Independent schools briefing, Quarter 1 2021

The impact of McCloud and the 2020 TPS valuation

The McCloud judgment stems from changes made to public service pensions in 2015. For the Teachers' Pension Scheme (TPS) these changes meant a switch from final salary to career averaged revalued earnings benefits and, at the same time, a better accrual rate but a higher retirement age.

As part of this change, the Government sought to protect members close to retirement. It is this feature that was judged to be age-discriminatory.

In February 2021, the Government announced the remedy to remove this age discrimination, along with updates to the 2016 and 2020 valuations.

This briefing aims to help independent schools understand the issues and plan ahead by looking at the impact of the McCloud judgment and the outlook for the 2020 valuation.

A brief history of TPS benefits

Before 1 April 2015, the TPS had two tranches of final salary benefits (in the legacy scheme).

The **first tranche** (for those who joined the TPS before 1 January 2007) had a Normal Pension Age (NPA) of 60 with 1/80th final salary benefits, plus a lump sum equal to three times' pension.

The **second tranche** (for those who joined the TPS on or after 1 January 2007) had an NPA of 65 with 1/60th final salary benefits. A lump sum can be taken but is paid for by giving up pension.

The reformed scheme, introduced on 1 April 2015, brought a **third tranche** – Career Average Revalued Earnings (CARE) benefits with an accrual rate of 1/57th, above-inflationary increases in active service, and NPA equal to State Pension Age.

Headline benefits	Legacy scheme		Reformed scheme
	Joined pre 1 Jan 2007	Joined from 1 Jan 2007	
Pension	1/80th	1/60th	1/57th
Lump sum on top	3 × pension	Can exchange some pension for cash	
Indexation in active service	'Final Salary'		CPI + 1.6% pa
Normal Pension Age	60	65	State Pension Age

The age discriminatory transitional protections

There were different types of protection for active members based on their age on 1 April 2012.

All other members joined the reformed scheme from 1 April 2015. Because the protections were based on age, they were deemed to be age-discriminatory.

Age on 1 April 2012	Protection
Within 10 years of legacy NPA	Indefinite membership of legacy scheme
Between 10 and 13½ years of legacy NPA	Limited extra membership of the legacy scheme after April 2015

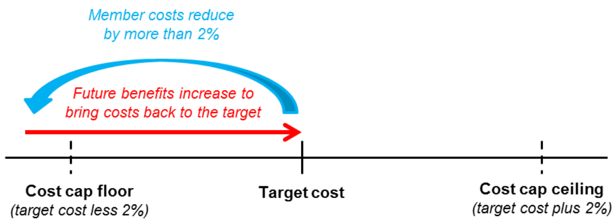
What is the McCloud remedy?

In late 2020, the Government consulted on two proposals to give affected members of public service schemes a choice between benefits under their legacy scheme and the reformed scheme, in respect of service between 1 April 2015 and 31 March 2022.

In February 2021, the Government opted for the 'Deferred Choice Underpin' approach. Affected members will have their reformed scheme service moved back to the legacy scheme. At retirement, affected members will then have the choice to move service back again. From 1 April 2022, all TPS members will be in the reformed CARE scheme.

The 2016 valuation and cost cap mechanism

Alongside the reformed scheme, a cost cap mechanism was introduced and a 'target cost' established. If the cost of future benefits is deemed to be more or less than 2% of the target cost, then future benefits would be changed.



Critically, this mechanism covered *'member costs'* (relating to assumptions about the membership profile, including life expectancy) but not *'employer costs'* (relating to financial and technical assumptions, including the SCAPE discount rate – the most influential and sensitive assumption).

While the lower SCAPE discount rate pushed up employer costs, this was outside of the cost cap assessment where changes to demographic assumptions and pay restraint pushed costs down.

Although this seems somewhat counterintuitive, the cost cap mechanism revealed that the cost of future benefits was more than 2% *cheaper* than the target cost, triggering an increase in future benefits.

Around 3.3% of the 23.68% currently paid by schools was to correct the cost cap floor breach and improve future benefits. However, this was not an 'extra' cost – it was to correct a cheapening of future benefits. The big cost increase in September 2019 was mainly due to the lower SCAPE discount rate.

However, in the shadow of McCloud, these benefit improvements were put on hold. Since the final judgment, the Government has announced that the costs of McCloud will be treated as 'member costs' so the remedy is effectively the benefit improvement.

Next steps for GAD

The Government Actuary's Department (GAD) has a job on its hands.

First, GAD will re-run the 2016 cost cap mechanism to see if the McCloud remedy brings scheme costs back within the 2% corridor around the target cost.

Then GAD will work on the 2020 valuation. However, there will also be a review of both the valuation methodology and cost cap mechanism. We have not seen a timetable for this valuation, and we might not hear results until the second half of 2022 potentially at the earliest.

With so much work to be done, the Government announced that contribution changes from the 2020 valuation will be introduced in April 2024 – a year later than previously scheduled.

What does all this mean for schools?

There will be no change to the 23.68% contribution rate paid by schools until April 2024.

The $64,000 question is what will the 23.68% rate become in 2024? Unfortunately, without a crystal ball, we cannot say with any certainty.

In a 2020 briefing, we considered what impact a lower forecast for future GDP growth could have on the SCAPE discount rate and, ultimately, the contribution payable by schools. The consequence of this *in isolation* could increase the employer rate to 30%-35%. However, this is just one assumption of many and, ultimately, the outcome will be influenced by wider political and economic factors.

A large increase in pension costs for schools would mean increases of a similar size for employers in other areas of public service – including the NHS. In the past, Government has funded the additional contributions for some services. Another future jump in employer pension costs could raise difficult questions around the financial sustainability of public service pension schemes more widely.

<u>Possible upward cost pressures</u>

One of the many consequences of Covid-19 is the impact on the UK economy and, ultimately, this feeds into the cost of public service pensions. Reduced expectations of long-term GDP growth leads to higher public service pension costs today.

Due to the McCloud remedy, there will be more legacy scheme benefits (up to April 2022) to pay for than were previously allowed for.

<u>Possible downward cost pressures</u>

Recent trends in future mortality improvements indicate that they will not be as high as previously thought – as was the case with the 2016 valuation. Covid-19 brings additional uncertainty.

To balance some of the potentially significant increases in employer costs due to lower forecasts of long-term GDP growth, there may be political and economic pressure to keep employer costs down.

Uncertainty

The review of the methodology behind the SCAPE discount rate could have a significant impact on the 2020 valuation results.

The review of the cost cap mechanism could also have a material impact, and we don't know whether a further cost cap correction will be needed after 2024.

Scheme experience and assumptions for the future will also be critical. These include pay growth, pension increases, ill-health retirements and mortality rates.

In conclusion

In our view, uncertain future TPS costs are just one consideration for independent schools.

Short-term affordability of the 23.68% in schools' business plans is obviously critical; this rate is set to continue until April 2024. But pension strategy and business plans should take account of future sustainability and the risk of cost changes – either from pensions or other areas of income/outgoings.

How First Actuarial can help

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

We help schools develop their pensions strategy and manage pension change projects. We also 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 adept at running remote meetings, for both governors and teachers.

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