HM TREASURY

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26 November 2014

Dear Martin

Public Service Pensions (Valuations and Employer Cost Cap) Directions 2014

It was good to meet you on 19 September and discuss the work that you will be taking forward in your new role, including work on the valuations of the public service pension schemes.

2. As has been noted in my correspondence with your predecessor, the Treasury recognises that it is important that these Directions are kept under review in order to ensure that they deliver the Government's policy with regard to scheme valuations and the employer cost cap. As the work on these valuations nears completion for many of the public service pension schemes, some further technical issues have emerged (each relating to specific schemes) which necessitate amendments to the Directions.

A. Amendment to Schedule 2: Notional Assets for First Valuation – NHS Superannuation Scheme (Scotland) (NHSSS) and Scottish Teachers' Superannuation Scheme (STSS)

3. I understand that in the process of conducting valuations, scheme actuaries typically carry out analyses to determine the underlying drivers of observed changes in the costs of providing pension benefits (as measured by employer contribution rates). Examples of such drivers of change include different valuation assumptions or methodology, or recent experience differing from previous assumptions.

4. I understand that these analyses typically include a residual balancing item which cannot be attributed to any single cause of change. This residual item is often, but not always, a relatively small contributing factor to the change in costs and generally reflects modelling simplifications in different parts of the analyses (including, for example, the data granularity and valuation models used in the current valuation and changes in these features relative to the previous valuation).

5. Initial valuation results for the schemes which makes provision for health service workers in Scotland (the NHS Superannuation Scheme, or NHSSS) and the Scottish Teachers' Superannuation Scheme (STSS) have revealed significant changes in the costs of providing pension benefits.

6. In respect of the NHSSS these changes cannot be directly attributed to any particular cause and a comparison of the initial assessment of scheme liabilities "as at" 2012 with liabilities "as at" 2004 (i.e. at the previous valuation) indicates a large increase in liabilities which cannot be attributed to any particular cause. Similarly, in respect of the STSS, a comparison of previous valuation results also highlights a large change in liabilities.

7. Further analysis of these results has indicated that these changes are very likely to be due to changes in the quality of the data used for these valuations.

8. Specifically, analyses of these valuation results indicate that the data used to set the opening balance of the notional assets (or "SCAPE fund" starting balance) equal to scheme liabilities for these two schemes was of poor quality, which led to a significant understatement of the opening balance of the notional assets. More recent valuation results, based on better quality data, have therefore shown large increases in scheme liabilities.

9. As these increases in liabilities are not matched by corresponding increases in the notional asset balances for each scheme, these changes would result in large scheme deficits. For the NHSSS, the cost of paying down this deficit over a 15 year spreading period, as specified in the Directions, would require an additional employer contribution of over 6 per cent of pensionable pay. For the STSS, the corresponding increase would be over 3 per cent of pensionable pay.

10. As you will be aware, the Treasury's approach with regard to the valuations of the public service pension schemes is (and remains) that these valuations should capture the full cost of providing the public service pension schemes. However, the Treasury's view is that without adjustments, the valuations of these schemes would include large unattributed effects which are likely to be due to significant changes in underlying data rather than real changes in pension costs. These would have significant effects on the contribution rates payable by employers. Including costs arising from data changes on this scale would be inconsistent with the Treasury's principles that the valuation results should reflect the full expected costs of the pension benefits provided by the schemes.

11. Officials from the Treasury have worked closely with their counterparts in the Scottish Public Pensions Agency to ensure that the adjustments to be made to the notional asset balances for the NHSSS and STSS maximise the likelihood that these adjustments reflect only data effects. The Treasury is now satisfied that it is unlikely that any further scrutiny of the data or assumptions underlying either these current (or previous) valuations would significantly increase the likelihood that the proposed adjustments will reflect only the unexpected

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differences between the previous datasets and the data to be used for the 2012 valuations.

12. As such, the Treasury proposes to bring forward the amending Directions 6(a) and 6(b) of the Annex to this letter to adjust the notional asset balances specified in the Directions in respect of the NHSSS and STSS.

B. Amendment to Schedule 2: Notional Assets for First Valuation – Firefighters' Pension Scheme in England

13. A similar issue has arisen in respect of the Firefighters' scheme in England. Earlier this year the Directions established the opening balance of the notional assets for this scheme using the 2007 valuation for that scheme.

14. As in the case of the Scottish schemes, initial results of the "as at" 2012 valuation of the Firefighters' pension scheme in England revealed a significant movement in the costs of providing pension benefits which could not be directly attributed to any particular change. For this scheme, these unattributed effects suggested a significant overstatement of the value of the schemes' liabilities that was used to determine the opening balance of this scheme's notional assets. This potentially causes a significant surplus in the scheme which, when spread over a 15 year spreading period as specified in the Directions, would reduce employer contributions by over 5 per cent of pensionable pay.

15. As in the case of the Scottish schemes, further analyses of these results and the data underpinning both the 2007 and the 2012 valuation have been completed. In the case of the Firefighters' scheme, further analysis has identified that these effects have arisen to a large extent because the data provided by some Fire and Rescue Authorities for the 2007 valuation included injury awards and pension increases awarded after 31 March 2007. As a result, it is clear that the 2007 valuation overstated the value of the scheme's liabilities as at 31 March 2007, and that this contributed to a large, and otherwise unexplained, surplus arising in the initial results of the 2012 valuation for this scheme.

16. As with the adjustments to be made in respect of the Scottish schemes, it would not be in line with the Treasury's principles for the employer contribution rate paid to the Firefighter's pension scheme to reflect the impact of these data issues. As such, the Treasury intends to bring forward amending Direction 6(c) to adjust the value of the opening balance of this scheme's notional assets.

17. As in the case of the Scottish schemes, officials from the Treasury have worked closely with their counterparts in the Department for Communities and Local Government to ensure that the adjustment to be made to the notional asset balance for the Firefighters' pension scheme in England maximises the likelihood that the adjustments reflects only data effects. The Treasury is now satisfied that it is unlikely that any further scrutiny of the data or assumptions

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underlying either the current (or previous) valuations would significantly increase the likelihood that the proposed adjustments will reflect only the unexpected differences between the 2007 dataset and the data to be used for the 2012 valuations.

Future action on quality of scheme valuation data

18. The Treasury is concerned about the data problems highlighted by these valuations.

19. In line with the recommendations of the Independent Public Service Pensions Commission, the Public Service Pensions Act 2013 establishes a new governance framework for the public service pension schemes. It is anticipated that these new governance structures will go some way towards ensuring that schemes are able to provide high quality valuation data in the future. The Treasury also plans to explore this issue further in 2015, after the introduction of the new schemes, and to consider whether schemes should be taking any additional steps to improve the quality of their valuation data. However, given the adjustments to the Directions that have been required in respect of the Scottish NHS and teachers' schemes, and the Firefighters' scheme in England, we will also work with the departments responsible for those schemes to consider whether there are any specific actions they should take to improve the quality of their data.

C. Amendments to Schedule 1: Connected Schemes and Schedule 3: Preliminary Valuation

20. Minor changes are required to amend the legislative references in Schedule 1 and Schedule 3 in respect of the pension scheme for local government workers in Scotland, the Armed Forces Pension Scheme and the Firefighters' pension scheme in England before the preliminary valuations can formally proceed to completion.

21. Schedules 1 and 3 list the details of the existing pension schemes, which are to be valued as part of the preliminary and subsequent valuations of the schemes.

22. In relation to the valuation of the scheme which provides pension benefits for members of the Armed Forces, it has recently come to light that an additional legislative reference is required to ensure that all the features of the existing scheme are in scope of the valuations. In particular, there are provisions within the Armed Forces Pension Scheme 1975 which allow members who retire with an immediate pension before age 55 to take temporary commutation of part of their pension up to age 55. However, the statutory instrument by which this provision is made – Part 4 of the Armed Forces (Redundancy, Resettlement and Gratuity Earnings Schemes) Order 2010 – is not currently listed in Schedule 1, or in column 2 of Schedule 3 of the Directions. The amending Directions 5(b) and 7(3) at the Annex insert these references into

the relevant Schedules.

23. Similarly, amendments to Schedules 1 and 3 are required in relation to the Local Government Pension Scheme in Scotland. Previously, pension provision for local government workers in Scotland was made via three sets of regulations:

- The Local Government Pension Scheme (Scotland) Regulations 1998, as preserved by the Local Government Pension Scheme (Transitional Provisions) (Scotland) Regulations 2008;
- The Local Government Pension Scheme (Benefits, Membership and Contributions) (Scotland) Regulations 2008; and
- The Local Government Pension Scheme (Administration) (Scotland) Regulations 2008.

24. Transitional regulations making provision for local government workers in Scotland who have accrued benefits in these schemes prior to 1 April 2015 have now been made. As such, these regulations have been superseded by the Local Government Pension Scheme (Scotland) Regulations 2014 and the Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) (Scotland) Regulations 2014, insofar as those regulations relate to benefits accrued on or before 31 March 2015. Amending Directions 5(a) and 7(1)(a) update the relevant references in Schedules 1 and 3 accordingly.

25. Schedule 3 also lists the details of the proposed new pension schemes which are to be valued as part of the preliminary valuation. In relation to the new scheme for local government workers in Scotland, the schedule includes a reference to the draft Local Government Pension Scheme (Scotland) Regulations 2014, insofar as these Regulations are deemed to be a scheme made under section 1 of the Public Service Pensions Act 2013 by section 28 of that Act.

26. The regulations which will make provision for the new pension scheme for local government workers in Scotland after 2015 have also now been formally made. In addition to the provision made in the final Local Government Pension Scheme (Scotland) Regulations 2014, some of the pension benefits available to members of these schemes are provided for by the Local Government Pension Scheme (Transitional Provisions and Savings) (Scotland) Regulations 2014. The proposed amendment, as detailed in amending Direction 7(1)(b), therefore inserts a reference to the 2014 Regulations into Schedule 3, and updates the reference more generally. Without this amendment the valuations of the pension scheme for local government workers in Scotland would only capture some elements of the benefits provided for these workers. Including these amendments ensures that the entire scheme is taken into account when conducting valuations for the local government workers in Scotland.

27. A similar change is also needed in respect of the Firefighters' Pension Scheme in England. As drafted, the Directions require scheme actuaries to value the pension benefits as detailed in the Firefighters' Pension Scheme in England Proposed Final Agreement published 24th May 2012. Since the Directions were

first published, the Government has made an adjustment to the design of the new pension scheme, and the relevant regulations have been laid as The Firefighters' Pension Scheme (England) Regulations 2014. Amending Direction 7(2) replaces the previous reference with a reference to these regulations. This will ensure that the correct scheme design for firefighters' in England will be taken into account when employer contribution rates for that scheme are determined and the employer cost cap is set.

D. Further amendments in respect of the scheme for local government workers in Scotland

28. Finally, the proposed amending Directions make a further change in respect of local government workers in Scotland. Directions 9(5) and 18(c) ensure that the valuation carried out in respect of local government workers in England and Wales value the scheme as if no person had made an election under Regulation 10 of the Local Government Pension Scheme regulations 2013. These provisions ensure that the effects of the "50/50" option available in that scheme – the option to accrue half the standard rate of benefits in exchange for half of the standard rate of member contributions – is ignored for the purpose of the operation of the employer cost cap mechanism in respect of that scheme. This is in line with the Treasury's policy intention that changes in the take up of this option should not affect the operation of the employer cost cap mechanism. The proposed amendments 3 and 4 of the amending Directions at the Annex to this letter replicate this provision in respect of local government workers in Scotland, to ensure that this policy intent is also delivered in the operation of the employer cost cap mechanism for the Local Government Pension Scheme in Scotland.

29. I would be grateful if you could offer your professional opinion on these revisions to the Directions, particularly whether the revised directions will deliver our policy intention. I look forward to receiving your views in respect of this statutory consultation.

Yours sincerely

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Annex – Proposed amending Directions

HM Treasury

The Public Service Pensions (Valuations and Employer Cost Cap) (Amendment) (No. 3) Directions 2014

The Treasury, in exercise of the powers conferred on them by sections 11(2) and 12(3) of the Public Service Pensions Act 2013([1]), make the following Directions.

Citation and entry into force

1. These Directions may be cited as the Public Service Pensions (Valuations and Employer Cost Cap) (Amendment) (No. 3) Directions 2014, and come into force on the date that they are signed.

Amendment of the 2014 Directions

2. The Public Service Pensions (Valuations and Employer Cost Cap) Directions 2014 are amended as follows.

3. Add as direction 9(6) "In respect of a scheme established for local government workers in Scotland, the responsible person must ensure that the data provided to the scheme actuary is adjusted as if no member has made an election under regulation 10 of the Local Government Pension Scheme (Scotland) Regulations 2014([2]).".

4. For direction 18(c) substitute–

"(c) no members of a scheme providing benefits to local government workers–

(i) in England and Wales ever have, or ever will, make an election under regulation 10 of the Local Government Pension Scheme Regulations 2013; or

(ii) in Scotland ever have, or ever will, make an election under regulation 10 of the Local Government Pension Scheme (Scotland) Regulations 2014;"

5. In the second column of the table in Schedule 1 –

(a) for the entry in the fourth row (Local government workers (Scotland)), substitute "The scheme established in the Local Government Pension Scheme (Scotland) Regulations 2014 and the Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) (Scotland) Regulations 2014, to the extent that the scheme relates to benefits accrued in respect of service on or before 31 March 2015"; and

(b) in the entry in the fourteenth row (Members of the armed forces), for "10." substitute "11." and add after "9. The Reserve Forces (Full Time Reserve Service Pension Scheme 1997) Regulations 2010" the entry "10. Part 4 of the Armed Forces (Redundancy, Resettlement and Gratuity Earnings Schemes) Order 2010".

6. In the second column of the table in Schedule 2–

(a) for the entry in the fourth row (Teachers (Scotland)), substitute "£13,630,000,000";

([1]) 2013 c. 25.

([2]) S.S.I. 2014/164

(b) for the entry in the sixth row (Health service workers (Scotland)) substitute "£14,492,000,000"; and

(c) for the entry in the seventh row (Fire and rescue workers (England)) substitute "£13,100,000,000".

7.—(1) In the fourth row of the table in Schedule 3 (local government workers (Scotland))–

(a) for the entry in the second column substitute "The scheme established in the Local Government Pension Scheme (Scotland) Regulations 2014 and the Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) (Scotland) Regulations 2014, insofar as that the scheme relates to benefits accrued in respect of service on or before 31 March 2015"; and

(b) for the entry in the third column substitute "The scheme established in the Local Government Pension Scheme (Scotland) Regulations 2014 and the Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) (Scotland) Regulations 2014, insofar as that the scheme relates to benefits accrued in respect of service on or after 1 April 2015".

(2) In the ninth row of the table in Schedule 3 (Fire and rescue workers (England)), for the entry in the third column substitute "The scheme established by the Firefighters' Pension Scheme (England) Regulations 2014".

(3) In the fourteenth row of the table in Schedule 3 (Members of the armed forces), in the entry in the second column, for "10." substitute "11." and add after "9. The Reserve Forces (Full Time Reserve Service Pension Scheme 1997) Regulations 2010" the entry "10. Part 4 of the Armed Forces (Redundancy, Resettlement and Gratuity Earnings Schemes) Order 2010".

Signed

[redacted]
Director General, Public Spending and Finance
for Her Majesty's Treasury

[X] 2014

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