



Reference:

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By email only to James.Richardson@hmtreasury.gsi.gov.uk

31 August 2011

Dear James

**Cost ceilings for scheme level discussions:
Advice on transition and past service costs**

Thank you for your letter dated 31 August 2011 requesting that I supply advice which will inform HM Treasury's determination of data, methodology and assumptions for the purpose of assessing costs arising from past service effects and transitional arrangements in the cost ceiling process.

As requested, I am pleased to attach a report providing initial advice by Michael Scanlon on appropriate methodology, data and assumptions for this purpose.

In my opinion the report produced by Michael and the HM Treasury Workforce Pay and Pensions advisory team in GAD provides an approach which meets the HM Treasury objectives in a way which, on an interim basis, seeks to deliver balance and fairness against those objectives.

I understand that HM Treasury is also engaging with others in order to inform its decision, and we will be happy to provide further advice as required.

Yours sincerely

Trevor Llanwarne
Government Actuary

cc: Stephen Humphrey, GAD
Michael Scanlon, GAD



HM Treasury
Cost ceilings for scheme level discussions
Initial advice on transition and past service costs

Date: 31 August 2011

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HM Treasury: Cost ceilings for scheme level discussions
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1 Introduction

- 1.1 On 19 July 2011, the Chief Secretary to the Treasury (Rt Hon Danny Alexander MP) announced that the Government will provide scheme-specific cost ceilings. The objective of the cost ceilings is to allow scheme specific discussions to deliver pension scheme designs that reflect the differing characteristics of different workforces, within specified cost limits.

Cost ceilings

- 1.2 Cost ceilings will be set with reference to the scheme specific contribution rates required to provide the benefits for a 'Reference Scheme' design, specified by HM Treasury. The contribution rate required in respect of a proposal for benefit design must be less than or equal to the cost ceiling

HM Treasury process for determining methodology, data and assumptions

- 1.3 HM Treasury will specify the data, methodology and assumptions for the purpose of setting cost ceilings, assessing costs arising from past service effects and transitional arrangements, and verifying that proposed pension scheme designs are within the cost ceiling, having obtained advice from GAD.
- 1.4 HM Treasury is also engaging with others in order to inform its decision.
- 1.5 HM Treasury has commissioned GAD to provide initial advice on appropriate methodology, data and assumptions to be used for the purpose of assessing costs arising from past service effects and transitional arrangements.
- 1.6 This note sets out GAD's initial advice on the appropriate methodology, data and assumptions for the purpose of assessing costs arising from past service effects and transitional arrangements. This note should be read in conjunction with our note of 31 August 2011: *Cost ceilings for scheme level discussions: Final draft advice on data, methodology and assumptions*.

Transition and past service costs

- 1.7 As noted in the annexes attached to James Richardson's letter of 22 July 2011 to Jeremy Pocklington, any variations to the 'reference scheme' which would lead to further costs relating to past service effects and transitional arrangements will need to be proposed with other variations to the 'reference scheme' which generate equivalent cost reductions.
- 1.8 HM Treasury has set the baseline scheme design against which the proposals for reformed schemes will be measured, as follows:
- > Benefits in respect of service up to and including 31 March 2015: accrued rights as at 31 March 2015, plus the final salary link, where applicable
 - > Benefits in respect of service from 1 April 2015: 'reference scheme'
- 1.9 This note is based on our understanding of the terms 'transitional arrangements' and 'past service effects', as set out in section 2. We understand that this is in line with the intended meaning of those terms in the annexes attached to James Richardson's letter of 22 July 2011 to Jeremy Pocklington.

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GAD's initial advice on past service effects and transitional arrangements

- 1.10 We set out our initial advice on appropriate data, methodology and assumptions for the purpose of assessing costs arising from past service effects and transitional arrangements in Section 2.
- 1.11 This advice is presented so that it could be incorporated as an extra section within subsequent iterations of our note of 31 August 2011: *Cost ceilings for scheme level discussions: Final draft advice on data, methodology and assumptions*, and it is intended this is done in due course.

Averaging and spreading periods

- 1.12 In the framework suggested in section 2, HM Treasury would need to determine the length of the period over which the average contribution rate is considered for transitional arrangements and, separately, the length of the spreading period for past service costs, having regard to the objectives for cost ceilings.
- 1.13 If there was no spreading period for past service costs or averaging period for transitional costs, then the cost ceiling would mean that the costs of proposals for reformed schemes would have to be lower than the costs of the reference scheme in the year from 1 April 2015¹.
- 1.14 The effect of the spreading period and averaging period is that the cost of proposals for reformed schemes may be higher than the cost of the reference scheme initially, so long as these are balanced by the cost of proposals for reformed schemes being lower subsequently, within the averaging period.
- 1.15 Choosing a shorter, rather than longer, averaging period or spreading period would reduce the period of time over which the costs of proposals for scheme reforms could exceed the costs of the reference scheme. A shorter averaging period or spreading period therefore provides tighter control of costs in the near term, but may mean that proposals with significant past service effects or long lasting transitional arrangements could not be accommodated within the cost ceiling.
- 1.16 It is also important to have a cost control beyond the averaging period over which transitional costs are measured. It is likely that most proposals for reformed schemes that are below the cost ceiling during the averaging period would also be below the cost ceiling after that period. However we do suggest that HM Treasury also considers whether proposals for scheme designs may create additional cost risks beyond the period over which transitional costs are measured.
- 1.17 The period over which the average contribution rate required is considered could be different to the period over which past service costs are spread, although we suggest that HM Treasury considers whether they should be the same.

Employer contribution caps

- 1.18 James Richardson's letter of 22 July 2011 to Jeremy Pocklington noted that, in the future, the taxpayers' contributions to the schemes will be capped by an 'employer contribution cap', which will be applied to the employer's portion of SCAPE contribution rates emerging from the scheme valuations. That letter also explained that the setting of cost ceilings is a separate process from determining the future 'employer

¹ References to 'cost' in this paragraph (and subsequent paragraphs) are to the cost of benefits accrued by members during the year. These benefits would be paid to members after their retirement, potentially many years in the future. Some benefits may be payable to the member's dependants, after the member's death.

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contribution caps'. In order to avoid misunderstandings, it may be helpful if HM Treasury were to reiterate this point in subsequent communications to schemes and other interested parties. For the avoidance of doubt, this note considers the treatment of transitional arrangements and past service effects within the cost ceiling process; it does not consider the period over which any surpluses or deficits arising in future SCAPE scheme valuations may be spread.

- 1.19 We understand that the process of determining employer contribution caps, and the methodology and assumptions to be used for the purpose of implementing them, will be set out in due course. It may be helpful if HM Treasury were to provide an indication of the timescales for this process.
- 1.20 The period over which any surpluses or deficits arising in future SCAPE scheme valuations may be spread will need to be considered as part of the process for determining how the future 'employer contribution caps' will operate. It will also be necessary to consider how any transitional arrangements and past service costs are treated within the future 'employer contribution caps'. When setting the averaging period and spreading period for cost ceilings, we suggest that HM Treasury considers the potential impact on the spreading period in actuarial valuations for 'employer contribution caps'. There might be an expectation that the future 'employer contribution caps' would be set to accommodate a proposal for scheme reforms that is within the cost ceilings, and this might imply that the spreading period actuarial valuations for 'employer contribution caps' would need to be no shorter than the averaging period and spreading period for cost ceilings in order to avoid an adverse impact.

Purpose, users and commissioning

- 1.21 This report has been prepared by GAD at the request of HM Treasury. The purpose of the report is to provide initial advice on the appropriate methodology, data and assumptions for the purpose of assessing costs arising from past service effects and transitional arrangements in cost ceiling calculations.

Third party reliance and liability

- 1.22 This report has been prepared for HM Treasury. I am content for HM Treasury to release this report to third parties (including public service schemes, trades unions and respective scheme actuaries), provided that:
 - > it is released in full
 - > the advice is not quoted selectively or partially, and
 - > GAD is identified as the source of the report
- 1.23 Third parties whose interests may differ from those of HM Treasury should be encouraged to seek their own actuarial advice where appropriate.
- 1.24 Other than HM Treasury, no person or third party is entitled to place any reliance on the contents of this report, except to any extent explicitly stated herein, and GAD has no liability to any person or third party for any act or omission taken, either in whole or in part, on the basis of this report. If any contents of this report are to be used to inform any Government policy decisions GAD should be consulted before those decisions are made.

2 Costs arising from past service effects and transitional arrangements

- 2.1 We understand transitional arrangements to be temporary variations to proposals for reformed schemes that will affect the accrual of benefits after 1 April 2015. We understand past service effects to be improvements to benefits in respect of service up to and including 31 March 2015 above the baseline of accrued rights plus the final salary link that becomes an entitlement at 31 March 2015 without any further service requirement.
- 2.2 In order to define the costs arising from past service effects and transitional arrangements as above, it is necessary to be able to split the total benefit that would be provided in the reformed schemes into two parts: those relating to service before and after 31 March 2015. A suggested method of attributing benefits to periods of pensionable service is set out in Appendix A.
- 2.3 Since transitional arrangements relate to the accrual of benefits after 1 April 2015, the contribution rate required in respect of the proposed accrual of benefits after 1 April 2015 can include the effects of transitional arrangements. However past service effects create an immediate one-off obligation, and it is necessary to provide a methodology to include such obligations within the cost ceiling.

Recommendations

- 2.4 We suggest that the costs arising from past service effects are spread over a period of years.
- 2.5 To provide some flexibility for transitional arrangements, we suggest that the average contribution rate required over a period of years from 2015 is compared against the cost ceiling.
- 2.6 The costs of proposals for reformed schemes, including costs relating to past service effects and transitional arrangements, would then be compared with the cost ceilings as follows:

$$\begin{array}{|c|} \hline \text{Average contribution} \\ \text{rate required} \\ \text{in period of years} \\ \text{from 2015} \\ \hline \end{array} + \begin{array}{|c|} \hline \text{Past service costs} \\ \text{spread over} \\ \text{a period of years} \\ \text{from 2015} \\ \hline \end{array} \leq \begin{array}{|c|} \hline \text{Cost ceiling} \\ \hline \end{array}$$

- 2.7 We suggest that the data and assumptions adopted to measure transition and past service costs are consistent with the data and assumptions adopted to set cost ceilings. In particular, we suggest that the averaging and spreading calculations should allow for the changes in pensionable pay and the time value of money.
- 2.8 It is also important to have a cost control beyond the averaging period over which transitional costs are measured. We suggest that HM Treasury also considers whether proposals for scheme designs may create additional cost risks beyond this period.

Rationales for recommendations

- 2.9 We have made the above recommendations for consistency with the data, methodology and assumptions for the purpose of setting cost ceilings.
- 2.10 We have suggested that the costs arising from past service effects are spread over a period of years for simplicity and transparency, because a similar method is typically used to spread surpluses or deficits in the actuarial valuations of the schemes.

Appendix A: Attributing benefits to periods of service

- A.1 In many cases it is clear how to attribute the benefits to different periods of service. For example, it is straightforward to attribute a benefit of the form of “a pension of one eightieth of salary for each year of service” to different periods of service.
- A.2 However, it is less clear how other benefits should be ascribed to different periods of service. For example, it is not clear how a benefit in the form of “a lump sum of twice salary on death in service and an annual dependant’s pension of half the member’s annual salary” should be ascribed to different periods of service, because the benefit does not build up with each year of service.
- A.3 The baseline scheme design in paragraph 1.8 provides a natural attribution for the benefits that relate to service on or before 31 March 2015: these are the accrued rights as at 31 March 2015, plus the final salary link, where applicable. We suggest that all other benefits in the baseline scheme design are ascribed to service from 1 April 2015.
- A.4 We suggest that the benefits in the proposals for reformed schemes are ascribed to periods of service in a way consistent with that set out in paragraph A.3 above.
- A.5 In cases where it is not clear how to apply paragraphs A.3 and A.4 above to ascribe benefits to periods of service, then we suggest that suitable adaptations of the method set out in International Accounting Standard 19 are used.