

Independent schools briefing, Quarter 2 2020

Outlook for the 2020 valuation of the Teachers' Pension Scheme

The effective date of the Teachers' Pension Scheme (TPS) valuation is 31 March 2020, with implementation planned for 2023. The valuation could result in higher costs for schools if changes are made to the SCAPE (Superannuation Contributions Adjusted for Past Experience) discount rate – the most important actuarial assumption behind the valuation.

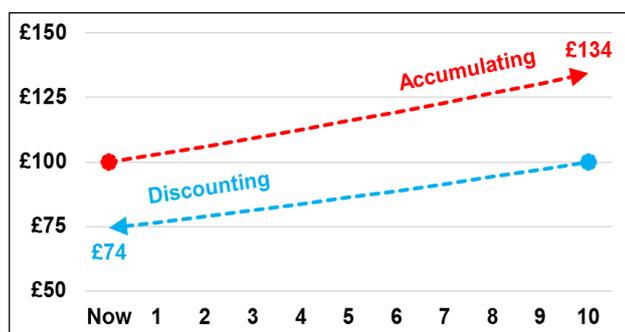
This briefing provides a technical view of the outlook for that valuation.

Introducing the 'time value' of money

The **value of money** depends on how much is paid and when it is paid. I'm sure we'd all like to have £100 now rather than £100 in 5 years' time, as we know the money can be invested for a return.

For example, if I save £100 today and earn interest of 3% per year, then in 10 years' time I'll have £135.

Now let's look at this the other way around. What if I need to pay £100 in 10 years' time, how much do I need to invest now to pay for it? If the money saved earns interest of 3% per year, you would put aside £74 today. The lower the interest rate, the more the money needed today to make a future payment.

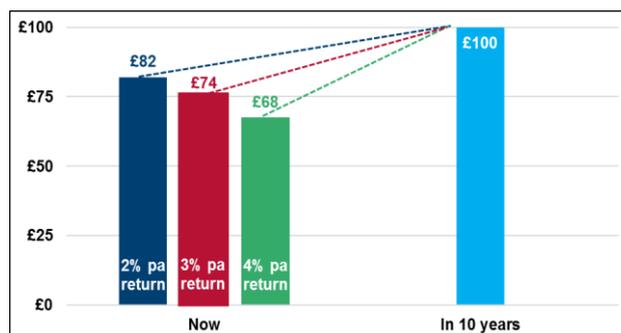


The process of working backwards from an amount to be paid in the future to an amount needed now, in order to provide for it, is called **discounting**.

Pension scheme valuations

A pension scheme expects to make payments in the future to current pensioners, members yet to retire and members' beneficiaries.

In an actuarial valuation, all these expected benefit payments are discounted back to the effective date of the valuation using a **discount rate**. This is the most important assumption in a valuation. The overall valuation is highly sensitive to discount rate changes, as illustrated below. The lower the discount rate, the more money is needed today.



The discounted values of all expected benefit payments are added together to form the **liabilities**. These are compared against the pension scheme assets to see whether the scheme is in **surplus** or **deficit**.

Discounting in the TPS valuation

A value is placed on the liabilities of unfunded public service pension schemes such as the TPS, using the **SCAPE discount rate**.

Although the TPS holds no physical assets, it does track **notional assets**, which reflect the value of pension contributions paid by schools and teachers.

The SCAPE discount rate was initially linked to the Social Time Preference Rate – which allows for society's preference to consume sooner rather than later – and set at 3.5% per year above inflation.

This changed in 2011 when it was linked to growth in the UK's Gross Domestic Product (GDP), as forecast by the Office for Budget Responsibility (OBR).

As forecasts for GDP growth have fallen, the SCAPE discount rate has fallen too, as we see here:

Date effective from	SCAPE discount rate (above inflation)
April 1991	3.5% per year
April 2011	3.0% per year
April 2016	2.8% per year
April 2019	2.4% per year

As a reminder, **the lower the discount rate**, the more money needed today – in other words, **the higher the cost of pensions**. The table below shows the increasing cost to schools, much of which is due to the falling discount rate:

Effective date	Employer rate
Before April 2002	7.40%
April 2002	8.35%
April 2003	13.50%
January 2007	14.10%
September 2015	16.48%
September 2019	23.68%

Outlook for the 2020 valuation

Accompanying the March 2020 Budget speech were documents showing that, using OBR forecasts, the implied SCAPE discount rate was **1.8% per year** over inflation – a big fall from that used last valuation.

To put this into context, using sensitivities provided in the 2016 valuation report, the consequence of a 0.6% per year reduction in the SCAPE discount rate (with no other change) could lead to an increased contribution rate for schools of **around 35%**. There are many other issues (outlined below) which will impact on the final result, and we should acknowledge that wider political and economic repercussions will be important factors.

What else might impact on the 2020 valuation

The OBR forecast on GDP growth was set before **Covid-19** took its toll on the economy. Time will tell how this will affect the SCAPE discount rate and the cost of pensions, but there will be short term economic difficulties.

A **review of the methodology** behind the SCAPE discount rate is also due. The impact of the pandemic may make this review even more pressing.

Other assumptions used in the valuation – including **pay growth, pension increases** and, of course, **mortality rates** – will also impact pension costs.

The **McCloud judgement** ruled that transitional protections implemented for older members of public service final salary schemes were age discriminatory. Remedial action to correct this will be carried out over the next two years and will come at a cost initially estimated at around £4bn a year for all public service schemes. The 2018/19 TPS accounts reserved a total estimated cost of £7bn.

Finally, the Government Actuary is set to review the **cost cap mechanism** (introduced as part of public service pension reform) to check whether it is working as intended and delivering the government's objectives. Although the 'cost cap floor' was breached – which should have triggered scheme changes in 2019 – this was paused due to the uncertainty surrounding the McCloud judgement.

How First Actuarial can help

First Actuarial is a nationwide firm of pensions actuaries and consultants, helping independent schools with all their pensions issues.

We help schools develop their pensions strategy, manage pension change projects, and provide training, modelling, DC contribution design, DC provider selection and consultation support services.

We offer a unique blend of public service pensions expertise, consultancy and communication skills. We are particularly adept at running remote meetings, for both governors and teachers.

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