



Scrutiny Unit Briefing Note

Public Sector Pensions

This note provides background and briefing to help you understand the key figures in the accounts of public sector pension schemes.

It sets out the main public sector pension schemes, their size and characteristics. It also looks at how pension schemes are accounted for under *Financial Reporting Standard 17 (Retirement Benefits)*, and how to interpret the resulting pension liability figures.

Introduction

Public sector pensions schemes are all ‘defined benefit schemes’, which means that scheme rules determine how much pension an individual will receive, usually dependant on final salary and the number of years of service.

All public sector schemes have been undergoing reforms recently. In some cases this has changed the terms for some existing members, and in many cases the basis of pensions for new members is different from that for current members. For example, in 2002 the Principal Civil Service Pension Scheme (PCSPS) closed its ‘classic’ and ‘classic plus’ schemes to new members, and now offers the ‘premium’ scheme instead.

Most public sector pension schemes are unfunded, which means they have no assets to speak of (there are no investments). Current pensioners are paid out of current resources on a year by year basis. The Local Government Pension Scheme is an exception to this, being funded by investments. Other schemes have ‘notional’ funds, which are effectively unfunded but where a separate ‘notional’ account is maintained for each worker, establishing a closer link between contributions and benefits.

In October 2004 the Pensions Commission produced its first report which analysed the adequacy of pensions provision and saving in the UK. It found that there were about 4.7 million active members of public sector pension schemes. Of these, 1.04 million are in unfunded schemes (such as the civil service, the armed forces, police and fire service schemes), 2.02 million are in notionally funded schemes (such as the NHS and education schemes), and 1.5 million are in funded local government schemes. In addition 0.1 million are in funded schemes in what might be termed the 'quasi-public sector', e.g. universities¹.

The Government Actuary's Department estimates that, including single-member schemes, there may be as many as 30,000 to 40,000 pension schemes in the public sector, although these include many single-member schemes. Table 1 lists the largest public sector pension schemes in terms of membership, along with some smaller schemes for comparison. Four of the largest schemes are central government schemes with their own Estimates and resource accounts (NHS Pensions, Teacher's Pensions, the Civil Service (PCSPS) and the Armed Forces Pension Scheme) and two are local government schemes (Local Government Pension Scheme and Police Pension Schemes). In terms of membership the Local Government Pension Scheme is by far the largest, although there are few details on the scheme as a whole because each local authority is responsible for administering the scheme itself locally. There is no single set of accounts for this pension scheme.

Together, the four largest central government schemes have balance sheet liabilities of around £450 billion. They pay out around £14.5 billion a year to pensioners, but the liabilities accruing each year for future pensions expenditure mean that the total cost (net resource requirement) recognised in the accounts is around £30 billion a year.

¹ Pensions Commission *Pensions: Challenges and Choices. The First Report of the Pensions Commission*, October 2004.

Table 1a: The main central government pension schemes

Scheme	Number of members (Active/Deferred /Pensions in Payment)	Own Estimate?	Main Estimates 2006-07				Resource Accounts 2005-06	
			Gross Resources Requested	Appropriations in Aid <i>(used to help meet pensions payments)</i>	Net Resource Requirement	Net Cash Requirement	Provision	Net liabilities
National Health Service Pension Scheme	1,260,939 372,121 520,167	Yes	£17.5 billion	£7.3 billion	£10.2 billion	- £3.2 billion ²	£127.9 billion (2004-05)	£127.9 billion (2004-05) UNFUNDED
Teachers' Pensions Scheme (England and Wales)	590,032 391,016 488,132	Yes	£12.6 billion	£4.2 billion	£8.4 billion	£1.3 billion	£143 billion	£143 billion UNFUNDED
Principal Civil Service Pension Scheme	603,000 306,000 558,000	Yes	£9.2 billion	£3.2 billion	£5.9 billion	£495 million	£101.3 billion	£100.9 billion UNFUNDED
Armed Forces Pension Scheme	193,310 296,633 350,421	Yes	£6.0 billion	£1.4 billion	£4.6 billion	£1.6 billion	£76.4 billion	£76.6 billion UNFUNDED
UKAEA Pension Schemes	14,097 10,192 16,011	Yes	£308 million	£101 million	£207 million	£67 million	£4.2 billion	£4.2 billion UNFUNDED
DfID: Overseas Superannuation (closed schemes)	0 0 20,180	Yes	£66 million	negligible	£66 million	£115 million	£1.3 billion	£1.3 billion UNFUNDED

² The figure given in the estimate is a notional £1000 as Estimates cannot show negative cash requirements. The net cash requirement is negative because the scheme currently receives more cash from active members than it pays out to pensioners - the excess is paid into the Consolidated Fund.

Table 1b: The main local government and quasi-public sector pension schemes

Scheme	Number of members (Active/Deferred /Pensions in Payment)	Own Estimate?	Main Estimates 2006-07				Resource Accounts 2005-06	
			Gross Resources Requested	Appropriations in Aid <i>(used to help meet pensions payments)</i>	Net Resource Requirement	Net Cash Requirement	Provision	Net liabilities
Local Government Pension Scheme ³	1,500,000 1,100,000 900,000	No	Administration is the responsibility of individual authorities so there is no single set of accounts. An examination of the scheme was carried out by ODPM in 2004 relating to the year 2003-03, for England and Wales only. This found that the scheme paid out around £4 billion per annum, and had investments totalling some £67.5 billion - FUNDED					
Police Pension Schemes	143,000 police officers	No	Administration is the responsibility of individual authorities so there is no single set of accounts, although some data is collected centrally by CIPFA and the Home Office. This indicates that net liabilities are in the region of £76 billion - UNFUNDED					
Firefighters Pension schemes	67,000 firefighters	No	Administration is the responsibility of individual authorities so there is no single set of accounts, although some data is collected centrally by CIPFA and the Home Office. This indicates that net liabilities are in the region of £158 billion - UNFUNDED					
Universities Superannuation Scheme	115,600 66,100 44,700	No	The University Superannuation Scheme does not produce resource accounts but a private sector-style annual report and accounts. The accounts for 2005-06 show the scheme made payments to pensioners of £790 million, and has investments of some £28.2 billion - FUNDED					

Definitions:

Active member – an employee who is making contributions to the pension scheme from their salary.

Deferred member – a person who has left the relevant employment before their retirement age, so is no longer making contributions but will still be eligible for a pension when they reach retirement age.

Pension in payment – a pensioner, or their dependant receiving a pension.

³ Local Government Pension Scheme figures are for England and Wales only

The Estimates

The Estimate for a pension scheme:

- only includes Annually Managed Expenditure (AME). The costs do not form part of departmental budgets determined in the three-year Spending Reviews, so there is no DEL (Departmental Expenditure Limit).
- Only includes 'Programme' expenditure – costs associated with running the scheme do not count against 'administration' cost limits.

The administration costs comprise staff costs (policy, finance, IT staff and administrative staff to input and update data, process pension projections and make payments), accommodation costs, IT etc. These overheads of running a central government unfunded pension scheme are not borne by the scheme itself, but by the main sponsoring department and the employers who participate in the scheme. This is why there is only Programme expenditure shown in the Estimates and no staff costs etc. reported in the pension scheme resource accounts.

For example, the sponsoring department of the PCSPS is the Cabinet Office and the staff costs etc. of administering the PCSPS appear in the Cabinet Office Resource Accounts. A small proportion of the PCSPS employer pension contributions from government departments is retained by the Cabinet Office (through appropriations-in-aid) to cover these administrative costs.

Main cash flows in pension scheme accounts

There are three main cash flows in public sector pension scheme accounts:

- **Cash is received from employers** – these are employee contributions, collected from gross salaries by employers, and the employers' own contributions. These have various names; in PCSPS they are called ASLCs (Accruing Superannuation Liability Charges) and in the Armed Forces

Pension Scheme they are called SCAPE (Superannuation Contributions Adjusted for Past Experience).

- **Cash is paid out to pensioners** – lump sum payments are generally paid on retirement and payments are then made every month (the equivalent of a monthly payroll). The administration of these payments may be contracted out. For example, Capita is involved in the administration of several public sector pension schemes.
- **Transfers in and out** – where active members of the pension scheme transfer their pension rights to a new pension scheme, perhaps because they get a new job with different pension arrangements.

If a net cash deficit arises (because total payments to existing pensioners exceed the contributions received from employers and employees in the year) then additional cash will be requested through the Estimate. In a funded scheme there will also be cash flows associated with the sale and purchase of assets and investments.

Accounting treatment – the balance sheet

The accounting treatment of pensions is covered by *Financial Reporting Standard 17 (Retirement Benefits)*, an accounting standard issued in 2000. This requires the reporting of pension scheme assets and liabilities in the balance sheet.

Pension scheme assets comprise the investments (shares, bonds, cash etc.) made by the scheme managers. Pension scheme liabilities are the costs of paying the expected final value of all future pension benefits that the employer is currently committed to make. The net of the assets and liabilities appears in the balance sheet in the accounts for the scheme. If there is a net liability (which will always be the case if the scheme in question is unfunded), a provision is required in the balance sheet to recognise the future cost of paying pensions from current expenditure. The net asset or liability only represents a snapshot on the balance sheet date, and the fluctuating value of some assets could have a significant impact on the pension provision.

The balance sheet pension provision for the entire scheme will be valued by an actuary, based on a number of facts about the current scheme members (i.e. their ages, current salaries, service to date) and particular assumptions about the future (i.e. investment returns, earnings increases and price inflation, demographics). Pension schemes will have a periodic full revaluation (based on the data for each individual in the scheme) and annual updates in the interim.

Most schemes are able to choose their own actuary by putting the contract out to tender. The Government Actuary's Department (GAD) is the actuary for many public sector pension schemes, although the PCSPS uses a private sector actuary.

Because some pension liabilities will not be due for payment for many years, the liabilities calculated by the actuary are converted to an aggregate value stated in today's money terms using a discount rate which takes account of the time value of money and the risk characteristics of the liability. More information about provisions and the discount rate is provided in Annex 1.

The increase or decrease in the pension provision from the previous year's balance sheet is then broken down into a number of separate components, and reported in the notes of the pension scheme's accounts, as shown in the PCSPS example below:

	2005-06	2004-05
	£000	£000
A	(84,111,573)	(78,577,532)
B	(10,593,889)	-
C	(3,436,793)	(2,676,662)
D	(1,120)	(1,100)
E	(122,172)	(76,476)
F	(516,836)	(139,585)
G	(5,100,079)	(4,703,119)
H	3,416,300	3,177,853
I	124,477	100,395
J	(82,667)	16,777
K	(911,961)	(1,232,124)
	<u>(101,336,313)</u>	<u>(84,111,573)</u>

28.2 Analysis of movement in scheme liability

Provision for pension liability - extract from Civil Superannuation Resource Accounts 2005-06
(HC 1493, page 32)

Components C-G will tend to increase the pension liability, components H and I will tend to decrease the pension liability and components B, J and K could have an impact either way.

- **A:** The **scheme liability**, as calculated in the previous year's accounts, represents the starting position for the latest year.
- **B:** The **discount rate** for government pension schemes covered by the public sector Financial Reporting Manual is updated annually, and changed from 2.8% to 1.8% on 31 March 2007. A decrease in the discount rate brings about an immediate, or an "overnight", increase in the pension liabilities (and vice versa).
- **C:** The **current service cost** is the value of future pensions accrued by employees who have worked and contributed to their pension in the year. During the year employees will have increased their expected final salary through an annual pay increase and undertaken an additional year's service, both of which increase future pension entitlements.
- **D: Past service costs** result from any back-dated changes to pension entitlements. For example, if a department previously paid staff a non-consolidated performance related bonus each year but bought themselves out of this obligation with a one-off increase to salaries, that salary increase would increase pension obligations (because final salaries would be higher as a result).
- **E: Enhancements** arise from the award of extra years service which are not actually worked by employees (usually on early retirement or the purchase of extra years by members). These enhancements increase the future pension liability.
- **F: Pension transfers in** come from new employees who have transferred their pension benefits from another provider in a previous job, increasing the future pension liability.
- **G:** The pension scheme liabilities calculated in the previous year (see 'A') are all now one year closer to being paid, because everyone in the scheme is now

one year older. As a result those liabilities are now greater in present value terms. An **interest** charge is used to calculate this increase in the value of the liability. It is effectively undoing one year's worth of the 'discounting' that had been applied in the previous year (in accounting terms, this is called an 'unwinding' of the discount).

- **H: Benefits payable** are the pension payments made to current pensioners, including lump sums paid on retirement and a monthly pension thereafter. The payments act to reduce the future liability.
- **I: Pension payments to and on account of leavers** are the opposite of transfers in (see 'F').
- **J:** A group transfer occurs when the employees of a whole organisation transfer into a pension scheme, but it can take several years to agree the full terms and conditions if they are not already the same. Until that point, a provision for group transfers is separately disclosed. **Transfers to/from the provision for group transfers** occur when the terms of group transfers are finally agreed.
- **K:** An **actuarial gain or loss** arises because the actuary is able to compare the assumptions they made last year (e.g. for inflation and earnings increases etc.) with what actually happened. Because of the way all the other movements in the provision can be calculated this is generally a balancing figure.

Accounting treatment – the revenue account

Most of the key 'transactions' in the accounts occur as movements in the pension provision and have already been described above. Financial accounting is carried out using the principle of 'double entry' and so these movements in the provision will be mirrored by opposite transactions elsewhere in either the revenue account or the balance sheet.

For example, the PCSPS revenue account (below) includes the matching double entries for components C-G in the pension provision, described above.

	Note	2005-06 (£000)	2004-05 (£000)
Principal arrangements			
PCSPS			
Contributions:			
Contributions receivable	9	(2,830,219)	(2,067,110)
Transfers in	10	(612,851)	(176,594)
Other pension income	11	(90,241)	(45,992)
		<u>(3,533,311)</u>	<u>(2,289,696)</u>
Charged to provisions			
Pension cost	12	3,437,913	2,677,762
Enhancements	13	122,172	76,476
Transfers-in	14	516,836	139,585
Interest on scheme liabilities	15	5,100,079	4,703,119
		<u>9,177,000</u>	<u>7,596,942</u>
Group transfer provisions			
Movements	16	-	(3,734)
Not charged to provisions			
Benefits payable	17	7,060	7,242
Net outgoings for the year		<u>5,650,749</u>	<u>5,310,754</u>

Revenue Account - extract from Civil Superannuation Resource Accounts 2005-06 (HC 1493, page 17)

The only other key 'transactions' in the accounts, besides the movements in the provision, are the contributions receivable from employers and employees. These appear as income in the Revenue Account, shown above as 'L'. Note that the pensions payable in the year, unlike contributions receivable, are not accounted for directly in the revenue account, but are instead part of the movement in the pension provision in the balance sheet (see 'H' above).

Narrative aspects of a pension scheme resource account

A pension scheme resource account will include a report from the scheme managers, a report from the scheme actuary, a statement on internal control, an auditor's certificate and a description of the scheme's accounting policies; all of which are useful places to find out about the state of the pension scheme.

Pension liabilities in departmental accounts

Most public sector pension schemes are 'multi-employer' schemes which means that the employees of more than one employer are brought together in the scheme.

Because individual employers (e.g. individual departments or agencies) are unable to identify their own share of the assets and liabilities of the pension scheme, they do not have to show them in their own accounts. The only pension-related costs in the employer's accounts will be the employer contributions to the scheme and any amounts due to pay early retirements (until the pension scheme takes over the cost at the normal retirement age).

However, you may sometimes see pension liabilities stated in the balance sheets of some public sector employer organisations. This is either because they have their own pension scheme (without its own Estimate), or because the organisation is part of a multi-employer pension scheme in which they can identify their share of the assets and liabilities. The net liability will have been calculated in exactly the same way as described above, but then divided up between the employers so that they each include their share of it in their own accounts.

By-analogy schemes

There are a number of 'by-analogy' schemes which use the rules of another scheme but are financially separate. For example the House of Commons staff are in a scheme that is analogous to the PCSPS. This scheme is accounted for in the main House of Commons Administration Resource Accounts and there is no separate pension scheme account.

Defined contribution schemes

Defined contribution schemes are funded schemes (i.e there is a fund with investment assets) but there is no guaranteed level of pension on retirement. These schemes only pay out according to the value of the assets in the scheme at the time. The employer's accounts will only show the employer contributions paid during the year. The assets might be accounted for in a separate pension scheme account. There is no pension liability because employers have made no commitment to pay a pre-determined level of pension on retirement and have no additional responsibility to top-up any short-falls.

Annex 1

A discussion of provisions, the discount rate and the government's fiscal rules

What is a provision?

Even though the cash to settle the pension liability for a current employee may not be paid out for several years, it is prudent to recognise the expense of the future pensions as soon as they are known. Pension scheme managers will know they will have to pay a pension (albeit at some point in the future) as soon as someone is employed who meets the qualifying criteria for the pension scheme.

Under accounting rules there are three conditions which, if satisfied, will result in a provision for future costs being recognised as a liability in a set of financial statements:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that a transfer of economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

A provision is therefore made for future pension liabilities because:

- a public sector body employing staff includes the offer of a pension in an employee's terms and conditions of employment;
- it is probable that the public sector body will be required to pay the pension in order to fulfil the contract of employment; and
- an actuary can make a reliable estimate of the amount of the pension which will be paid.

Why do we discount provisions?

Some provisions (including most of those relating to pensions) will be payable over many years. The value of having to make a payment in the future is less than having to make it now. For example, the value of having to make a payment of £100 in ten years' time might be only £70 today, because £70 invested today would grow to £100 in ten years time as interest accumulates. That is why the schemes discount the provision (i.e the future liability) to its 'present value' for inclusion in the financial statements.

How is the discount rate determined?

Private sector pension schemes are required by the FRS 17 accounting standard to apply a discount rate based on yields on 'high quality corporate bonds', which takes account of the time value of money and the characteristics of the liability. The principle is to value the future liabilities in terms of the rate of return on the investments (corporate bonds) which would mature in a similar timeframe. The use of the AA corporate bond rate is specifically recommended in order to ensure consistency between employers.

In the public sector, the Treasury's Financial Reporting Manual requires pension scheme liabilities to also be discounted using the AA corporate bond rate, even though the schemes are unfunded, to keep them in line with internationally accepted practice for private pension schemes. The rate in use in 2005-06 was 3.5%, in 2006-07 it was 2.8% and in 2007-08 the rate is 1.8%.

Local government and police pension schemes follow separate guidance issued by CIPFA (Chartered Institute of Public Finance and Accountancy).

The impact of a change in the discount rate

A decrease (increase) in the discount rate brings about an immediate, sometimes called an overnight, increase (decrease) in the pension liabilities, even though no other factors involved in the calculation of the provision have changed.

An increase in the provision resulting purely from a change in the discount rate is classified as a change in an actuarial assumption and is not, therefore, a 'cost' to be borne in the accounts. As such, it does not need cover in the pension scheme Estimate. Gains or losses arising from changes in actuarial assumptions appear in the departments' Statement of Recognised Gains and Losses, not in their Operating Cost Statement.

Is this the right discount rate to use for public sector pensions?

There is some debate as to whether the AA corporate bond rate is the most appropriate rate to use for a pension scheme which has no investments. The use of a lower discount rate related to the government's ability to borrow, for example the market rate for index-linked gilts, would result in significantly higher net liabilities. The market real interest rate for gilts of an appropriate term was 1.12% in March 2006 – much lower than the AA corporate bond rate.

The Treasury's position remains that:

“Following international best practice, the Government uses the same accounting standards to calculate the public sector pensions liability as private sector pension funds. However, what matters is the annual cash requirement to pay pensions benefits, which remains fully affordable”⁵.

The cash required to pay pensioner benefits each year is unaffected by changes in the discount rate because the benefits are determined by the scheme rules, and updated annually by the rise in retail prices.

How does this relate to the government's fiscal rules?

Public sector pension liabilities are often discussed in the context of the Government's sustainable investment rule, which limits public sector net debt to 40% of GDP. The future liabilities of unfunded public sector pensions schemes are not included in this measure at all, discounted or otherwise. Similarly, government liabilities for any

⁵ *The Times*, 22 September 2006

shortfalls in the pension schemes of some privatised companies such as British Telecom – so-called ‘Crown guarantees’ – are also excluded from the official debt measure.

The most recent official estimate is that at March 2005, public sector unfunded pension liabilities totalled some £530 billion. This means that the liabilities that are not included in the official measure of net debt are at least as large as those that are. However:

- The 40% target was set on the basis that these liabilities were not included, and it would doubtless have been set at a much higher level if they had been included.
- The value that should be attributed to the public sector pension liabilities is very sensitive to the discount rate used. For example, marginal changes in the discount rate could alter the £530 billion estimate by £100 billion or more.
- The unfunded pension liabilities will be met through future tax revenues, which are also not included in the fiscal rule measure.
- The government is able to reduce the generosity of the future accrual of public sector workers’ pension rights, which, it might be argued, raises a doubt about whether unfunded pensions should be technically classified as ‘liabilities’ at all.
- While the reporting of ‘Crown guarantee’ liabilities by government departments must follow accounting standards,⁶ Crown guarantees are only payable in the event that the privatised company is unable to make the necessary payments itself. Consequently, in keeping with generally accepted accounting practice, these commitments need not be reported as liabilities (and thereby form part of government ‘debt’) where payments are unlikely to occur.

The National Institute of Economic and Social Research has suggested that 'transparency in disclosing the nature of these liabilities is far more important than deciding what is included in measured net debt and what isn't.'⁷

⁶ In response to a Parliamentary Question Lord McKenzie of Luton confirmed that 'It is a matter for the department that provided the Crown guarantee to report the Crown guarantee and any obligations created by the Crown guarantee to Parliament in accordance with the requirements of government accounting and in its departmental resource accounts in accordance with the Government's *Financial Reporting Manual*, which complies with generally accepted accounting practice' - HL 5367, Hansard Col WA88 3 May 2006

⁷ Treasury Committee oral evidence for the budget 2006, 26 March 2006