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Briefing

Teachers' Pension Scheme: where next?

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In 2018, the Government announced that the contribution rate required of employers who participate in the Teachers' Pension Scheme (TPS), would increase by 7.2%, from 16.4% of pay to 23.6%.

This was driven by the results of the 2016 valuation of TPS, and was a result of three factors:

- Changes in the assumptions used to assess the cost of pensions, which added 3.1%;
- The application of the 'Cost Cap Mechanism', which required there to be an improvement in the level of benefits being offered and added a further 2.3%; and
- A final adjustment of 0.8% to allow for the fact that time had passed between the date of the valuation (April 2016) and the date when the increases would come into effect (September 2019).

In this note we focus on the first of these points. What drove the change in 2016, what has happened since that time, and what might come out of the 2020 valuation that is now under way? As an additional point, we also consider the changing market for any independent schools looking to exit TPS and use a Defined Contribution (DC) pension scheme in its place.

Assumptions and the SCAPE discount rate

Key assumptions

Pensions are long-term arrangements and if we want to know how much to pay today to provide a pension decades from now, we have to make a series of assumptions about how that pension might look when today's workforce comes to retire.

Given a particular pension scheme structure (in other words, the formula for calculating benefits), assumptions are needed to determine the costs:

- How long will that pension be paid for?
- How will the amount of pension change over the course of an individual's life both before and after retiring?
- How much money is needed today to provide that pension in the future?

This calculation can become hugely complex, with assumptions covering life expectancies, population demographics, the likelihood of members exercising any options they have and the rate of price inflation and salary growth all key. However, the assumption that converts all of this complexity into a final answer – "what is the cost today?" – is the discount rate.

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Discounting

Discounting is simply the idea that if you need to pay a sum of money in the future, you don't need that much money today if you can earn a return on a smaller sum of money. For example, if you need to pay £100 in a year's time, but you're confident that you can earn 10% on your investments over the next year, then you only need to invest around £91 today: 10% growth on your fund of £91 will take you to just over £100 in a year's time.

SCAPE

TPS is not a 'funded' arrangement – the Government doesn't set aside assets to meet these long term pension obligations, but meets the payments each year as they fall due.

However, in order to work out how much schools are required to pay, the Government considers the amount of pension expected to be paid in each future year and calculates how much would need to be set aside now to pay for those benefits if TPS operated in the same way as a funded scheme. The calculation is entirely notional, but requires an assumption to be made about the rate of return – the discount rate – on the notional assets backing the scheme.

This discount rate is known as the SCAPE (Superannuation Contributions Adjusted for Past Experience) discount rate. It's set by the Government and currently, by reference to the rate of expected long-term GDP growth. In 2018, this rate reduced from 2.8% to 2.4%[1], and this apparently modest change was sufficient to add 3.1% to the cost of TPS pensions.

It's worth noting this is the real rate of growth assumed, so represents growth in excess of price inflation.

Long term GDP growth

OBR forecasts

The Office for Budget Responsibility publishes regular reports on the expected near-term and medium-term rate of GDP growth. These were last reviewed in April 2019 and suggested real GDP growth of 1.6% p.a. in the near-term (2019 to 2023). From time to time, it also considers long-term GDP growth, but the most recent formal reporting on long-term growth was published in 2011[2].

Recent conditions

The last 12 months has seen a period of unprecedented economic disruption, with the prolonged Brexit negotiations giving way to the market shocks caused by the Covid-19 pandemic. GPD has taken a hit around the world, and the UK is no exception to this. There are numerous studies and speculative articles published, but a common theme is that clearly, GDP growth in the near-term will have taken a tremendous hit.

It remains to be seen what the longer-term impact of Covid-19 has on global and UK economic growth. However, even without that hammer blow, yields in the UK were at historically low levels with much uncertainty surrounding the future economic prosperity. However, one thing that most commentators would agree on is that expectations for long-term economic growth are unlikely to have improved since 2016.

What could this mean for TPS costs?

Sensitivity of results in 2016

According to the valuation carried out in 2016 by the Government Actuary[3], a reduction in the SCAPE discount rate of 0.25% would lead to an increase in the TPS employer contribution rate of 5.3%.

The report also states it's considered 'Likely' that the rate will change in time to affect the 2020 valuation, and that the impact of this *'may well be more than 2% of pay'*.

1. https://commonslibrary.parliament.uk/economy-business/work-incomes/public-service-pensions-less-for-more/
2. https://obr.uk/forecasts-in-depth/the-economy-forecast/real-gdp-growth/
3. https://www.teacherspensions.co.uk/-/media/documents/member/documents/news-items/teachers-pension-scheme-actuarial-valuation-2016.ashx?rev=1d463cd3f4344c199ca0c2bcf193dc90&hash=D90840D6F4AF06461F6D927C4E6265B0

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Weighing the odds

Given everything that has happened recently, the prospect of a further reduction in the discount rate, with the accompanying rise in TPS costs, must surely be a strong prospect. However, in a state-backed pension scheme, where rules can be revised and sometimes entirely scrapped at the behest of the Government of the day, nothing can be certain. The Government can, within reason, set the contribution rate at whatever level it chooses.

Where the employer contribution rate will end up is a matter of conjecture. We have seen estimates range from no change at all up to 35% or more. While the upper end of this range could seem like scaremongering, in reality, and according to the Government's own analysis, this could come about if the discount were to fall by little more than 0.5%.

Although not considered in detail here, there is also the fallout from the McCloud judgement to account for. If the end result of that is a requirement to reduce the retirement age for all staff, that comes with a cost attached. How that cost could be apportioned is not known at this stage.

It's in the interests of the Government to maximise revenue. Where contributions to public sector pension schemes come from private sector sources, as with Independent Schools, the payments represent net income to the Treasury (as opposed to the recycling of public money) and so the more incentive there is for the contribution rate to be as high as possible.

Set against this is the argument that it could be unwise for the Government to price Independent Schools out of the TPS market, however much actuarial sense it might make to increase costs by the sort of margins considered here. If the costs became unaffordable for the majority of schools, then the Treasury could lose a valuable source of private sector funds.

When will we know?

The 2020 valuation will be in its earliest stages now. TPS is a huge, complex scheme and valuing it is an understandably slow process. If the 2016 valuation is any guide, we might expect to hear the initial conclusions around mid to late 2022, with any change in the contribution requirements likely to be effective from around September 2023.

What are the provider options for independent schools looking to set up a Defined Contribution arrangements as an alternative or replacement option

The September 2019 increases have resulted in many independent schools looking at alternative options to TPS, whether it be as a replacement or additional choice. In addition to contribution structures, a large part of this consideration will be deciding which pension provider to use and this is an area where we've seen significant developments in the last year. Initially many schools were choosing to use the same provider – one that offers a master trust solution targeted directly at independent schools. This streamlined approach offers several advantages – competitive charges, a trusted brand and the ability to obtain associated benefits such as lump sum death in service and income protection cover at a standardised cost (with future increases not dependent on school specific claims experience).

However, this isn't to say it isn't worth considering other options. Schools may already have arrangements in place with DC pension providers for support staff, which could be a useful starting point, and many other pension providers are now targeting this sector with competitive offerings. Compared to a standardised offering such solutions may offer lower member charges (particularly for larger schools), greater ability to bespoke solutions (branding, online microsites etc.) and increased implementation support. Although other benefits may need to be sourced separately, this can also lead to more competitive rates and as with pension arrangements it may be that existing arrangements used by a school can have new categories added. Furthermore, if schools wish to offer a DC plan as an alternative to TPS (as opposed a replacement) and also offer provide income protection for DC members they would generally need to source this cover separately to a packaged solution anyway.

Ultimately the best solutions will depend on the specific circumstances of a school and what teachers value the most, so it's important to consider the available options relative to this.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in with touch Tim Williams, Associate and FIA or Martin Willis, Principal and APFS via the following:

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