House of cards?

The public sector is the last bastion of defined benefit pension provision in the UK. But is this crumbling edifice in danger of toppling? Stephanie Hawthorne reports

Summary
- The pension reforms stemming from the Public Service Pensions Act 2013 were not radical enough, some claim.
- The LGPS is in relatively good shape but the other public service unfunded schemes are unsustainable unless UK GDP zooms ahead.
- On such contentious issues no significant changes are likely for several years.

Lumbering public-sector pension schemes are unsustainable, devouring taxpayers' money and providing over-generous defined benefits long since consigned to history in the private sector, say their critics.

But is this is too facile a view? "It is all too easy to fall into the trap of considering the sector as one giant amorphous blob," says PLSA head of DB, LGPS, and standards, Joe Dabrowski. "There are significant differences between funded schemes – the vast bulk of which is in the Local Government Pension Scheme – and the wide range of other unfunded public sector schemes such as NHS, police and teachers. The sustainability of the schemes can vary enormously."

Major reforms

The Public Service Pensions Act 2013 brought in major reforms to the six largest public-service pension schemes in the UK – the pay-as-you-go schemes for the armed forces, the civil service, NHS, teachers, police and firefighters and the funded Local Government Pension Scheme. Key changes included pension benefits being based on career average revalued earnings (CARE); a pension age linked to the state pension age for teachers, local government, NHS and the civil service; and a pension age of 60 for members of the schemes for the police, firefighters and armed forces. Active members of the schemes prior to April 2015 (2014 for local government) were transferred onto the new schemes, except for those covered by transitional protection for those 'closest to retirement'.

In addition, public-sector pensions in payment are now linked to the CPI rather than RPI.

These reforms have made a substantial impact and are projected to cut spending on public-service pensions, from around 2 per cent to below 1.5 per cent of GDP, over the next 50 years, according to House of Commons Library research. But this figure is hotly contested.

LGPS is shipshape

The funded LGPS is in better shape than the unfunded sector. "It is one of the largest funded and open DB schemes in the world at £275 billion and provides pensions to close to six million members, the average being less than £10,000 a year," says Dabrowksi, adding, "its funding position overall is strong".

Barnett Waddingham, partner, Barry McKay, agrees: "The strong investment returns achieved by LGPS funds over the long term typically pay for around two-thirds of the cost of the benefits, with contributions meeting the other third. The current round of valuations in England and Wales are generally showing an improvement in funding levels, with a number of funds being fully funded, and current costs being stable, although this will vary by employer."

But the unfunded schemes are in altogether a different place.

Smoke and mirrors

The government has been partly sheltered from the DB cost pressures experienced by private-sector employers because of the artificial discount rate used to value and put costs on public-sector pensions. Unfunded public-sector pensions are calculated using the SCAPE *[Superannuation Contributions Adjusted for Past Experience]* discount rate. Mercer chief actuary, Charles Cowling, says this is "now CPI+2.4 per cent a year with the crucial underlying assumption backing the SCAPE rate, the assumed long-term growth in UK gross domestic product (GDP)".

He explains: "This is a much higher discount rate than the private sector uses (typically the private sector uses a discount rate that is less than CPI) and this means that public-sector pensions are presented as being much cheaper (maybe as much as 50 per cent cheaper) than private-sector pensions. Unless the government is going to reduce public-sector pensions in years when GDP growth is less than CPI+2.4 per cent, an ever-growing financial burden is being transferred to younger generations."

LCP partner, Bart Huby, agrees that these costs have not been transparently assessed or clearly recognised in the public finances.

"Depending on how you measure them, the UK currently has unfunded public-sector pension liabilities of close to £2 trillion – these are financial obligations that will have to be met by future taxpayers, in the same way as the interest and capital on gilts, but they do not properly form part of recognised public-sector debt," he states.

Insufficiently radical

In some areas, the reforms were less than ideal. Huby points to the overall

cost/generosity of benefits: "In order to compensate for the move to CARE and the increase in the retirement age, the government agreed to increase pension accrual rates, in some cases substantially – eg in the Civil Service Scheme, to 2.32 per cent, an increase of nearly 40 per cent compared with the previous pension accrual rate of 1/60th."

He adds: "Substantially higher member contribution rates have meant that significant numbers of potential members (reportedly 16 per cent in the NHS pension scheme) have opted out, and so are not in fact building up a pension."

There is also more complexity, with Huby pointing to "different post-2015 arrangements being put in place for the four main public-service schemes (Teachers, Civil Service, NHSPS and LGPS) with different accrual rates, CARE revaluation rates, member contribution rates, and transitional arrangements.

"The transitional arrangements, which protected older employees close to retirement – have now been deemed age-discriminatory *[due to the recent McCloud ruling]*, with a potential extra cost to the public purse of around £4 billion."

Following the ruling, public-sector pensions are subject to a great deal of flux and uncertainty, Royal London's director of policy, Steve Webb, believes. "The government will have to revisit its reforms, possibly reversing the recent cuts and then reintroducing new cuts, potentially including those close to pension age," he explains.

The McCloud ruling could also be a catalyst to simplify the 2015 reforms, "potentially onto a uniform public-service pension basis for all main sections of the public sector and to put them on a more sustainable basis," Huby suggests.

One option to reduce the high opt-out rate would be to allow workers to opt for reduced contributions and reduced accrual, but there are no easy answers, says Webb.

"The big problem with closing 'unfunded' DB schemes such as those for teachers, nurses and civil servants and replacing them with funded DC schemes is how to fill the resultant funding gap," he explains.

"This could result in a substantial shortfall, which would need to be made up by general taxation. In short, unwinding an unfunded pension regime and replacing it with a funded regime can probably only be done very slowly."

Unstable equilibrium

Spence & Partners, owner and director, David Davison, adds: "If you go back to 2015 reforms, the genesis of those reforms went back to 2008 or 2009 so there was about seven years of negotiation before there was any impact."

Given the parliamentary arithmetic, Cosan Consulting director John Reeve agrees. "I suspect that the future of public-sector pensions is that they won't change significantly in the future," he states.

But there is clear daylight between the generosity of pension benefits provided in the public and private sectors, which Hymans Robertson partner, Richard Warden, says could be "hard to maintain over the long term as either public-sector pension levels will need to be reduced, or private-sector pension levels need to rise."

In the end, Irwin Mitchell partner, Penny Cogher, stresses: "There is always an unwillingness to change the public-sector pension arrangements due to so many entrenched interests – the unions, the politicians, the judges, the Prime Minister, the civil servants, all benefit from public-sector pension arrangements. Even when some change has been attempted, there has been legitimate push back from the Supreme Court that the manner in which the changes have been made has been unlawful as they have been made in a discriminatory way. "

She concludes: "The unfunded public schemes, in particular, have a colossal underfunding, which, for the most part, is swept under the carpet. This cannot be sustainable long term and at some stage someone/some party will have to be sufficiently brave and determined to challenge the position, probably due to intergenerational unfairness. It won't be easy."

Written by Stephanie Hawthorne, a freelance journalist