Unfunded Public Service Pension Schemes

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18 May 2011

GAD role in recent discount rate consultation

- “In house adviser”
- Part of the process
- Supplier of information
- Support with technical forums etc.

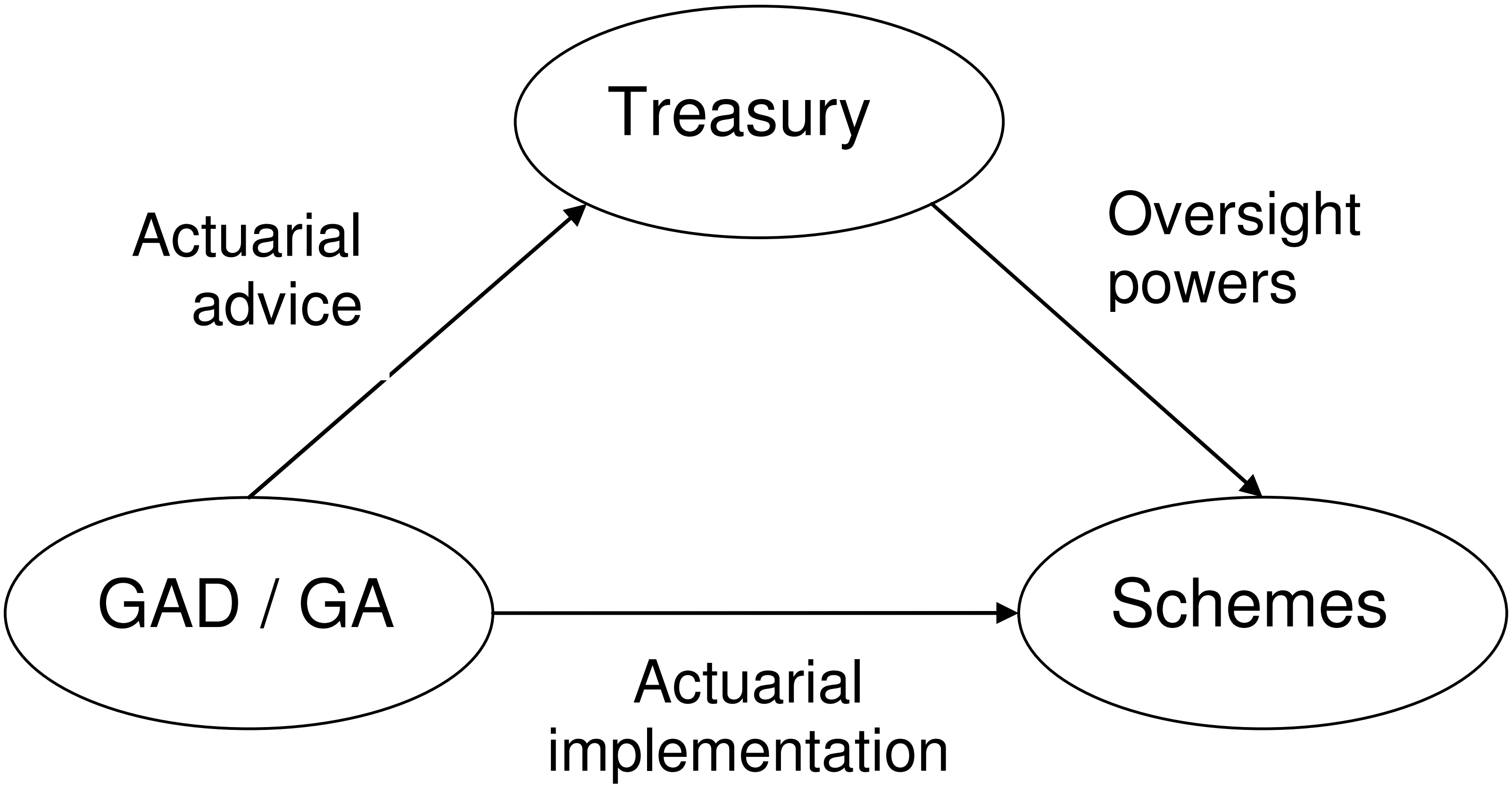
"People are entitled to their own opinions but they are not entitled to their own facts"

Stephen Chu US Secretary of Energy

What is different about public sector pensions?

Issue	Pensions Act Scheme	UK Insurance Companies	Central Government Public Sector Pension
Legislation	One regime for all	One regime for all	Many regimes
Funding	Funded	Funded	Unfunded
Drivers Of Actuarial Work	Solvency, Contributions, Factors, Accounting, M&A ALM	Solvency Premiums, Options Accounting, M&A, ALM	Fairness for inter-generational tax payers, Contributions, Factors, Accounting, Outsourcing
Intended to manage the risk of sponsor insolvency	Yes	Yes	No
Role Of Actuary	Adviser	Adviser	Adviser & Determinator
Which Tools Need To Be Used	Micro-economic	Micro-economic	Macro and Micro-economic

How the assumptions process works (historically)



What discount rates are used for the unfunded schemes?

Previously using SCAPE 3.5% over RPI

1. Contributions (i) within government – the vast majority
   (ii) from independent parties (independent schools, GPs)
2. Outsourcing
3. Factors
4. Employee reward statements
5. Cap and share

Currently using other

6. Resource accounts (corporate bond based)

Note

The recent consultation related to the use of 3.5% for 1 (i) and (ii). Rest to be determined later.

Some facts (or debunking of myths)

1. Public sector pensions are run and accounted for (in terms of Total Managed Expenditure, PSBR) on a PAYG basis
2. Discount rate has no direct impact (apart from the minority 1 (ii) above) on PSBR, tax, the tax-payer, affordability, sustainability
3. SCAPE contributions of type 1 (i) are like management charges between TOPCO and sub of private sector corporate groups
4. The Government finances any extra cost on departments arising from lower discount rates through central funding so that departmental budgets will not come under additional pressure
5. If the discount rate were to fall for 1 (i) the direct practical impact is negligible (see 2 above) but there are then consequences on:
    - perceptions
    - comparison of bids in tender exercises (not involving staff transfers)
    - whole-of-Government consistency
    - possible (but not necessarily so) consequences for the other purposes
6. Costs do not double (see over….)

Net public service pensions expenditure

OBR June 2010 Pre-Budget forecast

£ billion

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Benefit expenditure	22.5	24.3	25.4	27.0	28.5	30.4	32.1
Contribution income	-19.4	-21.2	-21.3	-21.5	-21.3	-21.4	-21.8
Cap and Share					-1.0	-1.0	-1.0
Net public service pensions	3.1	3.1	4.0	5.5	6.2	8.0	9.4

- Expenditure and income on a cash basis (ie not IAS 19)
- Covers pension schemes for civil service, Armed forces, teachers, NHS; does not including pension schemes for the police, firefighters and local government
- Contribution income includes payments from employees and employers (eg Government departments, NHS trusts)
- Cap and share is projected increase in employee contributions as a result of the previous Government's policies
- Source: OBR, June 2010

Some observations

BAS
TAS

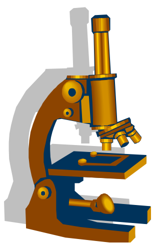
→

Materiality
+
Proportionality

→

Very Applicable
–
no solvency/prudence

V



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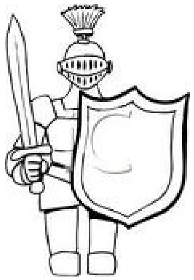

SCAPE discount rate

SCAPE Contributions – recap of approach

- The contributions paid (by employer and employees) are set to reflect the cost of pensions earned by employee in year
  - Adjustment if past contributions were too high or too low
- Projected future expenditure expressed in today's terms using a discount rate
- Employer contributions provide budgetary control over employers (but do not affect the ultimate cost to taxpayers)

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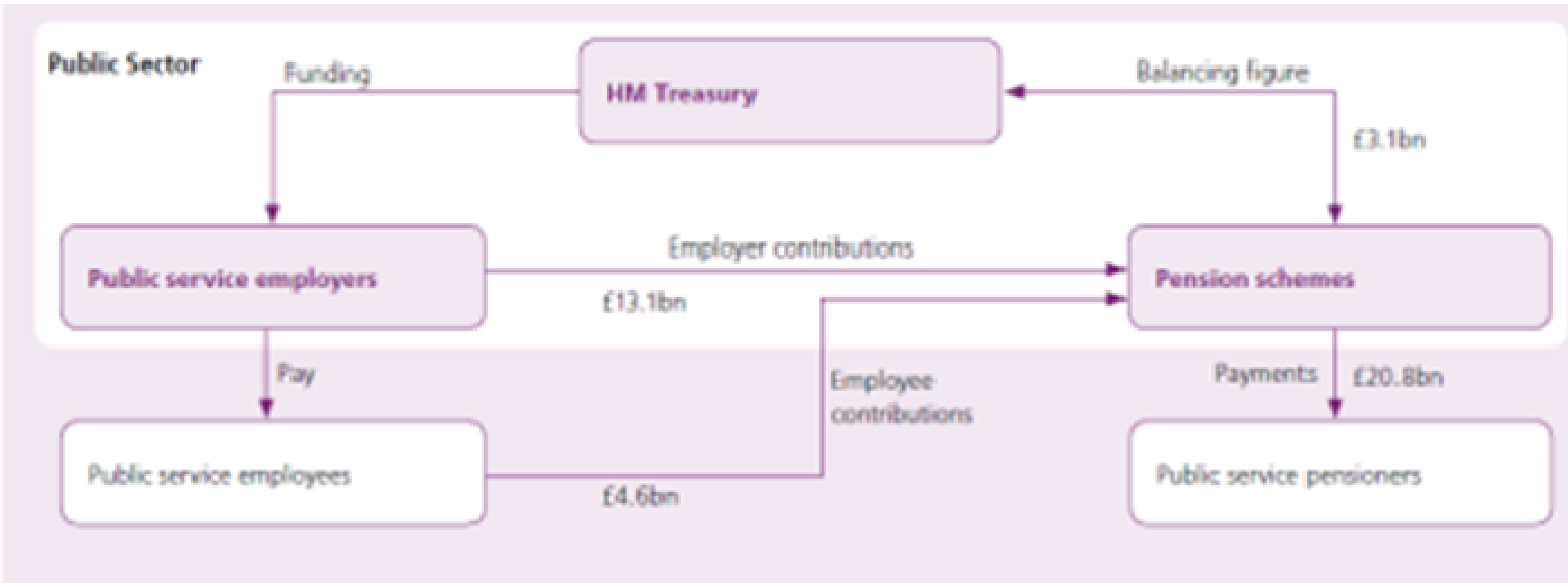
Unfunded public service pension schemes

Contributions and pension expenditure



Source: Independent Public Service Pensions Commission, Interim Report, 7 October 2010, Box 1.B
Note: Figures for AFPS, PCSPS, TPS (E&W), NHSPS (E&W) in 2009-10

Note: Member contributions to increase from April 2012 by average of 3%, but phased and progressive

Unfunded public service pension schemes

Long Term Projection of Costs

Source: Independent Public Service Pensions Commission, Interim Report, 7 October 2010, Chart 4.A

Note: Pensions indexation based on CPI from Apr 2011

SCAPE discount rate

Who is affected by a reduction in the discount rate?

- Employers within the public sector
  - Departmental budgets will not come under additional pressure
- Independent providers with access to schemes
  - Contributions up (but note other factors)
- New independent providers
  - Cost advantage of public service providers may be reduced
- Future Government expenditure
  - Increased contributions do not increase Government Expenditure
- Members (Options, transfer values – beyond scope of consultation)

SCAPE discount rate

5 objectives for the SCAPE discount rate

- Fair reflection of costs
- Reflect future risks to Government income
- Support plurality of provision of public services
- Transparent and simple
- Stability

- Conclusion was that first 2 are most important

SCAPE discount rate

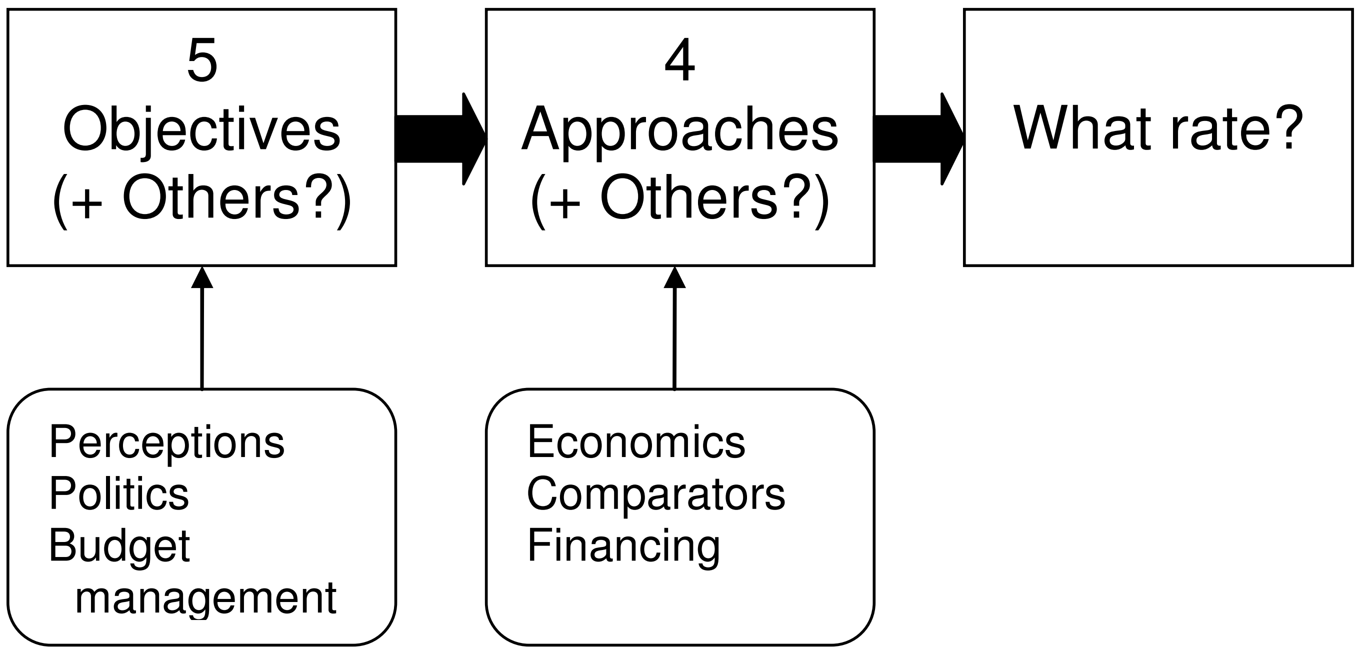
4 options considered for approach to setting rate

- Consistent with private sector and other funded schemes
- Based on the yield on index-linked gilts
- In line with expected GDP growth
- Based on social-time preference rate (with or without adjustment)

- Govt recognised case to be made for all options (as did Actuarial Profession response)

SCAPE discount rate

Structure of the SCAPE consultation



> Where exactly does the actuary fit in?

ILG yields

<u>Some arguments put forward in consultation responses:</u>

- Value attached by capital markets to Govt cashflows
- Cost for a funded scheme backed by assets of an equivalent maturity, risk profile and credit quality
- But does it represent cost to Government?
  - when Govt is monopoly supplier to ILG market
- Yields would rise if more ILGs issued to fund schemes
- “would not assist the objective of stability nor the fair reflection of costs” (Actuarial Profession response)
- Ultimately Govt finds the arguments against this option persuasive

GDP growth

Some arguments put forward in consultation responses:

- Future source of income to fund liabilities is the tax base, so contributions should be set with reference to future growth of that income stream
- Best ensures that the future cost of the public service unfunded schemes remains affordable
- Intergenerational fairness
- Makes comparison with private sector more difficult
- Drawback of basing on a forecast
- Ultimately Govt believes this option best meets the purposes and objectives identified

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SCAPE – Recap of conclusion

- Recall previous rate was 3.5% real (net of RPI)
- Govt recognised case to be made for all options
- In light of objectives decided to use GDP growth
  - “theoretically sound and practical”
  - rate adopted is 3% real (net of CPI)

"In the long history of humankind (and animal kind, too) those who learned to collaborate and improvise most effectively have prevailed"

Charles Darwin