FAQs for the National Council and National Board on the Actuarial Valuation of the Police Pension Schemes

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1. **What is an actuarial valuation?**

   An actuarial valuation is an analysis performed by an actuary[1] into a pension scheme's finances to test that the contributions paid into the scheme are sufficient to meet the benefits which are promised from it. The valuation is based on a snapshot of a pension scheme's finances on a particular date.

2. **What impact does an actuarial valuation have in respect of public service pension schemes, such as the police pension schemes?**

   In most public service pension schemes, including the police pension schemes, the contributions made by employers and scheme members cover the costs of providing pensions under the scheme. The actuarial valuation will determine how much needs to be paid into the schemes to meet these costs, for the next four years.

   Under the Public Service Pensions Act 2013 ("the Act") public service schemes, like the police schemes, must conduct actuarial valuations every four years. The actuarial valuation of the police schemes is conducted by the scheme actuary, the Government Actuary's Department ("GAD").

   HM Treasury ("HMT") determines the specifics of how an actuarial valuation for public service pension schemes should be conducted, through its valuation directions. These cover things like the assumptions to be used (e.g. for members' earnings and longevity) and what the actuarial valuation report must contain.

[1] Pension actuaries work with other specialists, such as pension lawyers and administrators, to help pension schemes meet the needs of scheme sponsors, employers and scheme members. Actuaries are professional mathematicians who provide specialist advice on issues such as scheme valuations and funding (ensuring the contributions into the scheme are sufficient to meet the benefits which are promised from it) and scheme design (the level and form of benefits to be provided to the members).

The two main purposes of actuarial valuations of public service pension schemes are:

i. To see if the cost of the scheme is on target. This is determined via the Employer Cost Cap mechanism (see Q3 for more details); and
ii. To determine the employers' contribution rate.

3. What is the Employer Cost Cap mechanism?

There is a target cost of each public service pension scheme, known as the Employer Cost Cap. To be judged to be close enough to target, schemes must remain within specified margins either side of the Employer Cost Cap. Actuarial valuations measure future costs against the Employer Cost Cap and if it shows that there has been unexpected changes in costs, which go beyond the specified margins, then action will need to be taken to rectify the position.

There are two types of costs. Member costs relate to assumptions which need to be made about the profile of scheme members, such as members' life expectancy, salary growth and career paths. Employer costs relate to financial or technical assumptions about pensions (such as the 'discount rate', which is used to assess the current cost of future payments to members from the scheme. For example, a cost of £100 today is ***not*** what is needed to pay out £100 in the future, because of inflation, interest on investments, and so on).

The Employer Cost Cap is designed to control changes in unexpected "member costs" rather than "employer costs". If there are changes to "employer costs" these will feed into any adjustment of the employer contribution rate.

4. What does the Employer Cost Cap mean for the police pension schemes?

The target cost of the police pension schemes, the Employer Cost Cap, is set at 12.8% of pensionable pay, with a 2% margin either side. An actuarial valuation measures future costs against the Employer Cost Cap. If a valuation shows that there has been unexpected changes in costs which mean that the Employer Cost Cap level has risen above 14.8% or has fallen below 10.8% then that will constitute a breach.

5. What happens if there is a breach of the Employer Cost Cap in the police pension schemes?

If there is a breach, action will need to be taken to return scheme costs to the level of the Employer Cost Cap (12.8% of pensionable pay). The first step is that the Home Secretary will consult the police pension schemes' governance body, the Scheme Advisory Board[2] ("SAB") for its advice on how to do this. Under Section 12(7) of the Act the steps which are taken to rectify the breach may include a change to members' benefits and/or members' contributions.[3]

If agreement cannot be reached between the Home Secretary and the SAB, the default position under the Police Pensions Regulations 2015 is that the accrual rate of CARE 2015 Scheme members is adjusted accordingly (i.e. if future costs have fallen below 10.8%, the accrual rate will be improved from 1/55.3. If future costs have risen above 14.8%, the accrual rate will be worsened from 1/55.3).

6. What is the current position with the actuarial valuation of the police pension schemes?

The actuarial valuation of the three police pension schemes is taking place now, based on a snapshot of the financial position of the schemes as at 31 March 2016.

On 6 September HMT published its draft valuation directions, which set out how the actuarial valuation should be conducted. On this basis GAD has prepared a draft valuation report for the Home Office, which has also been shared with the SAB.

GAD's valuation results are in draft form until HMT's valuation directions are finalised, but there are not expected to be any significant changes.

[2] The PFEW is a member of the SAB. The other members are: the National Police Chiefs' Council; the Association of Police and Crime Commissioners; the Chief Police Officers' Staff Association; the Police Superintendents' Association; and the National Association of Retired Police Officers.

[3] The commissioning letter from the Home Secretary to the SAB says that amending 1987 and 2006 members' benefits/contributions will not help impact on the breach. However, we are currently seeking an explanation from GAD about this as information from them seems to conflict with this.

7. What does the draft actuarial valuation report say?

As mentioned above (in Q2), the two main purposes of public service pension scheme valuations are:

i. To see if the cost of the scheme is on target. This is determined via the Employer Cost Cap mechanism (see Q3 for more details); and
ii. To determine the employers' contribution rate.

GAD's draft actuarial valuation report indicates that:

i. Employer contributions need to increase significantly for the period 1 April 2019 – 31 March 2023; and
ii. The Employer Cost Cap has fallen beyond the 2% margin, so restorative action to increase members' benefits and/or reduce members' contributions needs to be taken for the period 1 April 2019 – 31 March 2023.

In a way this is a "good" breach for members, as it means that for the next four years the benefits will be better than originally specified.

8. Why do employer contributions need to increase?

Employer contributions need to increase because of changes in "employer costs", which are financial or technical in nature. For example, there has been a reduction in the discount rate (which is used to assess the current cost of future payments from the scheme) which has resulted in *a higher value being placed on scheme benefits*, which increases the schemes' liabilities.

There has also been an increase in the cost required to pay for benefits accruing over the 1 April 2019 – 31 March 2023 period as well as an increase in the cost of the past service deficit.

Another cost which Employers need to meet is the increased commutation payments following the Milne v GAD Pension Ombudsman ruling.[4] Mr Milne was a retired firefighter who was successful in his complaint that GAD should have reviewed and maintained appropriate commutation factors for the Firefighters' Pension Scheme between 1998 and 2006. The principle of the ruling also applied to

[4] The decision can be found here: https://www.pensions-ombudsman.org.uk/determinations/2015/po-1327/firefighters-pension-scheme/

the Police Pension Scheme 1987 and so many police officers who retired between 1 December 2001 and 30 November 2006 received increased commutation payments.

We understand HMT has said that there will be additional funding available for most of the impact of the employer contribution rate increase in 2019-20 and that further discussions will be taken forward as part of the 2019 Spending Review.

9. Why has the Employer Cost Cap been breached?

The Employer Cost Cap has been breached because of changes to "member costs" such as changes in demographic assumptions (i.e. a reduction in the assumed increase in life expectancy of members) and changes in financial assumptions (i.e. a change in the short-term salary growth assumption for members).

10. Was a breach of the Employer Cost Cap expected?

No.

A HMT document from November 2012 called 'Establishing an Employer Cost Cap in Public Service Schemes' says: *"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."* However, in the first set of public service pension scheme valuations to have taken place since the Employer Cost Cap mechanism was established, the costs of at least some schemes (such as the police schemes) have exceeded the 2% margin and led to a breach.

Also, the prevailing view was that if there was a breach, it would be that scheme costs had risen too high, rather than falling too low.

As a result of the unexpected breaches to the Employer Cost Cap, the Government has asked GAD to conduct a review of the mechanism *"to check whether it is working as intended and delivering government's objective to protect taxpayers and workers from unforeseen changes in pension costs."* The review will conclude in time for the next four yearly actuarial valuation.

11. Hasn't the NPCC made a comment recently about the potential impact of the increase to employer contributions?

Yes, a recent statement from the NPCC said that the funding required to meet the increased employer contribution cost *"means that forces in England and Wales may need to find an extra £417 million by 2020/21. This is equivalent to nearly 10,000 officers…"* suggesting that this could have an indirect impact on our members.

We consider that comments such as this are unhelpful and that the NPCC needs to secure further money from the Government. These comments also mask the fact that the outcome of the actuarial valuation will benefit many pension scheme members.

Further, we currently have been led to understand that the Treasury will cover at least part of the first year's increase to employer contributions, with specific funding.

12. What discussions are taking place at the SAB?

Following the breach of the Employer Cost Cap, the SAB has received a commissioning letter from the Home Secretary, requesting its advice on how to rectify the breach. The SAB must now consider what advice it will provide to the Home Secretary.

The steps taken to rectify the breach may include the increase of members' benefits and/or a reduction in members' contributions. However, the commissioning letter to the SAB says that benefits for fully protected members of the 1987 and 2006 pension schemes are not assessed as part of the Employer Cost Cap mechanism and so improvements to benefits accruing for these members will not help rectify the cost cap breach.

If the SAB and the Home Secretary cannot reach agreement on how to rectify the breach then the default position is an improvement to the CARE 2015 Scheme accrual rate (from the current 1/55.3).

The SAB has no remit to consider any change to the employer's contribution rate

13. What are the timescales involved for discussions at the SAB?

A number of Technical Working Groups have been arranged from now until early December so that the SAB can determine its position. The Home Office will consider the advice of the SAB and formulate a proposed solution to address the breach

The Home Office and the SAB will then continue to engage in dialogue with a view to reaching agreement on the solution to be adopted at the statutory SAB meeting on 14 January 2019. If, by 29 January, a consensus position has not been reached then the default position (of improving the accrual rate from the current 1/55.3) will be applied with effect from 1 April 2019 until 31 March 2023.

14. What actions are the PFEW taking?

As part of its membership of the SAB, the PFEW is considering the options available to rectify the Employer Cost Cap breach. It will be attending all the Technical Working Group and statutory SAB meetings as well as seeking further technical information from GAD to help determine its, and the SAB's, position.