. The Commission also recommended that if this cost were exceeded then the Government should consult on how to reduce costs, with an automatic default to be applied if agreement could not be reached.

1.4 In response to this recommendation, the Government has committed to putting in place an employer cost cap to protect against unforeseen changes in scheme costs. The cost cap will provide backstop protection to the taxpayer, to ensure that the risks of increased costs are shared between scheme members and public service employers. The cap arrangements will be symmetrical, so that if costs fall below a certain threshold, the savings will be used to the benefit of scheme members. Clause 11 of the Public Service Pensions Bill provides the legislative framework for this mechanism.

1.5 The cost cap arrangements will apply to all the main public service pension schemes once reformed. This includes the new unfunded schemes that will be introduced in 2015 and the new local government schemes that will be introduced in England and Wales, and in Northern Ireland, in 2014 (and in Scotland in 2015). The cap will apply across the existing and new schemes for each workforce[1], and to any other new schemes subsequently set up under the provisions of the Public Service Pensions Bill.

1.6 The cost cap will operate in a consistent way for all unfunded schemes. The local government schemes differ from the other large public service schemes, as they are funded schemes, comprised of a number of individual funds. In these schemes, the cost cap will operate at the scheme level, rather than at the level of each individual fund.

[1] Civil servants, the judiciary, teachers, health service workers, local government workers, fire and rescue workers, members of police forces and the armed forces.

1.7 The Government is currently considering more detailed proposals on the operation of the cost cap in the local government scheme, including in Scotland where there is currently no model fund. Further details will be provided in due course.

The operation of the employer cost cap

1.8 All public service employers pay contributions to the public service pension schemes on behalf of their employees. The rate paid, when combined with the rate of contributions paid by members, covers the costs of providing pensions under the scheme, as determined by an actuarial valuation of the scheme[2]. The employer contribution rate is normally expressed as a percentage of pensionable pay. In the existing public service pension schemes, the employer contribution rate ranges from 14.0 per cent to 37.3 per cent of pensionable pay[3]. The Public Service Pensions Bill specifies that scheme regulations must set a rate of employer contributions that will establish the level of the cost cap.

1.9 There may be small fluctuations in scheme costs between valuations. So that these do not lead to frequent small changes in the scheme after each valuation, there will be a two percentage point margin above and below the cap. The upper margin will form a 'ceiling' on the employer contribution rate, with the lower margin forming a 'floor'. For example, if the employer cost cap is set at 14 per cent of pensionable pay, the ceiling and floor will be set at 16 and 12 per cent respectively.

1.10 For the unfunded schemes, employer contribution rates, as calculated at future valuations, will be compared to the cap. If costs change so that the employer contribution rate needed to meet the costs of providing pensions rises above the ceiling or falls below the floor, action will be required to restore costs to the level of the cap. It is necessary that costs return to the level of the cap to ensure that costs do not remain two percentage points above or below the level of the cap in the long term. A long term increase in the costs of the scheme would not be fair to taxpayers, whereas the opposite would not be fair to scheme members.

1.11 Using the example in paragraph 1.9, if a subsequent valuation determines that the employer contribution rate needs to rise to 17 percent of pensionable pay to meet the costs of the scheme, action would be needed to reduce this to 14 percent. Similarly, if the valuation showed that the contribution rate would fall to 11 percent, action would be taken to restore this to the 14 percent level. Variations between 12 and 16 per cent would not automatically require any adjustment to the scheme.

1.12 The Public Service Pensions Bill makes provision for scheme regulations to set out the procedure to be followed should such a breach of the ceiling or floor occur. There will be a process of consultation to allow the responsible authority, the scheme managers, employers and members (or their representatives) to reach agreement on how the scheme costs will be returned to the level of the cap. This adjustment to the employer contribution rate may be brought about via a change in the benefits members accrue going forward, a change to member contributions, or some other adjustment. There is no intention to make changes to benefits already accrued via the cost cap mechanism. Treasury consent will be required before the changes are implemented, in line with the general requirement for Treasury consent for scheme changes.

1.13 While the Government expects that agreement would be reached via this process, the Bill sets out that there may be a default action if this is not the case. Scheme regulations will

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2 Available at http://www.hm-treasury.gov.uk/tax_pensions_resources.htm

3 Independent Public Service Pensions Commission Final Report, 10 March 2010, pages 159-162, http://www.hmtreasury.gov.uk/d/hutton_pensions.htm

therefore set out what should be changed if there is no agreement within a specified period. This will have the effect of adjusting members' future benefit accruals or contribution rates so that the costs of providing the revised pension scheme are in line with the cap.

Costs that will be controlled by the cap

1.14 The contribution rate paid by employers covers several different elements of scheme costs. There are distinctions between:

- past service and future service costs of the schemes;
- the costs of pre- and post-reform schemes; and
- the costs associated with the active, deferred and pensioner members of the schemes.

1.15 Future service costs are the expected costs of the pension rights that members will accrue over a specified period in the future. These can increase or decrease between valuations if assumptions or the scheme's membership profile changes – for example due to a change in life expectancy assumptions.

1.16 Past service costs – which may be deficits or surpluses – arise if the costs of pension rights that have already been accrued turn out to be higher or lower than expected. This may happen if the scheme experience – for example, about retirement behaviour – differs from scheme expectations and so the contributions paid do not match the cost of the pension rights accrued during this period. Changes in assumptions can also affect past service costs in the same way that they can affect future service costs.

1.17 Past service costs relate to members who have already retired (pensioner members) or who have left the scheme but are yet to retire (deferred members), or to rights which active members have already accrued (i.e. benefits in respect of service they have already worked). As pensioner and deferred members will have accrued their rights in the existing schemes, and active members may have service in these schemes, past service costs may arise from the existing schemes even after the reformed schemes are introduced in 2015.

1.18 Employers will pay a contribution rate which reflects all of these elements of the costs of the scheme. However, the cap mechanism will be designed so that some of these elements are excluded. As only active members will see their benefits or contributions adjusted if the ceiling or floor is breached, the Government considers that it would be unfair to control all of the costs associated with pensioner and deferred members of the existing pension schemes. These elements of costs will therefore not be controlled by the cost cap mechanism.

1.19 The cost cap will control all other member cost risks, including the past and future cost risks associated with:

- Active members of the reformed schemes, including any service they have in the existing schemes[4];
- Deferred and pensioner members of the reformed schemes; and
- Transitionally protected active members of the existing schemes.

[4] The cost risks arising from active members' service in the existing schemes will be controlled by the cap where there has been no break in service of longer than five years between membership of the existing and new schemes. This is in line with the retention of the final salary link for members that rejoin active service within five years.

The details of this policy will be set out in directions. Scheme regulations will set out in more detail how this will be implemented for individual schemes.

1.20 This means there may be a difference between the employer contribution rate that is actually paid by employers, and the rate which is controlled by the cap. Public service employers, and ultimately the Exchequer, will bear the additional risk associated with pensioner and deferred members of the existing schemes, rather than members.

Changes in costs that will affect the cap

1.21 In addition to excluding the past service costs of deferred and pensioner members of the existing schemes, the Government has committed that cost risks associated with "employer" costs will not affect the operation of the cost cap. While these costs may affect the employer contribution rate that is actually paid, changes in these costs will not affect the cost cap mechanism. Only changes in those costs defined as "member costs" will affect the cap.

1.22 Many of the assumptions that must be made to carry out a valuation relate to the profile of scheme members – for example the expectations about their life expectancy, growth in salaries, or career paths. These will be defined as "member costs". Other decisions and assumptions that must be made to carry out a valuation are financial or technical in nature – for example the discount rate that is used to assess the present costs of future benefits, or the actuarial methodology to be used. These will be defined as "employer costs".

1.23 The Government has stated that adjustments will only be made via the cost cap mechanism if they arise from changes in the "member costs". Changes that arise solely from changes in "employer costs" will not be controlled by the employer cost cap and will not trigger changes in member contributions or benefits. Public service employers, and ultimately the Exchequer, will bear the risks of changes in these costs.

Setting the cap

1.24 The initial level of the cap will be set at a level that is deemed to be sustainable in the long-term. For the unfunded schemes, the cap will be set with reference to the results of the first valuation of the reformed schemes – this will help to ensure that future costs do not vary significantly when compared with the cap. For these schemes, valuations will use 2012 data and will be completed before the reformed schemes are introduced in April 2015.

1.25 As set out above, the valuation will determine an employer contribution rate necessary to meet all of the costs of the scheme. However, not all of these costs will be included when the level of the cap is set. It is expected that the cap will instead be set on the basis of the future service cost of the reformed schemes for all members, as assessed by the first valuation. Any past service deficits or surpluses that are uncovered at first valuations will not be included in the cap when it is first set, but will still be paid by employers.

1.26 Any new past service costs that arise from the second and subsequent valuations will, however, be controlled by the cap – any change in these will be counted when any movement towards the floor or ceiling is considered.

1.27 The assumptions used to set the cap will be the Government's best estimates about the future. We would not expect to generate cost pressures or savings at subsequent valuations unless there are changes to key variables. These changes may take the form of sudden shocks, or gradual changes which could lead to adjustments in assumptions.

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