National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Evaluating the government balance sheet: pensions

HC 238 SESSION 2016-17 30 JUNE 2016

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HM Treasury

Evaluating the government balance sheet: pensions

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 30 June 2016

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

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29 June 2016

HC 238 | £10.00

This report examines the pension commitments on the Whole of Government Accounts (WGA) balance sheet, the risks they pose to the UK's public finances, and how the government is managing these risks.

11136 06/16 NAO

Contents

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Foreword

The government's public sector pension liability has increased by around a third in five years. It is now the single largest liability on the government's Whole of Government Accounts (WGA) balance sheet. In 2014-15 the net liability was £1,493 billion: over a quarter larger than government borrowing and financing reported in the WGA, and equivalent to 81% of gross domestic product (GDP) or £55,000 per UK household. However, this is a long-term liability which will be payable over a significant number of years. In 2014-15, the government made pension payments totalling £127 billion comprising around £38 billion to former public sector employees and £89 billion in state pension benefits. This represented just under a sixth of total government costs. Public sector pension payments, net of member contributions, were equivalent to 1.6% of GDP and around £1,000 per UK household.

The number of people in retirement and eligible for government-funded pensions compared with those in work continues to increase. As a result, the Office for Budget Responsibility projects that expenditure on the state pension will continue to rise and forecasts government expenditure on state and unfunded public pensions will be 8.4%, or 8% net of member contributions to unfunded schemes, of GDP in 50 years' time. The government's policy is to provide financially for people in retirement, but there is a limit to the level of pensions that government can afford to finance annually without either reducing other areas of spending and impacting on public services, or having to increase taxation or borrowing. Reducing the level of income pensioners receive in retirement to bring down costs is difficult because of the impact on individuals; and could cause increases in spending in other areas such as means-tested benefits.

This report is one of a number that explore the major financial risks highlighted in the Whole of Government Accounts balance sheet and considers how the government is managing them. This report sets out the range of the government's pension commitments and the current and future risks they pose to the public finances.

Key facts

£1,493bn	£127bn	>100
total net public sector pension liability recorded in the 2014-15 Whole of Government Accounts (WGA)	total pension payments recorded in the 2014-15 WGA	legally separate pension schemes for which government has a commitment

Over a quarter larger	net public sector pension liability relative to government borrowing and financing reported in the WGA
81%	total net public sector pension liability as a percentage of GDP at 2014-15
32%	increase in net public sector pension liability since 2009-10
1.6%	public sector pension payments in 2014-15, net of member contributions, as a percentage of GDP
£89 billion	state pension expenditure in 2014-15
£38 billion	pension payments made to former public sector employees in 2014-15
8%	of GDP is projected to be spent by the government on state and unfunded public sector pensions net of member contributions to unfunded schemes in 50 years' time
Two-thirds	average funding level of the funded pension schemes recorded in the WGA on an accounting basis

Summary

1 The main aim of pension provision is to make sure individuals receive an adequate income in retirement. There are many different types of pension, including the state pension, occupational pensions provided by employers for their staff and personal pensions provided by insurance companies. The government's role in funding pensions is similarly varied and complex. As well as providing a state pension to people who have reached state pension age, the government has an obligation to pay former public sector employees an occupational pension and protects the pensions of those in private schemes that are affected by employer insolvency. The government also regulates private sector work based pension schemes through the Pensions Regulator, although this is outside the scope of this report.

2 Current and likely future spending on pensions is a significant element of total government expenditure and liabilities. The scale of pension costs and liabilities is particularly striking when compared with other significant figures in the 2014-15 Whole of Government Accounts (WGA):

- The net public sector pension liability of £1,493 billion as at 31 March 2015 was the single largest liability on the balance sheet. It represented 42% of total liabilities and £55,000 per UK household. The liability is equivalent to around 81% of gross domestic product (GDP). By comparison, it is over a quarter larger than government borrowing and financing reported in the WGA (£1,175 billion).
- The net public sector pension liability is a continuing long-term commitment that will be payable over a significant number of years. In 2014-15, the government made pension payments totalling £127 billion, comprising around £38 billion to former public sector employees and £89 billion in state pension benefits. This represented just under a sixth of total government costs.
- Public sector pension payments, net of member contributions, were equivalent to 1.6% of GDP and around £1,000 per UK household.
- Despite these payments, in 2014-15, the government's net public sector pension liability increased by £190 billion. Excluding actuarial movements, this is mainly due to:
  - the cost of public sector employees building up another year of pension entitlement (£44 billion), which is equivalent to just less than a quarter of the total staff costs;
  - net financing costs (£57 billion), which account for more than half of the increase in the net pension liability in 2014-15. These costs reflect adjustments in the value of the liability as the benefits become closer to being paid out and are based on the discount rate used to value pensions in today's prices. By comparison, as reported in the WGA, government borrowing cost £28 billion to finance in 2014-15.

3 The government's main concern is to meet its policy to provide financially for people in retirement while ensuring that pensions are affordable in the long term. Significant and continued increases in the cost of pensions would require the government to reduce spending in other areas; increase its income through higher taxation; or increase borrowing, to continue to support retirement incomes on the same basis. However, reducing the cost of pensions by reducing the level of pension received in retirement is difficult because of the impact on individuals. Doing so could result in unintended consequences such as increases in means-tested benefits.

4 An ageing population puts significant pressure on pension affordability. Arrangements such as the state pension, which is a benefit rather than a contractual obligation for the government, and unfunded public sector pension schemes have generally worked on the basis that pension contributions from the current workforce pay for the pensions received by the previous workforce. However, as the population of the UK has aged, the ratio of people in retirement compared with those in work has risen. This trend is expected to continue over the next 40 years, which will further increase the proportion of pension payments made to retired individuals relative to contributions received from those in work.

5 At the same time, the number of public sector employees has fallen by around 15% from 6.3 million to 5.4 million between 2009-10 and 2014-15. This increases pension costs in the short term as member contributions as a proportion of public sector pensions paid will fall. In the longer term, however, this reduction in the workforce will mean less people claiming a public sector pension in the future thereby reducing the cost of public sector pensions overall.

6 By comparison, public sector pension schemes for employees working outside central government are mostly funded arrangements. This means that pensions are paid out of an asset fund built up from employee and employer contributions along with investment returns. Returns on assets, and therefore the level of accumulated pension provision, are highly sensitive to market conditions. If returns on assets are low in the long term compared with inflation, the assets will not be sufficient to keep pace with the growth in the pension liability; and employees and employers may have to make additional contributions to reduce this deficit. The government also has a range of interactions with funded private sector pension arrangements, through its regulatory framework; the Pension Protection Fund; Financial Assistance Scheme; and guarantees to former public sector pension schemes.

7 In recent years, the government has made several reforms to state and public sector pensions to manage the risks to affordability. The most significant reforms to state pensions have been an increase in the pension age to reach 68 by 2046; the introduction of a requirement to review the State Pension age in every Parliament; and replacing the existing basic state pension and additional state pension with a new state pension.[1] For most public sector pension schemes, the government has aligned retirement age with the state pension age; changed the measure of inflation used to calculate pension increases; moved to career average salary pensions rather than final salary; and increased member contributions into the schemes. Most recently, in the 2016 Budget, the government announced that it was reducing the discount rate used to calculate employer contributions to unfunded schemes. This will increase pension costs for government bodies from 2019-20 but will not affect the overall costs to government significantly as the majority of these payments are internal transfers rather than external contributions. There has been greater variation in the government's reforms of funded schemes. Central government has less oversight of some of these schemes; they are more numerous and their arrangements and governance are more varied.

Scope of our report

8 This report is one of a number that explore the major risks to public finances highlighted in the Whole of Government Accounts (WGA) balance sheet. These reports examine how significant risks to the government's balance sheet have changed in recent years and considers how government is managing them. This report sets out the government's pension commitments and discusses the current and future risks that pensions pose to public finances. The Committee of Public Accounts has previously recommended that HM Treasury (the Treasury) makes better use of the WGA to inform decisions, particularly in areas that involve long-term liabilities, such as pensions.[2,3]

9 Part One introduces the main features of the public sector pension landscape. Parts Two and Three look at unfunded and funded pensions and risks to affordability in more detail.

10 In this report, we have drawn mainly on published material, particularly the WGA and other public sector accounts, as well as reports by the Office for Budget Responsibility (OBR) and our previous work. We have supplemented this data with information from interviews with officials in government on strategic risk management and pensions, as well as insight gained through our financial audit of public sector accounts.

11 We have not examined the effectiveness of specific reforms in this report nor the impact on individuals as we have recently completed work on automatic enrolment and are planning several more detailed reviews of specific reforms, such as the new state pension.[4]

1 The government is currently undertaking a further review of pension ages.
2 HC Committee of Public Accounts, *Whole of Government Accounts 2011-12*, Thirty-second Report of Session 2013-14, HC 667, December 2013.
3 HC Committee of Public Accounts, *Whole of Government Accounts 2012-13*, Twenty-sixth Report of Session 2014-15, HC 678, January 2015.
4 Comptroller and Auditor General, *Department for Work & Pensions, Automatic enrolment to workplace pensions*, Session 2015-16, HC 417, National Audit Office, November 2015.

Key findings

Nature of the challenge

12 **Demographic and economic trends significantly affect pension provision and the risks to affordability that the government has to manage.** The ratio of people in retirement to those in work continues to increase. This could require future adjustments to contribution levels, pension ages and/or the benefits paid to counteract any sustained increase in pension payments, relative to contributions received, across all government pension arrangements. The OBR projects that spending on the state pension will increase from 5.5% to 7.3% of GDP in the long term. At the same time, it forecasts that annual spending on unfunded pensions will fall by around 1% to 1.1% of GDP or to 0.7% of GDP net of member contributions. The unfunded pension projections assume that economic growth will remain higher than the level of pension increases. However, if the economy does not grow as expected, for example with low growth and high inflation, it could have a significant impact on the government's ability to pay pensions as they fall due. Similarly, a downturn in the economy would have a significant impact on the returns on assets held by funded schemes and, therefore, the schemes' ability to meet pension obligations without further increases in contributions (paragraphs 1.12 to 1.16).

13 **The government's reforms have helped to reduce pension costs but overall its balance sheet liability has continued to rise in recent years.** Recent changes to unfunded schemes since the government set up pension commissions in 2002 and 2010 have included increasing the retirement age, changing the measure of inflation used to calculate pension increases from Retail Prices Index (RPI) to Consumer Prices Index (CPI), raising employee contributions and moving to a career average rather than final salary pension. Nonetheless, at the same time, the pension liability has risen by 32% since it was first reported in the WGA in 2009-10. This is mainly because the value of the liability has been adjusted to reflect changes to the discount rate that is applied to adjust the liability to today's prices. Changes arising from movements in the discount rate do not affect the underlying costs of the scheme but are designed to represent the ability of the government to finance the liability in the future (paragraphs 1.10, 2.6 to 2.8).

14 **The contractual nature of unfunded and funded pension schemes affects the government's ability to influence its liabilities.** Unfunded pensions are uncommon across the pension landscape as they are contractual in nature yet are not supported by a pool of assets. The Treasury changed its unfunded public sector schemes in April 2015, following consultation with staff and unions. This included tying retirement age to the state pension age. In addition, the Local Government Pension Scheme (LGPS), which is a funded scheme, was reformed in 2014. The government is in the process of implementing reforms to other funded pension schemes by April 2018. Although it has less influence over those funded schemes, such as the BBC, which are outside of this work, these schemes are covered by legislation which sets the regulatory framework and requirements around funding and valuations. Ensuring that funded pension schemes have adequate assets to meet their contractual liabilities is a particular challenge at a time when funding is being reduced for both local authorities and the BBC, who are responsible for the major funded schemes (paragraphs 2.6, 3.11 to 3.15 and Figure 16).

15 The government's exposure to risk in relation to pensions is significant and challenging. This is due to the varied nature of pension arrangements over which the government has different degrees of influence and control; and the significant impact of the country's economic performance on affordability. A growing pension liability, as reflected in the WGA, presents a risk to public finances if the annual pension costs start to look unaffordable. There is a limit to the level of pensions that the government can reasonably finance annually as a proportion of GDP without having to reduce spending in other areas, increase income through taxation, or increase borrowing (paragraphs 2.10 to 2.11 and 3.15 to 3.16).

Government's approach

16 It is unclear what impact the government's management of the strategic short- and long-term risks associated with pension provision across the public sector has on movements in the liability. The government uses the OBR's cash flow projections and sensitivity analysis to assess the affordability of its future pension costs. It has capped future costs on unfunded pension schemes and local government funded schemes, and regular and consistent actuarial valuations across the schemes ensure contributions reflect the costs. However, these caps do not mitigate against economic effects such as high inflation and low economic growth, which could affect the government's ability to meet its pension obligations. There is a lack of transparency around how these actions to manage affordability risks impact on movements in the government's overall pension liability as disclosed in the WGA (paragraphs 2.11, 2.17 to 2.21 and 3.21 to 3.23).

17 Recent government reforms have generated cash in the short term and managed longer-term costs. Changes such as increasing employee contributions may improve the government's key fiscal measures for government debt, as changes in cash affect these but pension liabilities do not. At the same time, reforms to the benefit structure reduce the rate at which liabilities accrue and the OBR projects changes in the size of the public sector workforce and the ongoing impact of reforms will reduce pension expenditure in the future (paragraph 1.14). Nonetheless, as seen in the case of Royal Mail, the government may also decide to take on historic pension liabilities to facilitate privatisation, increasing its long-term liabilities (by £40 billion for Royal Mail); or it may guarantee pension payments in the event of insolvency, as with BT (whose guarantee was estimated at £7 billion based on the actuarial valuation of the scheme as at 30 June 2014), increasing its long-term risks (paragraphs 1.9, 1.14 and 3.17 to 3.20).

18 The government's support for funded schemes in both the public and private sector exposes it to some risks that it cannot directly control and which, in the case of the private sector, are not fully transparent.

- **Funded public sector schemes**

  Until recently, central government has had limited control over the size of net pension liabilities built up by the most significant funded schemes. However, the government could bear the risks to affordability if the schemes are no longer viable and there is a government guarantee in place; or if the schemes are not covered by the Pension Protection Fund. On average, the schemes of those entities reported in the WGA are around two-thirds funded on an accounting basis. However, just less than one third have less than 60 per cent of the assets needed to meet their liabilities. This liability, which totalled £120 billion in March 2015, presents a risk to the public finances as it may require resources to be diverted from other areas of spending to reduce the funding gap. This is a particular issue for local authorities that hold 89% of the funded pension liabilities. As the funded schemes are numerous, varied and largely operate outside of central government, managing them presents a significant challenge. Nonetheless, the government has greater oversight of the LGPS, which represents the largest funded scheme, and most other funded schemes are subject to the same pension legislation as private schemes in terms of sustainable funding levels (paragraphs 3.7 to 3.9).[5]

- **Support to the private sector**

  The government's Financial Assistance Scheme protects individuals' pensions in those private sector schemes that became insolvent before government set up the Pension Protection Fund. In 2014-15, the provision for potential future pay-outs from the fund had grown to £4.7 billion. From October 2013, the government has allowed some private sector access to public sector pensions, mainly for public sector employees who have been transferred out to private sector providers, although at 25,000 members this represents less than 1% of the total unfunded pension scheme members. Some private sector employers providing public services have also had access to public sector schemes since April 2014 to avoid smaller providers being at a competitive disadvantage. Nonetheless, the government continues to bear the risk that the future pension costs will be higher than expected and this exposure is likely to increase as reforms to the delivery of public services continue. The government has also offered guarantees over pension schemes such as the BT pension scheme in the past. But the Treasury does not have full visibility of the financial risks which it needs to manage its current and future exposure from those guarantees (paragraphs 2.5, 3.5 and 3.18 to 3.19).

5 The Local Government Pension Scheme is exempt from this legislation but will be subject to independent assessments of local authority actuarial valuations, although this framework is as yet untested.

19 The complexities of the pension landscape and its significance to the public finances mean transparency and appropriate disclosure of the government's approach to managing the risks is important. The government assesses pension costs and risks to affordability primarily through cash projections and the OBR's longer-term forecasts. The WGA has the potential to provide important additional information on the ongoing impact of the government's actions to manage its pension exposures. For example, the WGA applies specific accounting standards in its disclosure of pension liabilities. This makes sure pension disclosures are as consistent as possible across the public sector. However:

- The quality of membership data for individual pension schemes needs to be improved and can have a significant impact on the size of the liability disclosed (paragraph 2.18 and Figure 11).[6]
- Changes to government policy on the rate of pension accrual and retirement ages; together with relevant external assumptions such as life expectancy, the rate of inflation and the discount rates, as highlighted below, each have a major effect on the underlying trend data and patterns. However, the relative impact of these policies and assumptions is not clear (paragraphs 2.8 and 2.21).
- The WGA does not quantify the scale of the government's commitments to fund deficits in individual private pension schemes in the event of insolvency, nor does it assess the likelihood of insolvency or volatility in the deficit (paragraph 3.23).
- There is no explanation of how the WGA liability disclosures compare to the cash projections and forecasts the government uses to manage its overall exposure, which would provide a fuller picture of how government is managing its liabilities (paragraphs 2.9 and 2.11).

20 The pension liability in the WGA is highly sensitive to the discount rate chosen. Discount rates, which are used to adjust pension liabilities to today's prices, can be volatile. They can have a significant impact on year-on-year movements, and can mask other trends in the WGA's liability figures. The discount rate used across unfunded pension schemes is based on the rate of return on corporate bonds and a stated inflation assumption. This is in line with generally accepted financial reporting practice and has the advantage of being consistent with private sector schemes, aiding comparability. However, this discount rate may not reflect the unusual nature of unfunded pensions or the market's view of the sustainability of public finances, which is relevant to the Treasury's ability to meet its pension obligations and is reflected in the long-term cost of government debt. Funded schemes, where the corporate bond rate reflects the funding risks, have discretion over the exact corporate bond rate they use and expected future inflation. This produces significant variation in the rates that are applied, which can have a sizeable impact on liabilities, reducing comparability between schemes (paragraphs 2.19, 2.21 and 3.21).

6 Comptroller and Auditor General, *Investigation into members' experience of civil service pension administration*, Session 2015-16, HC 800, National Audit Office, February 2016.

Concluding remarks

21 Against a backdrop of an ageing population and an increasing proportion of people in retirement, the government has a challenging job in balancing the affordability of pension provision with its policy to provide financially for people in retirement. The health of the economy is one of the biggest risks to the affordability of pensions that the government has to manage. The multiple and varied nature of public sector pension arrangements creates a complex environment where managing the overall risks to the government's balance sheet is even more demanding. Although the WGA has the potential to help the government manage strategic risks relating to pensions, it does not clearly disclose the main reasons for cost increases, the sensitivity of the liability to changes in key assumptions or the full extent of the government's commitments to private sector schemes.

22 Recent government reforms to public sector pensions have managed costs and some have generated cash. Nonetheless, the government's pension liability has grown significantly in the last five years and will continue to grow as public sector employees accrue further pension entitlements. As the single largest liability on the balance sheet, there is a risk that continued growth in the liability could cause annual pension costs to become unaffordable. This would have an impact on funding for other public services or would require increases in taxation or borrowing. The scale of the pension landscape places an obligation on the Treasury to provide transparency on the range of financial risks the government is exposed to. We think the Treasury could more clearly demonstrate its grip on its largest balance sheet risk by providing better information on its management approach and its impact. As the pension landscape continues to evolve, the government needs to ensure its assurance and oversight framework is effective and covers the full range of its pension commitments. Without it the government risks making decisions that realise short-term gains but could increase its overall liability in the longer term.

Issues this report raises

23 This landscape report has highlighted a number of issues that merit further consideration and discussion:

Risk management framework

a **How to ensure the assurance and oversight framework is sufficient and appropriate for managing the full range of government's pension commitments as the pension landscape evolves.** This may be particularly difficult for those funded schemes and arrangements involving the private sector where central government has limited authority. Key features could include:

- **A comprehensive view of the government's total current and future exposure across its pension schemes and arrangements.** This may be challenging for long-standing guarantees that the government has provided over pension schemes but it is important for the government to be able to identify and quantify the full extent of its commitments, including to private sector schemes, to evaluate its total exposure.
- **Greater clarity about how the government assesses the long-term risks of pension provision and about the trade-offs it might make as a result.** Bringing together the long-term risks associated with the full range of the government's pension provision would provide greater transparency of the range of its exposures. Taking this portfolio approach to managing risks to affordability could help the government to consider more fundamental issues, such as the future sustainability of its unfunded pension liability; what sustainable funding levels would look like for funded schemes; and the optimum number and size of guarantees it offers to the private sector. It should be clear where government action could increase risks to affordability in the longer term. The government's appetite for risk may change depending on economic and demographic changes and needs to be kept under review.
- **Key measures for assessing affordability.** Such measures would be an essential part of government's strategic management of pensions. There are a number of measures to choose from, including figures from WGA and the OBR's projections of expenditure and economic forecasts. It is likely that a combination of measures would be most effective and provide appropriate levels of transparency.

Managing specific risks to unfunded and funded pension schemes

b **How the government can ensure that it monitors any pension-related financial risks it takes on from the private sector.** For example, when the government allows the private sector access to public sector pensions, it takes on the risk that pension costs in future will be higher than expected. The government needs to monitor the extent of these risks as the reform of public services continues.

c **Whether the challenge of consistent underfunding of funded public sector pension schemes is sufficient.** Most funded schemes are subject to the same pension legislation and regulation as private schemes in terms of sustainable funding levels. The Pensions Regulator has begun to assess how well the LGPS's funds meet governance and administration legal requirements and to build risk profiles for individual funds. However, this assessment does not cover deficits and recovery periods in the way it would for private sector schemes. Although actuarial valuations and contribution rates should now be subject to independent review to ensure the solvency of the funded scheme and long-term cost efficiency, these arrangements have not been tested yet.

d **How the Treasury can provide clarity on the underlying drivers of movements in pension liabilities.** The pension liability in the WGA is influenced by government policy on public sector employment, accrual rates and retirement ages; and external factors such as the rate of inflation, life expectancy and the discount rate. Although the Treasury uses cost projections and sensitivity analysis to understand the drivers of costs, it should focus on improving the disclosures in the WGA to ensure that the impact of these factors is more clearly explained. The Treasury should ensure that it is possible to monitor the influence of its management of the extent of its pension exposures; the factors that are related to overall demographics or economic factors; and the discount rate that is applied to reflect the liability in today's prices.

e **How scheme administrators, employers and sponsoring departments can work together to continue to improve the quality of data on pension scheme members.** Specifically, the Treasury and sponsoring departments should share knowledge of best practice across other public service schemes and identify particular areas of concern.

f **Whether enhancing disclosure of pension liabilities and commitments in pension scheme financial statements would increase the usefulness of the WGA to the government's assessments of long-term affordability.** Currently, the Treasury uses cash flow projections provided by the OBR and sensitivity analysis to analyse future pension costs and risks to affordability. Reconciling this information to the WGA and including further detail on key statistics would provide additional, useful trend information to inform judgements on long-term affordability. Important statistics would include numbers contributing to and drawing from funded and unfunded pension schemes, level of contributions into schemes as well as the impact of changes to discount rates on the liability. Sensitivity analysis of the government's key assumptions, including economic growth, around future pension costs could also provide transparency over the risks to affordability that the government has to manage.

Part One

Pension landscape

1.1 The main aim of pension provision is to ensure individuals have adequate income in retirement. There are many different forms of pensions, but the main types are the state pension, occupational pension schemes provided by employers for their staff and personal pensions provided by insurance companies. The government's role in relation to funding pensions is similarly varied. In addition to providing a state pension for people who have reached state pension age, the government provides occupational pension schemes for public sector employees. It also supports the private sector by offering access to public sector schemes and protecting private schemes if employers become insolvent. The government regulates private sector work-based pension schemes through the Pensions Regulator, although this is outside of the scope of this report.

1.2 In this part we set out the pension landscape in relation to the government, including the overall scale of pension expenditure and liabilities. We draw on the Whole of Government Accounts (WGA), which provides the most comprehensive overview of pension costs of all the individual schemes in the public sector. We also consider the key risks to affordability that the government must manage. Parts Two and Three examine expenditure and liabilities as well as the specific affordability risks around unfunded and funded pensions in greater detail. Parts Two and Three of the report also consider some of the limitations of the WGA in terms of providing transparency on pension costs and liabilities to readers of the accounts and also as a tool for the government to manage risks to affordability.

State and public sector pensions

1.3 The state pension is a benefit received by all pensioners reaching state pension age who have paid or been credited with sufficient National Insurance contributions (NICs) into the National Insurance Fund. Since April 2011, the government has committed to a 'triple lock' on the level of state pension received so that it increases in line with growth in the consumer prices index (CPI), average earnings or 2.5%, whichever is higher.

1.4 The government has no contractual obligation to provide the state pension and could withdraw or change the benefit in future. Without a contractual obligation to make future payments, the government does not recognise a future liability in its accounts and budgets for the annual cash flow of state pension paid in the same way as for other social security benefits. Although people are required to pay NICs to qualify for the state pension, there is no direct link between the contributions paid and the state pension received.

1.5 Public sector occupational pension schemes cover staff working in central government (eg civil service, NHS), local authorities and arm's-length bodies including public corporations, as well as some employees transferred from the public to the private sector or those working for private sector companies which have been contracted to provide public services.

1.6 Most of the schemes in central government are unfunded pension schemes. Unfunded schemes operate on a pay-as-you-go basis, whereby today's contributions from current employees and employers are used to pay today's pensions. These arrangements are uncommon across the UK pension landscape as they are contractual in nature, yet are not matched by a pool of assets. HM Treasury (the Treasury) covers any shortfall between the pensions paid and the contributions received and would also retain any surplus. By comparison, most of the schemes outside central government are funded pension schemes. Funded schemes operate by investing pension contributions from employers and employees to build up assets in a pension fund that are then used to pay pensions as they fall due. **Figure 1** sets out the government's main funding role in relation to pensions, which this part and the rest of the report explains further.

Figure 1
Government's role in financing pensions

	Financing arrangement	Example of pension schemes within the public sector boundary[1]	Example of support for private sector
Social security benefits	Pay-as-you-go arrangement	State pension	
Unfunded pension schemes (see Part Two)	Pay-as-you-go arrangement whereby pension contributions from current workforce pay pensions of those in retirement	Civil service Teachers NHS Armed forces Police Fire	Royal Mail pension scheme New Fair Deal guidance provides access for public sector employees compulsorily transferred to private sector Access to NHS scheme for independent providers of NHS clinical services
Funded pension schemes (see Part Three)	Assets held and used to make pension payments	Local Government Pension Scheme (LGPS) BBC Transport for London[2]	Pension Protection Fund Financial Assistance Scheme Government guarantees

Notes

1 Includes public corporations such as the BBC.

2 The Transport for London pension fund is a private sector pension arrangement in relation to which the government does not have a contractual obligation.

Source: National Audit Office analysis

1.7 As highlighted above, the government's commitments to private sector funded pension arrangements include the following:

- **Pension Protection Fund (PPF):** an insurance type of arrangement. It was set up under the Pensions Act 2004 to protect members of pension schemes if the sponsoring employer becomes insolvent. The PPF usually covers private sector schemes but some funded public sector schemes which fall within a broad definition of the public sector, such as the Transport for London and BBC pension schemes, are also eligible. There is no contractual government guarantee to cover pension schemes if the assets in the PPF are insufficient to cover the claims.
- **Financial Assistance Scheme (FAS):** a commitment by the government to provide assistance and pay benefits to certain individuals who lost out on their pensions when their private sector employer went insolvent before the PPF was established. Like unfunded pension schemes, the FAS pays benefits on a pay-as-you-go basis.
- **Guarantees to former public sector pension schemes:** in the past, when a nationalised industry or company was privatised, the pension scheme remained with the employer and government guaranteed the pension payments in the event of insolvency.

Overview of pensions in the WGA

1.8 The WGA was first published for the 2009-10 financial year. It now consolidates the accounts of over 6,000 organisations across the public sector to produce an accounts-based picture of the UK's public finances. The WGA is the largest consolidation of public sector accounts in the world. It represents a major step forward in the accountability and transparency of pension liabilities as it provides a record of all public sector pension liabilities that are largely comparable across the different schemes or entities within the WGA. It can also provide useful trend analysis, which shows movements in pension liabilities over time. Nonetheless, following its hearings on the 2011-12 and 2012-13 WGA, the Committee of Public Accounts recommended that the Treasury should make better use of the WGA to inform decisions, particularly in areas such as pensions.[7,8]

1.9 By comparison, the National Accounts are the primary source for reporting on the health of the UK economy, including statistics such as the current deficit in the public finances. The core National Accounts disclose the funded pension scheme liabilities but not the unfunded pension liabilities, although since 2012 it has included a supplementary table setting out the liabilities of both funded and unfunded schemes. However, one of the key fiscal measures derived from the National Accounts, public sector net debt, is primarily cash-based and therefore excludes pension liabilities from the calculation.

7 HC Committee of Public Accounts, *Whole of Government Accounts 2011-12*, Thirty-second Report of Session 2013-14, HC 667, December 2013.

8 HC Committee of Public Accounts, *Whole of Government Accounts 2012-13*, Twenty-sixth Report of Session 2014-15, HC 678, January 2015.

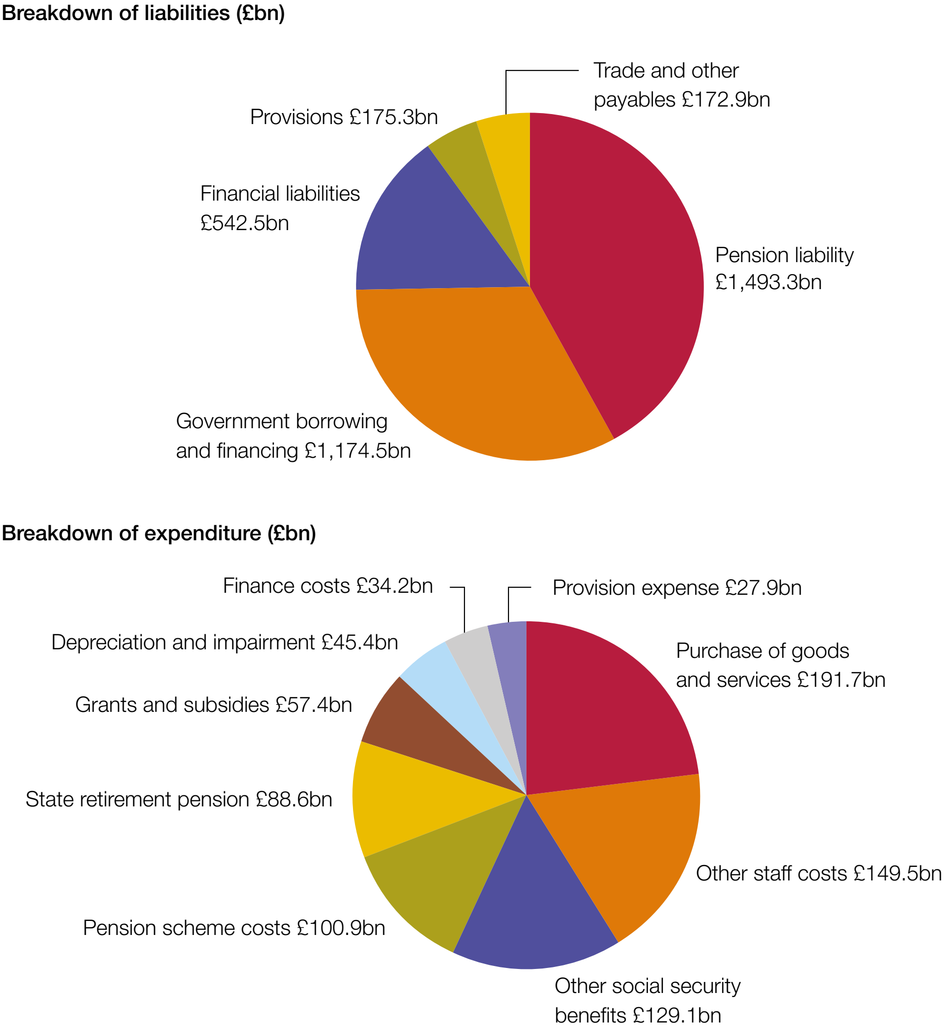
1.10 As the 2014-15 WGA shows, current and likely future spending on pensions is a significant element of total government expenditure and liabilities (**Figure 2** overleaf). The scale of pension costs and liabilities is particularly striking when compared with other significant figures in the WGA:

- The net pension liability, totalling £1,493 billion as at 31 March 2015, was the single largest liability on the balance sheet. It has increased by 32% since 2009-10. In 2014-15, it represented 42% of total liabilities and a total liability of £55,000 per UK household. The liability is equivalent to around 81 per cent of gross domestic product (GDP). By comparison, it is over a quarter larger than government borrowing and financing reported in the WGA (£1,175 billion).
- The net pension liability is a long-term commitment which will be payable over a significant number of years. In 2014-15, the government made pension payments totalling £127 billion, comprising around £38 billion to former public sector employees and £89 billion in state pension benefits. This represented just less than a sixth of total government costs.
- Public sector pension payments, net of member contributions, were equivalent to 1.6% of gross domestic product and around £1,000 per UK household.
- Despite these payments, in 2014-15, the government's net pension liability increased by £190 billion. Excluding actuarial movements, this is mainly due to:
  - the cost of public sector employees building up another year of pension entitlement (£44 billion) which is equivalent to just less than a quarter of the total staff costs; and
  - net financing costs (£57 billion) which account for more than half of the increase in the net pension liability in 2014-15. These costs reflect adjustments in the value of the liability as the benefits become closer to being paid out and are based on the discount rate used to value pensions in today's prices. By comparison, as reported in the WGA, government borrowing cost £28 billion to finance in 2014-15.

1.11 **Figure 3** on page 21 shows the different components of pension expenditure and liabilities in the WGA which we discuss in this report.

Figure 2

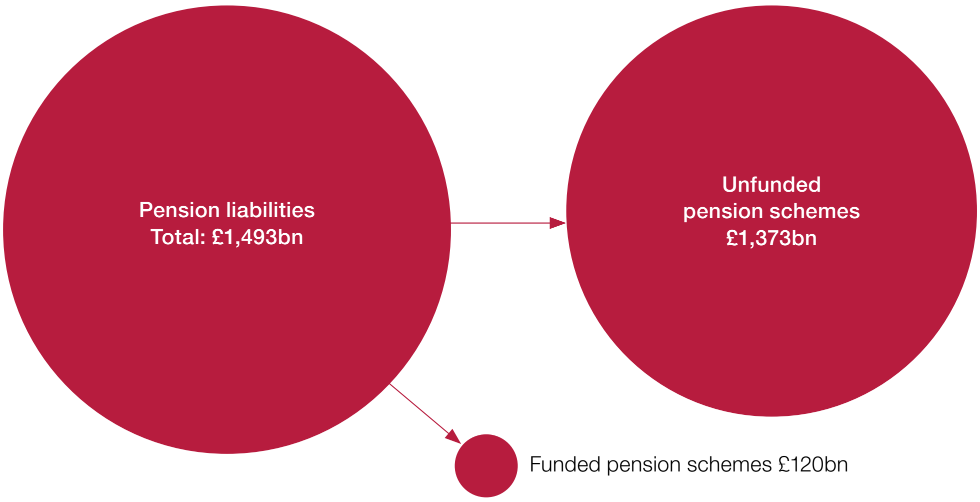
2014-15 Whole of Government Accounts expenditure and liabilities



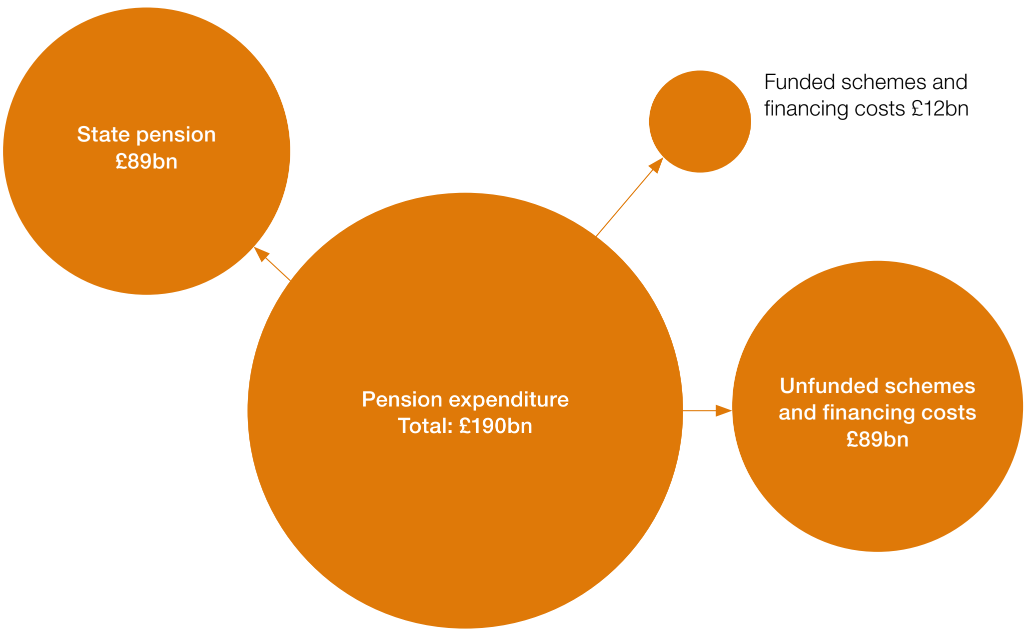
Source: HM Treasury, *Whole of Government Accounts 2014-15*

Figure 3
Pensions in 2014-15 Whole of Government Accounts

Pension liabilities as at 31 March 2015



Pension expenditure in year to 31 March 2015



Notes

1 Expenditure on funded and unfunded pension schemes is on an accruals basis.

2 The liability for the funded pension schemes is net of assets held.

3 Liabilities do not include a liability for the state pension.

Source: HM Treasury, *Whole of Government Accounts 2014-15*

Affordability

1.12 The government's main concern regarding pension provision is the need to balance affordability in the long-term with its policy to provide financially for people in retirement. Significant and continued increases in the cost of pensions would require the government to reduce other areas of spending or to increase its income through higher taxation or borrowing so it could continue to support retirement incomes on the same basis. However, reducing the cost of pension provision by reducing the level of pension received in retirement is difficult because of the impact on individuals. It could also result in unintended consequences such as increases to means-tested benefits.

1.13 An ageing population puts significant pressure on pension affordability. Arrangements such as the state and central government pensions have generally worked on the basis that contributions from the current workforce pay for the pensions received by the previous workforce. However, the forecast in **Figure 4** shows that, as the population of the UK ages, the ratio of people in retirement compared with those in work (dependency ratio) will increase. If this trend continues as expected, it could require future adjustments to contribution levels, pension ages and/or the benefits paid to counteract any sustained increase in pension payments relative to contributions received.

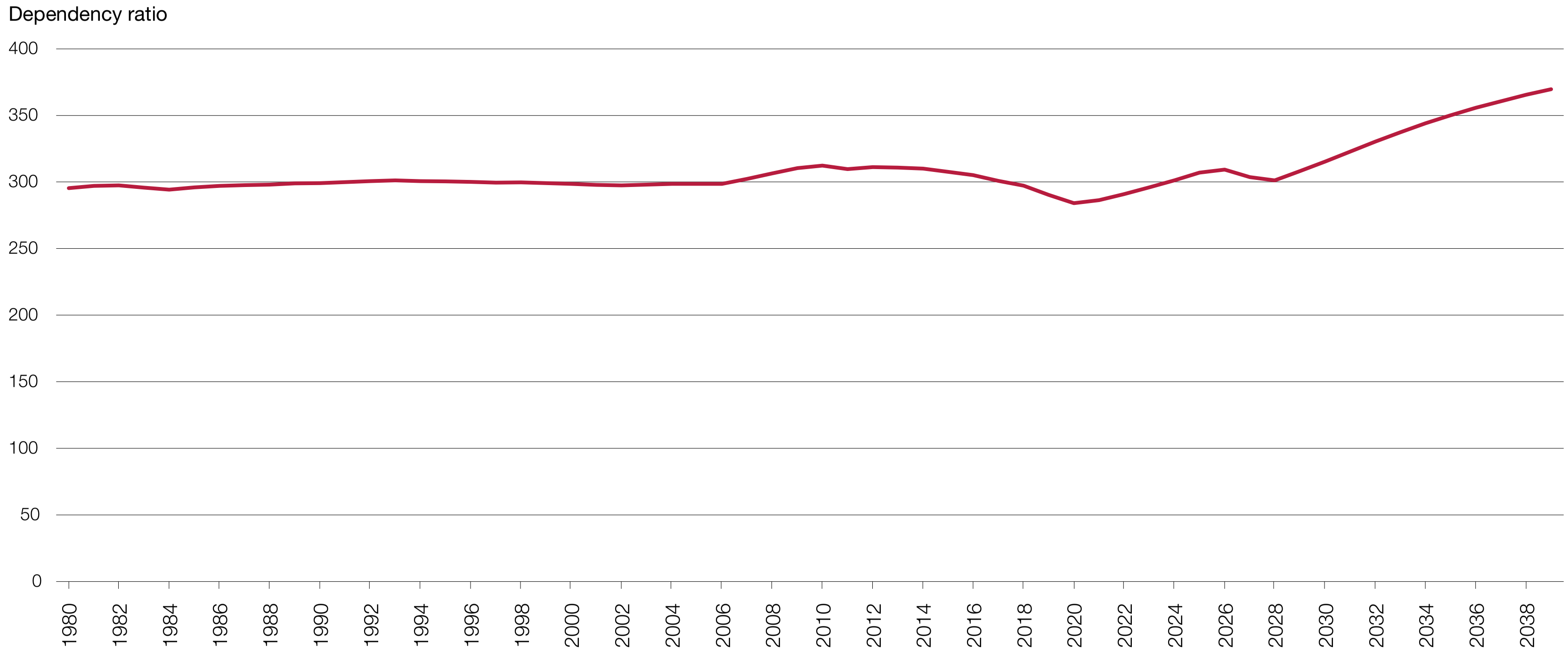
1.14 The Office for Budget Responsibility's (OBR's) forecasts for annual state pension expenditure as a proportion of GDP also show an upward trajectory from 5.5% to 7.3% of GDP (**Figure 5** on page 24). Nonetheless, the size of the public sector workforce which will be entitled to a public sector pension will have a significant impact on the level of future pension expenditure. The number of public sector employees has fallen by around 15 per cent from 6.3 million to 5.4 million between 2009-10 and 2014-15, or by 7 per cent from 5.7 million to 5.3 million once the effect of those significant bodies reclassified from the public to private sector is removed.[9] Figure 5 reflects the OBR's expectation that unfunded pensions will fall by around 1 per cent of GDP to 1.1% or to 0.7% net of member contributions in the long term. This is because there will be fewer public sector workers and because of assumed economic growth and the ongoing impact of reforms.[10]

1.15 NICs are used to finance the state pension, as well as other social security benefits and a fixed proportion of the NHS. However, the Government Actuary's Department estimates that, without a Treasury grant, the national insurance fund will be exhausted by 2035 and the OBR estimates that state pension payments will exceed income from NICs by 2038-39.[11,12]

9 Office for National Statistics, *UK Labour Market, Statistical Bulletin*, July 2015.
10 Office for Budget Responsibility, *Fiscal sustainability report supplementary data series*, June 2015.
11 Office for Budget Responsibility, *Fiscal sustainability report supplementary data series*, June 2015.
12 Government Actuary's Department, *Government Actuary's Quinquennial Review of the National Insurance Fund as at April 2010*, July 2014.

Figure 4
Projected dependency ratio

Dependency ratio per 1,000 people of working age



Notes

1 Based on Office for National Statistics data for actual (to 2014) and projected (2014-based) dependency ratios.

2 The chart shows the number of people above the state pension age (SPA) per 1000 people of working age (16 to SPA).

3 Ratios between 1980 and 2014 are mid-year estimates. Ratios from 2014 onwards are from 2014 based population data.

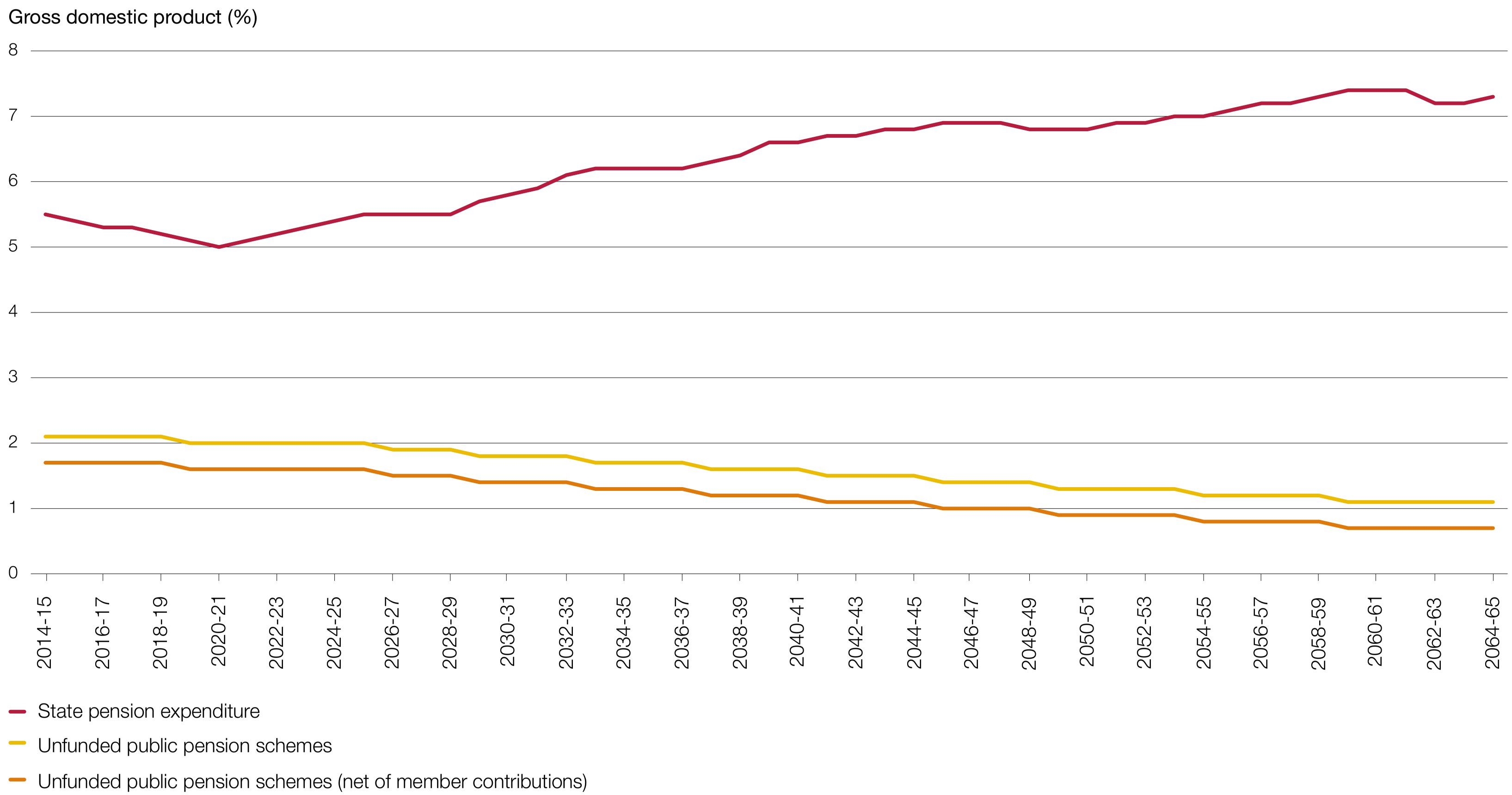
4 The data have been adjusted to take account of changes to the SPA up to and including the Pensions Act 2014.

Source: Office for National Statistics, *UK Perspectives 2016: The changing UK population*, 26 May 2016

Figure 5

Office for Budget Responsibility (OBR) forecasts

Projections for expenditure on state pension and unfunded pensions



Source: Office for Budget Responsibility, *Fiscal Sustainability Report supplementary data series*, June 2015

1.16 For funded schemes, a key risk to affordability is a sustained period of low investment returns. Funded pension schemes rely on investment returns on assets held to minimise the cash contributions in the fund. Low asset returns and increasing life expectancy have been the major contributors to the total pension scheme deficits across FTSE 100 companies. These were estimated to be £89 billion at March 2015.[13] Similar factors affect funded public sector pension schemes.

Recent reforms

1.17 The government set up the Pensions Commission in 2002 and the Independent Public Service Pensions Commission in 2010 (known as the Hutton Commission) to consider affordability of state and public sector pensions. In response, the government implemented the commissions' recommendations by increasing the state and public sector pension age, first set out in the Pensions Act 2007, to reach 68 (by 2046). The Public Service Pensions Act 2013 provides that the retirement age for members of public sector schemes is in line with their state pension age. The Pension Act 2014 also provides a framework for regular review of the state pension age. The first independent review into the state pension age following the Act will be carried out in 2016 and a report published in May 2017.

1.18 In April 2016, the new state pension replaced the system of basic state pension and the additional state pension, where occupational pension schemes could contract out and pay lower contributions.[14] The OBR projects that this reform to the state pension will reduce spending by 0.7% of GDP in the long term. We are currently planning several more detailed reviews that will consider specific reforms, such as the new state pension.

13 JLT, *The FTSE 100 and their pension disclosures*, September 2015, available at: www.jltemployeebenefits.com/our-insights/thought-leadership/sep-2015-jlt-ftse-100-report

14 Comptroller and Auditor General, *The impact of state pension reforms on people with Guaranteed Minimum Pensions*, Session 2015-16, HC 907, National Audit Office, March 2016.

Part Two

Unfunded pension schemes

Nature of the schemes

2.1 The government provides the vast majority of central government employees with access to a defined benefit pension scheme. It has a contractual obligation to provide a pension linked to an employee's salary and years of service accrued. Most public sector pension schemes are financed on a pay-as-you-go or unfunded basis. This means employer and employee contributions pay today's pensions and HM Treasury (the Treasury) makes up any difference through balancing payments. This arrangement of contractual liabilities without a matching pool of assets is uncommon across the UK pension landscape.

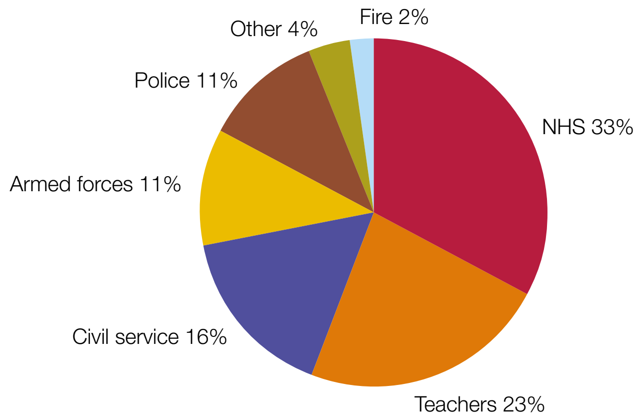
2.2 Contributions are based on rates set by actuarial valuations that are formally undertaken every four years. For unfunded schemes, the employer's contributions are effectively internal transfers within government, as any shortfall between contributions received and pensions paid is covered by the Treasury. This means changes to employer contributions do not impact on the overall affordability of the pensions for government. Therefore, affordability depends upon the level of benefits that are paid net of employee contributions.

2.3 As the government has a contractual obligation to provide the pension, the Whole of Government Accounts (WGA) includes a liability reflecting the commitment to pay pensions based on the service that employees have already built up. Pension schemes for teachers, the NHS and the civil service, each with their own benefit design, account for around three-quarters of the government's unfunded pension liability (**Figure 6**).

2.4 Unfunded public sector pension schemes also include the Royal Mail Statutory Pension Scheme (RMSPS). This was established in 2012 to transfer pension liabilities from the funded Royal Mail Pension Plan before Royal Mail's privatisation in October 2013.

Figure 6

Breakdown of unfunded liability in the Whole of Government Accounts by type of scheme in 2014-15



Source: National Audit Office analysis of *Whole of Government Accounts 2014-15*

2.5 Increasingly, some private sector employers have access to public sector pension schemes. This is largely because of reforms set out in the Treasury's new Fair Deal guidance in 2013. These ensure that public sector staff compulsorily transferred to the private sector retain access to their existing pension.[15] According to data collected by the Treasury, there are currently 25,000 members participating in public sector pension schemes as a result of the Fair Deal, representing less than 1 per cent of the total membership. Further, some public sector schemes may allow other employers, such as independent providers of NHS clinical services, to participate in the schemes in order to avoid smaller providers being at a competitive disadvantage.[16] For example, the Treasury's data show there are now 76 independent providers and 5,000 employers contributing to the NHS pension schemes in England and Wales. These arrangements are likely to increase in scope as reforms to the delivery of public services continue.

2.6 Since the Pension Commissions in 2002 and 2010 (paragraph 1.17), the government has made major changes to unfunded public sector pensions, including:

- changing the measure of inflation used to calculate pension increases from Retail Prices Index (RPI) to Consumer Prices Index (CPI);
- aligning the retirement age with the state pension age;
- basing pensions on a career salary average rather than final salary (from April 2015); and
- increasing member contributions by 3.2 percentage points in the period from 2012 to 2015.

15 HM Treasury, *Fair Deal for staff pensions: staff transfer from central government*, October 2013.
16 Department of Health, *The National Health Service Pension Scheme (Amendment) Regulations 2014: response to consultation*, March 2014.

2.7 The Office for Budget Responsibility (OBR) projects that these recent government reforms will reduce net annual expenditure in the long term by 0.6% of GDP.[17,18] **Figure 7** shows the impact of the changes on government debt in the short and long term and the impact on the WGA liability.

2.8 In the last five years, the WGA liability for unfunded schemes has increased by £358 billion to £1,373 billion in 2014-15 (**Figure 8**). However, there are a number of movements that underpin this trend:

- the liability decreased by £9 billion as current employees built up fewer pension entitlements than the benefits paid out of the scheme;
- the liability reduced by around £105 billion in 2010-11 because of the change from RPI to CPI in 2010-11 (Figure 7);
- the creation of the RMSPS in 2012 increased the liability by another £40 billion;
- the most significant single movement is a £237 billion increase as the value of the liability is adjusted to today's prices to reflect that accrued pensions are closer to being paid out; but
- the disclosures in WGA are not sufficiently detailed to explain how much of the remaining £195 billion movement in the liability is due to changes in the discount rate as opposed to other assumption changes (such as life expectancy) or to experience being different from what was expected.

Figure 7

Impact of reforms of different measures of savings

Change	Impact on current government debt	Impact on government debt in the long term	Impact on WGA liability
RPI to CPI pension increases	£6 billion annual saving by 2014-15[1]	Reduce benefit expenditure by 0.4% of GDP	£105 billion reduction recorded in 2010-11
Reform of benefit structure	No impact	Reduce benefit expenditure by 0.1% of GDP	No impact. However, will reduce further build-up of the liability from 2015
Increased employee contributions	£1.8 billion annual saving by 2014-15	Reduce staff costs by 0.1% of GDP	No impact as no fund of assets to offset the liability
Combined	**£7.8 billion annual saving by 2014-15**	**Reduce net expenditure by 0.6% of GDP**	**£105 billion reduction recorded in 2010-11**

Note

1 Taken from the Spending Review 2010.

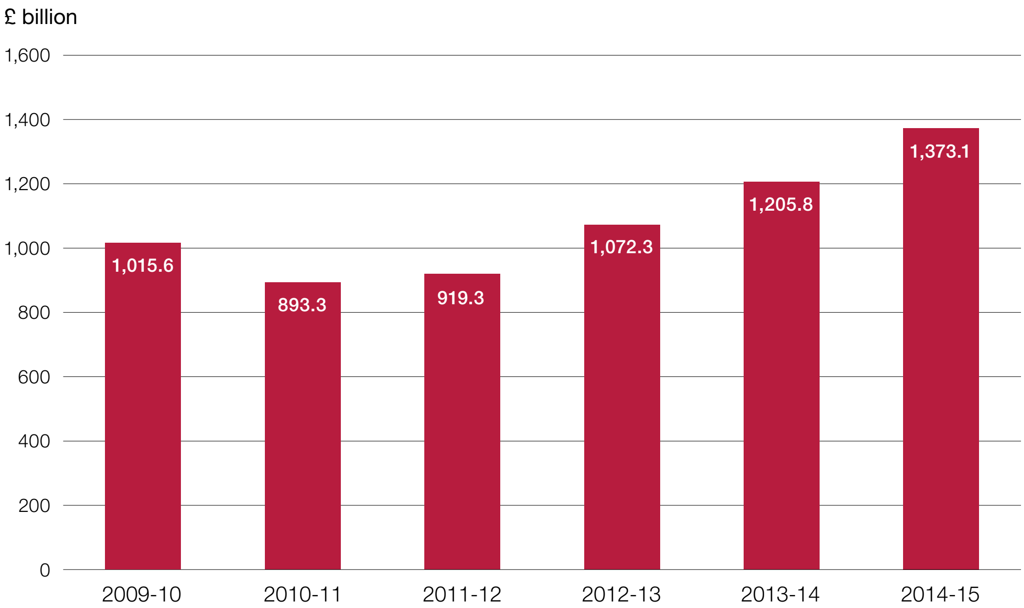
Source: National Audit Office analysis of the Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2012; HM Treasury, *Whole of Government Accounts 2010-11* and *2014-15;* and HM Treasury, *Spending Review 2010*, Cm 7942, October 2010

17 The Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2012.

18 This 0.6% reduction forms part of the OBR's projection that overall unfunded pensions will fall by around 1% (paragraph 1.14).

Figure 8
Change in the unfunded pension liability

Unfunded pension liability reported in the Whole of Government Accounts between 2009-10 and 2014-15



Source: HM Treasury, *Whole of Government Accounts*

Affordability

2.9 The liability figure in the WGA is a useful indicator of the government's exposure on unfunded pension arrangements and movements over time. However, although the liability gives an indication of future payments at today's prices, it represents the pension entitlement that individuals have built up to date and, in line with accounting standards, does not include the entitlement that they will accumulate in the future or the future income that will be received through contributions.

2.10 A growing pension liability presents a risk to public finances if the annual pension costs start to look unaffordable. There is a limit to the size of the liability as a proportion of GDP that government can reasonably finance each year on an unfunded basis without having to reduce other areas of spending or increase income through tax increases or further borrowing. For example, if the pension costs were to exceed a set proportion of GDP and be deemed unsustainable, this might prompt further review of the largest schemes.

2.11 The government uses the OBR's cash flow projections – which reflect pensions already accrued as well as those that will be earned in the future – and sensitivity analysis to assess the affordability of its future pension costs. It has capped future costs on unfunded pension schemes and regular and consistent actuarial valuations across the schemes are carried out to ensure contributions reflect the costs. The Committee of Public Accounts has highlighted previously the lack of criteria for the Treasury to judge the affordability of public service pension costs. It recommended that the Treasury set out what it considers an affordable level of spending against which to assess costs.[19]

2.12 In the 2016 Budget, the government announced that it was reducing the discount rate used to calculate employer contributions to unfunded schemes to 2.8%. This will increase pension costs for government bodies from 2019-20, reducing the Treasury's direct funding of the shortfall between contributions received and pensions paid. However, it will not reduce the overall cost to government as the majority of employer contributions are internal government transfers.

2.13 As outlined in Part One, adverse economic or demographic effects could have a significant impact on affordability due to the scale of unfunded pensions. The key factors affecting affordability are similar to those for the state pension (paragraph 1.13). The government has introduced a number of ways to help manage risks to the affordability of individual pension schemes in the longer term, as shown in **Figure 9**. For example, it can adjust pension ages, cap some costs of providing the schemes and, as seen above, change the measure of inflation used to increase pensions. The Treasury has also taken steps to improve its oversight and governance arrangements. Importantly, it is now more involved in the actuarial valuations that affect the level of employer contributions and therefore any shortfall that it may have to cover.

2.14 Despite these measures, the government does not have a way of managing the long-term risk should future government revenues be insufficient to meet pension payments. For example, if economic growth were static compared with inflation in the long term, the costs of providing pensions would increase compared with the level of revenues that could be raised. At the same time, the Treasury and other public sector organisations already facing budgetary pressures may not be able to pay the benefits due. In this scenario, the extreme option available to the government would be to reduce the level of public sector pensions, but it has limited flexibility to do this because of its contractual obligations. In recent times, within the EU, only Greece and Ireland have made changes to their contractual obligations in relation to public sector workers due to significant economic crises.

2.15 As highlighted in paragraph 1.9, the government's key fiscal measure of debt focuses on cash paid and received and therefore excludes pension liabilities. As a result, the government could raise cash and reduce debt while increasing the liability at the same time. Some government pension reforms have increased cash flow and reduced government debt in the short term at the expense of increasing pension liabilities (**Figure 10**).

19 HC Committee of Public Accounts, *The impact of the 2007-08 changes to public service pensions*, Thirty-eighth Report of Session 2010–2012, HC 833, May 2011.

Figure 9

Government measures to control costs in the long term

Risk to affordability	Risk mitigation approach
Longevity	Mechanism to adjust pension age if longevity continues to increase and hence the retirement ages in the public sector pension schemes. The reviews are based on the principle that people should spend a given proportion of their lives receiving a pension and therefore will take into account changes in life expectancy.
Cost of providing pension schemes	The cost cap mechanism is designed to prevent continual growth in pension costs. The cap is built into the actuarial valuation, whereby employee contributions increase or future accrual of benefits is reduced if certain costs increase by more than 2% of pay. The cap mitigates against changes affecting members that would increase costs such as increased life expectancy. But it does not apply to changes in discount rate, inflation or economic growth that could affect affordability.
Inflation and pension increases	The government can change the measure of inflation as defined in the Social Security Pensions Act 1975, which impacts on pension increases awarded.
Lack of central oversight	HM Treasury has increased power to direct the methodology and assumptions used in actuarial valuations.
Poor governance	Introduction of pension boards and increased oversight from the Pensions Regulator. From April 2015, the Pensions Regulator's role expanded and it now regulates public service pension schemes to improve standards of governance and administration and drive compliance with the associated legal requirements.

Source: National Audit Office analysis

Figure 10

Pension reforms that raise cash now but build up long-term liabilities

Reform or creation of unfunded arrangements	Impact on short-term cash flow	Impact on long-term cash flow	Short-term impact on government debt	Impact on WGA liability
Private sector contractors access to public sector pension schemes	Increase revenue	Increase benefit expenditure Increase revenue if policy remains	Reduce	Small increase in the short term potentially increasing over time
Royal Mail pension scheme de-funding	Increase revenue	Increase benefit expenditure	Reduce	Increase

Source: National Audit Office analysis

2.16 By giving the private sector access to public sector pension schemes (paragraph 2.5), the government is charging the employers now for the expected cost of those payments in the future. Although the government monitors the affordability of these schemes through actuarial valuations and checking current and past contributions adequately reflect the likely future costs, it is also taking on the risk that the cost in future could be higher than expected.

Limitations of the WGA

2.17 In addition to the cash projections the government already uses, the information in the WGA on the unfunded pension liability across the full range of schemes should also highlight potential risks to future affordability. There are many positive aspects to the modelling that underpins the liability figure, in particular, including specific accounting standards and guidance, which help ensure consistency of approach and disclosure. However, there are some limitations that the government would need to consider, particularly around the quality of data and the understanding of the discount rate applied to reflect the liability in today's prices.

2.18 As **Figure 11** shows, our audits of three of the largest unfunded pension schemes have highlighted concerns about the quality of membership data. Although there have been some improvements, we have highlighted issues with data in the 2014-15 civil service pension scheme accounts. We have also made recommendations to the Cabinet Office and the Civil Service Pension Board to work with employers and MyCSP to resolve data issues.[20] The impact of poor-quality data can be significant, as shown by the restatement for the armed forces 2011-12 accounts, which increased the pension liability as at 31 March 2011 by £0.9 billion.

2.19 The discount rate, used to adjust the liability figure to today's prices across government pension schemes, has been discussed extensively by the Treasury and the Financial Reporting Advisory Board in recent years.[21] The discount rate can be highly volatile and the impact of volatility in assumptions on pension liabilities can be significant as shown by the £237 billion increase in the liability over the last five years (paragraph 2.8).

Figure 11
Audit opinions on data quality

Scheme	Emphasis of matter statements	Qualifications	Restatement of liability
Civil service	2012-13, 2013-14, 2014-15	2010-11, 2011-12[1]	None
NHS	2005-06, 2006-07, 2007-08, 2008-09, 2009-10	None	None
Armed forces	None	2005-06, 2006-07, 2007-08	2011-12

Note

1 Although the Civil Service Accounts were qualified in 2014-15, this qualification related to a breach of the scheme's authorised limit for net resource expenditure rather than data quality.

Source: National Audit Office analysis

20 Comptroller and Auditor General, *Investigation into members' experience of civil service pension administration*, Session 2015-16, HC 800, National Audit Office, February 2016.

21 The Financial Reporting Advisory Board advises government on the application of accounting practice to government. More details are available at: www.gov.uk/government/groups/financial-reporting-advisory-board-frab

2.20 Although the police and fire service pension schemes choose their own discount rate, the Treasury sets the rate for all other unfunded schemes in line with the corporate bond rate, as required by generally accepted accounting practice. While this has the advantage of being comparable to private sector schemes, the corporate bond rate reflects the market's view on the relative risk of corporate bonds, rather than the sustainability of the government's finances and its ability to meet its ongoing liabilities, which is best reflected in the long-term cost of government debt. The corporate bond rate is appropriate for funded schemes where the government's ability to finance the liabilities is influenced by market rates. However, unfunded government schemes have no directly comparable arrangements in the UK private sector and are similar in nature to other government liabilities in terms of the exposure they provide. The discount rate for government pension arrangements is also inconsistent across similar types of liabilities, for example provisions such as the government's Financial Assistance Scheme – which is comparable in nature to unfunded pensions – use the cost of government borrowing as a discount rate.

2.21 The impact of discounting on the value of the pension liability can be considerable and dominates other significant year-on-year changes in the liability (paragraph 2.8). However, the WGA does not allow the reader to judge how much of the movement in the liability is due to changes in the discount rate. For example, **Figure 12** shows that the teachers' pension scheme liability is around 44 per cent (£84 billion) higher than it would have been if the discount rate used to value it had not changed from 2010-11. However, the liability is just 11% higher than it would have been if the 2009-10 discount rate of 1.8% had continued to be used. This level of movement for a factor that is external to the risks to the government's financing and exposure needs to be carefully explained to ensure that there is clear understanding of the underlying drivers of affordability within the schemes in the WGA. These drivers are the government's policy on retirement ages; the rate of public sector employment and life expectancy; the rate of accrual of benefits; and long-term expectations of inflation.

Figure 12

Variation in the teachers' pension liability in the 2014-15 accounts using the discount rate set for each of the last five years

Real discount rate for pensions	1.3%	1.8%	2.35%	2.8%	2.9%	1.8%
Year rate adopted	2014-15	2013-14	2012-13	2011-12	2010-11	2009-10
Teachers' Pension Scheme 2014-15 liability on revised rate	£276bn	£249bn	£221bn	£197bn	£192bn	£249bn

Note

1 These are approximate figures based on sensitivity analysis in the Teachers' Pension Scheme annual report and accounts.

Source: National Audit Office analysis of *Teachers' Pension Scheme (England and Wales), Annual Report and Accounts*

Part Three

Funded pension schemes

Nature of the schemes

3.1 Funded schemes within government are similar to unfunded schemes in the way the benefits are designed. The main difference is that, as with private sector schemes, contributions from employers and employees are used to generate assets that should offset the pension liability. If the liabilities are greater than the assets held, then the scheme is in deficit. The employer and, potentially, the employees are expected to make extra contributions to reduce it over an agreed period of time: the recovery period.

3.2 As with unfunded pensions, there is a contractual obligation to provide the pension. The largest scheme is the Local Government Pension Scheme (LGPS), which has around 5 million members in England and Wales, including active members, deferred members and pensioners.[22,23] The LGPS accounts for most of the funded pension net liability figure in the Whole of Government Accounts (WGA) and, similarly to some unfunded schemes (paragraph 2.5), it permits some non-public sector bodies to participate in the scheme. Data from the Department for Communities and Local Government show that in 2014-15 there were around 4,000 non-public bodies covering 134,000 members contributing to the LGPS in England and Wales. There are also schemes for other public bodies, including Transport for London,[24] and public corporations such as the BBC.

3.3 There is no central approach to managing assets held by the funded pension schemes. For example, each of the 99 separately administered regional funds in the LGPS has its own advisors and investment managers. Each fund also sets its own investment strategy. However, to reduce management costs by exploiting economies of scale, the government has committed to pooling the LGPS assets in the 90 funds in England and Wales into six larger funds. Assets will start to be transferred from April 2018.[25,26]

22 *The Local Government Pension Scheme (LGPS) in England and Wales Annual Report 2014*, April 2015. Available at: www.lgpsboard.org/index.php/schemedata/scheme-annual-report

23 The Department for Communities and Local Government, *Local Government Pension Scheme Funds England 2014-15, Statistical Release*, October 2015. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/471678/Pension_Release_England_2014-15.pdf

24 The Transport for London pension fund is a private sector pension arrangement to which the government does not have a contractual obligation.

25 HM Treasury, *Spending Review and Autumn Statement 2015*, Cm 9162, November 2015.

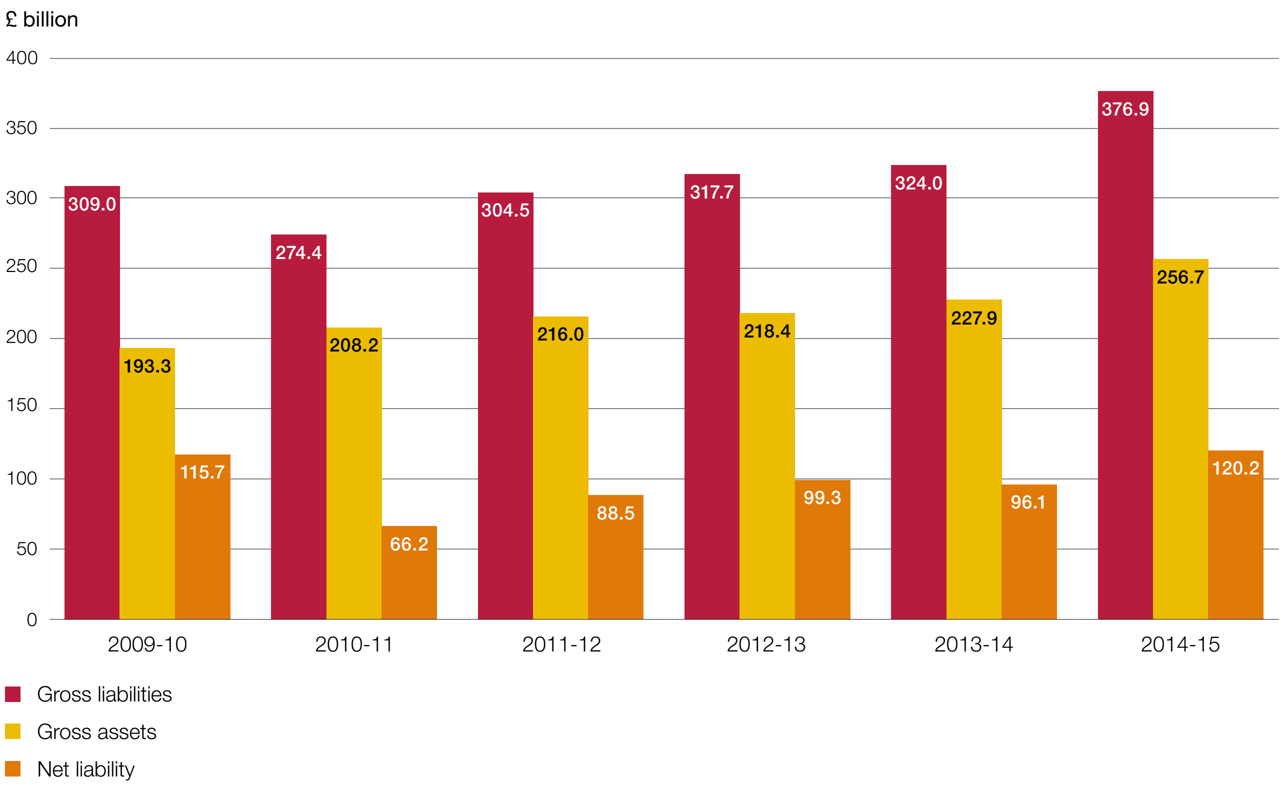
26 The Department for Communities and Local Government, *Local Government Pension Scheme: Investment Reform Criteria and Guidance*, November 2015. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/479925/criteria_and_guidance_for_investment_reform.pdf

3.4 The WGA includes the pension liability net of any assets held for those bodies which fall within the accounting boundary. In the last five years, the WGA net liability increased by £5 billion to £120 billion in 2014-15 (**Figure 13**). This change was mainly due to:

- a decrease of around £5 billion as contributions paid into the scheme exceeded the pension entitlement built up by current employees;
- a decrease of around £21 billion due to changing from Retail Prices Index (RPI) to Consumer Prices Index (CPI) in 2010-11;
- an increase of around £15 billion as the value of the net liability is adjusted to today's prices to reflect that accrued pensions are closer to being paid out; and
- as with the unfunded schemes, the disclosures in WGA are not sufficient to explain how much of the remaining £16 billion movement in the liability is due to changes in the discount rate as opposed to other assumption changes (such as life expectancy) or to experience being different from what was expected (paragraph 2.8).

Figure 13
Change in the funded pension liability

Funded pension liability reported in the Whole of Government Accounts between 2009-10 and 2014-15



Note

1 2013-14 figures were restated to reflect the inclusion of Network Rail in WGA from 2014-15.

Source: National Audit Office analysis of the *Whole of Government Accounts*

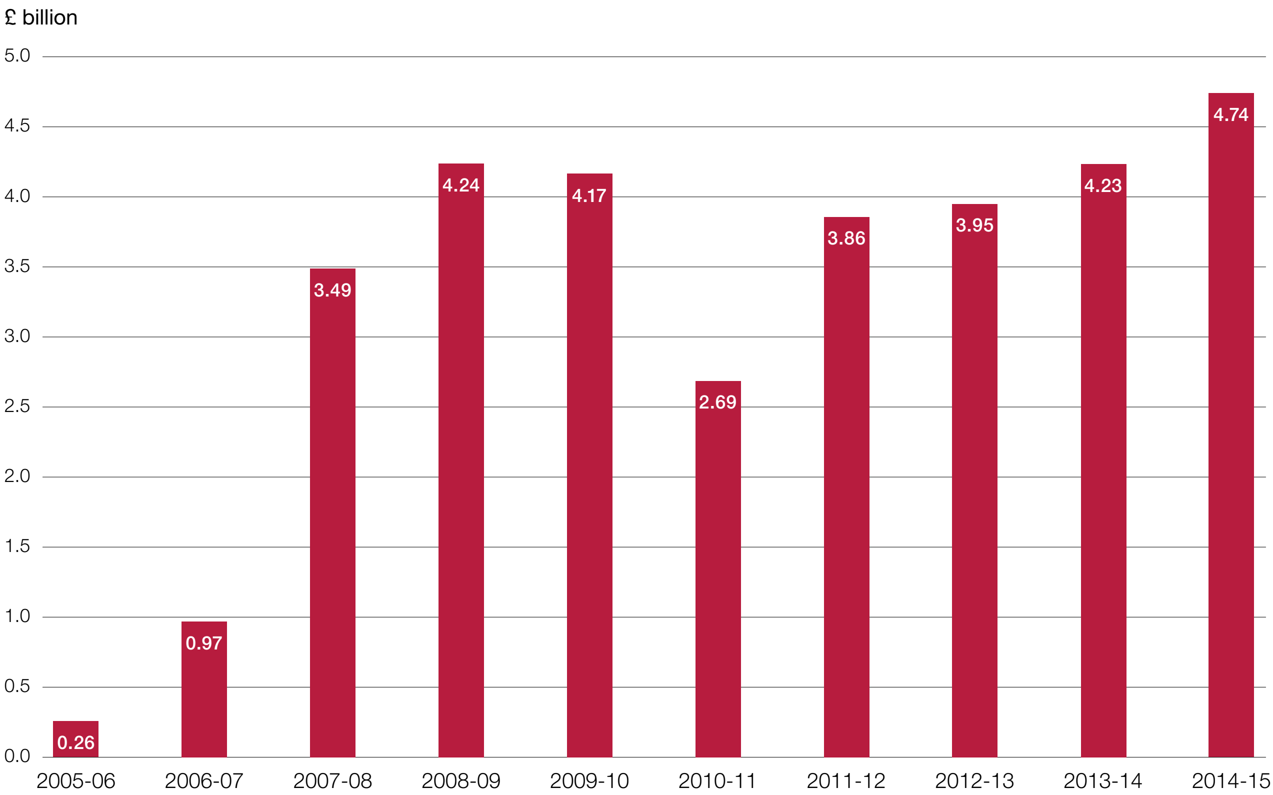
3.5 The WGA also includes the government's provision for the Financial Assistance Scheme (FAS) (paragraph 1.7). This reflects the government's commitment to pay assistance to individuals for pensions lost when their private sector employer went insolvent before the Pension Protection Fund (PPF) was introduced. The FAS was established in 2005 and is aimed at pension schemes that began to wind up between 1 January 1997 and 5 April 2005. The FAS provision has grown to £4.7 billion by 2014-15 (**Figure 14**), largely due to:

- legislation increasing the benefit provision and number of eligible pension schemes;
- the government taking on more of the pension scheme liabilities as it changed the way FAS was structured; and
- changes in assumptions and new data arising over the years.

Figure 14

Financial Assistance Scheme provision

Change in the Financial Assistance Scheme provision since 2005



Note

1 From 2010-11 there was a change in the model used to estimate the provision.

Source: National Audit Office analysis of the *Department for Work & Pensions Annual Report and Accounts*

3.6 After allowing for the movements highlighted in paragraph 3.5, the volatility in FAS provision shown in Figure 14 is mainly caused by changes in the methodology used to estimate the provision in 2010-11. It is also caused by continued improvements in data quality, changes in discount rates and events that were different from expectations. The estimate will change further as assets remaining in eligible pension schemes were transferred across to the FAS by March 2016. Although the amount that may need to be paid out in future is variable, individuals eligible to receive benefits will not have been building up further benefits. This means any increase in the provision will be because payments are one year closer to being made.

Affordability

3.7 One measure of future affordability on funded schemes is the funding level of the schemes and therefore the ability of the sponsoring employer to pay sufficient contributions so that there are sufficient assets to cover the liabilities when they fall due. On average, the schemes of those entities reported in the WGA are two-thirds funded and **Figure 15** overleaf shows the wide range in the funded net liability on an accounting basis. However, actuarial valuation methods may reflect different average funding levels. For example, aggregated valuations of the LGPS in England and Wales for 2013 show an average funding level of 79%.[27] By comparison, in the underlying WGA data, almost one in three bodies have funded schemes with less than 60% of the assets needed to meet the liabilities. Financing these deficits means that bodies responsible for the schemes could have less budget for other purposes or may need to generate additional funding in the future.

3.8 HM Treasury (the Treasury) is not involved in the process for determining the contribution rates for the funded schemes, as it is for the unfunded schemes, or the period over which any underfunding is recovered. On funded schemes, such as the LGPS, actuarial valuations are obtained by the administering authority which include plans to recover any deficit in the scheme. Funds can set recovery periods longer than the 15 years required for recovering underpayments on unfunded schemes and some have recovery periods of over 25 years. Spreading the cost over a longer period has the benefit of reducing annual expenditure but delays recovering the deficit in the long term.

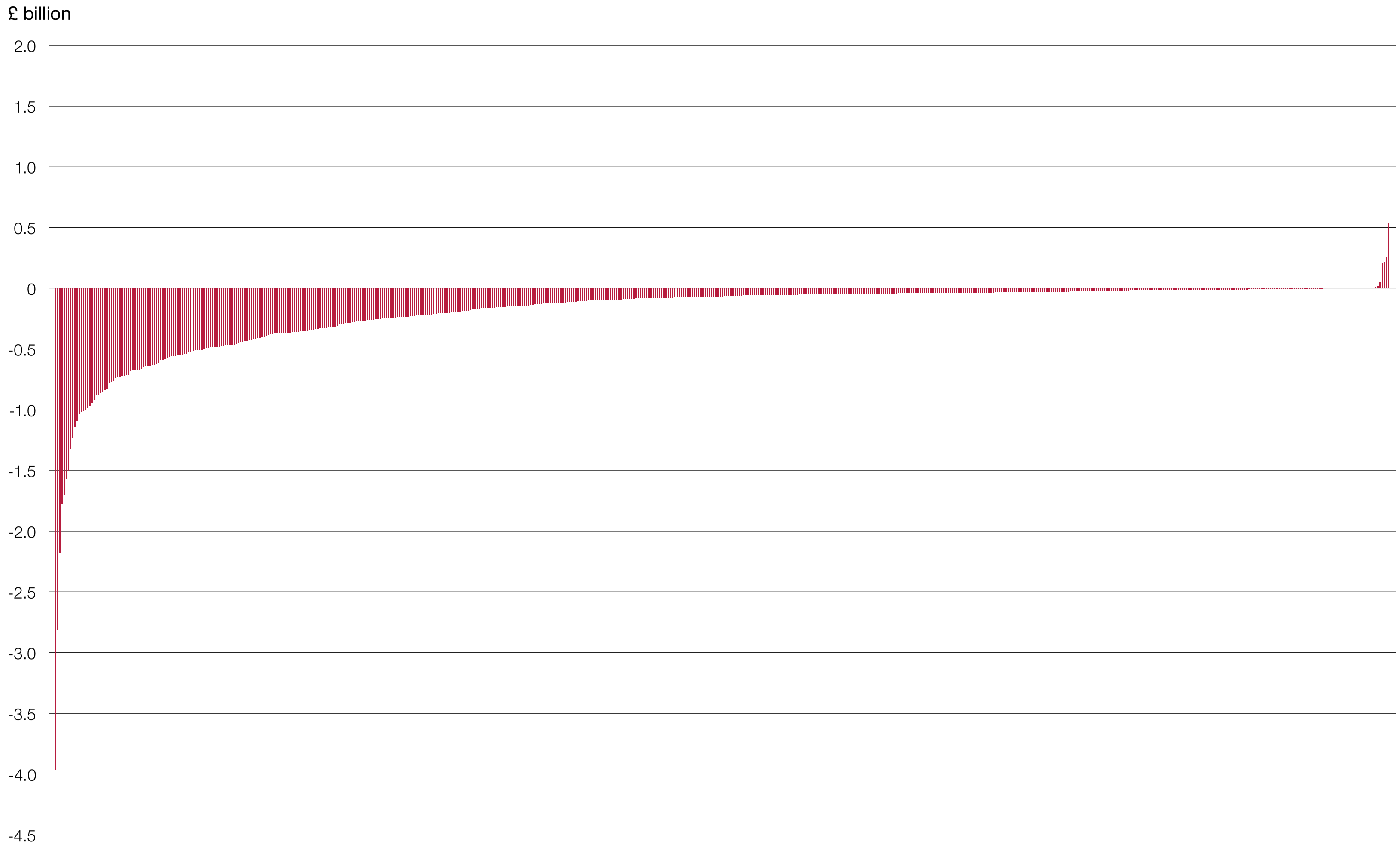
3.9 The Pensions Regulator assesses the appropriateness of assumptions and the length of the recovery period for private sector pension schemes and some public sector funded schemes but not the LGPS. Its role has expanded to include assessing how well the LGPS funds meet the governance and administration legal requirements and the standard to which they are being governed. It uses this information to build risk profiles for individual public service schemes. However, the Regulator's assessment does not cover deficits and recovery periods specifically.

27 Available at: www.lgpsboard.org/index.php/funding-2015

Figure 15

Funded net liability in the Whole of Government Accounts

The range of funded net liability by entity



Source: National Audit Office analysis of *Whole of Government Accounts 2014-15*

3.10 Nonetheless, the Public Service Pensions Act 2013 (the Act) gives central government greater oversight of the LGPS actuarial valuations and the appropriateness of employer contribution rates. It states that these should be subject to independent review by a qualified individual appointed by the Department for Communities and Local Government to ensure that the funded scheme is solvent and cost-efficient in the long term. Further, the Act gives the Treasury power to direct the methodology and assumptions used in the scheme valuation. To date, the Treasury has not set out what it considers to be an acceptable or sustainable level of underfunding that could inform decisions over reasonable recovery time frames.

3.11 Whereas the Treasury largely controlled the reforms for most unfunded schemes, reforms of funded schemes involve more stakeholders outside of central government and the Treasury has more or less direct influence depending on the nature of the scheme. For example, the LGPS is a statutory scheme and therefore the rules governing it are written in statute as for unfunded schemes. As a result, the Treasury had more influence over the reforms that could be made to the LGPS. This means reforms to the LGPS have been similar to those for unfunded schemes. Although there was not the same requirement to increase member contributions (paragraph 2.6), the LGPS moved from a final salary pension scheme to a career average salary one year earlier than the unfunded schemes. The Act has also put in place an employer cost cap to control future spending on the LGPS, although the first assessment against this cap has not yet been made and the cap will not apply to costs of the pension rights for deferred members or pensioner members accrued before 2014.

3.12 The reform process for other funded schemes is ongoing. The Treasury expects that reforms equivalent to those made to unfunded schemes and the LGPS will be implemented by April 2018 and has asked employers to present reform proposals for its approval. Although central government has less influence over those funded schemes, such as BT and the BBC, which are outside of this work, all such schemes are covered by legislation which sets requirements around funding, valuations and the pensions regulation framework. Further, for most funded schemes, the Treasury has the option to use the powers set out in the Public Service Pensions Act 2013 to restrict or close those schemes which do not reform far enough. The Treasury has not yet used these powers to close a funded, trust-based scheme, however.

3.13 Compared with LGPS, the sponsoring entities of these schemes have greater autonomy which has contributed to a range of pension entitlements across the schemes and the extent of any reforms made. For example, schemes such as those open to new employees of Transport for London offer pension benefits that have been closed to new employees in unfunded central government schemes for many years. These include final salary pensions, the option to take an unreduced pension from the age of 60 and pension increases linked to RPI. While Transport for London is working on proposals to reform the scheme in the interests of affordability and long-term sustainability, some reforms will require legislative change. Others, such as the BBC pension scheme, have reformed further and offer new joiners access to a defined contribution scheme instead.

3.14 **Figure 16** shows the difference in the reforms that have affected members of unfunded schemes compared with those in funded schemes. This is a consequence of the Treasury having different degrees of control in negotiations over reforms with employers. At the same time, increases in contributions from members of unfunded schemes have a greater impact on overall government's finances as they reduce any shortfall that the Treasury might have to fund whereas member contributions on funded schemes do not.

3.15 Adverse economic or demographic effects could have a significant impact on affordability on public bodies due to the relative size of their pension liabilities. Growth in the assets relative to the measure of inflation used to increase benefits has a significant impact. It affects the size of the deficit and hence the ability of entities to pay contributions into the schemes at a rate that may be affordable now and in the longer term. Liability estimates are also highly sensitive to demographic changes such as people living longer in retirement than expected. **Figure 17** draws on Transport for London's own sensitivity analysis published in its 2014-15 annual report and accounts to illustrate the impact of such changes on the net liability.

3.16 Aside from providing additional funding, the government does not have a way of managing the long-term affordability risks should asset returns be insufficient to meet higher than expected pension payments and result in unsustainable employer contributions or requests for increased funding. In the event of low asset returns in the long term compared with inflation, additional contributions may be required. At the same time, public sector organisations already facing budgetary pressures may not be able to fund the necessary increase in the level of contributions. In this scenario, the extreme option available to the government is either to provide direct funding or to allow employers of those funded schemes covered by the Pension Protection Fund (PPF) to go insolvent and transfer the scheme to the PPF.[28] To date, however, no public sector schemes have moved into the PPF. In this scenario, although not legally required to, the government might decide to ensure the payment of benefits to members of the schemes through other means or might opt to reduce benefit entitlement.

28 LGPS is not covered by the Pension Protection Fund.

Figure 16

The historic choice of financing a pension arrangement is influencing how the arrangement is being reformed

Reform	Unfunded schemes such as civil service	Funded schemes
Increased member contributions	Required to increase employee contributions by an average of 3.2 percentage points of pay	Government expects employee contributions on schemes covered by the Public Service Pension Act to be increased as part of wider reforms to be implemented by April 2018[1]
Benefit reforms	Treasury controlled process to set the benefits provided	Employer-led process with Treasury agreement
Pension flexibilities	Ban on transfers to access pension flexibilities	No ban on transfers

Note

1 Although the LGPS was not required to increase employee contributions, it did make other reforms such as moving from a final salary to career average salary scheme one year earlier than the unfunded schemes.

Source: National Audit Office analysis

Figure 17

Sensitivity of net liability to changes in key assumptions – Transport for London example

Factor impacting on affordability	Impact on net liability for Transport for London[1]
Discount rate 1% per year lower than expected	Increase deficit by around 19% of the scheme liabilities
Salary growth 1% higher than expected	Increase deficit by around 5% of the scheme liabilities
Individuals living five years longer than expected in retirement	Increase deficit by around 18% of the scheme liabilities

Notes

1 Available at: http://content.tfl.gov.uk/annual-report-2014-15.pdf – p. 220.

2 Impact on net liability is on an accounting basis.

Source: National Audit Office analysis of Transport for London, *Annual Report and Statement of Accounts 2014-15*

Managing guarantees over funded pension arrangements

3.17 As **Figure 18** shows, there are several examples where central government has provided financial support to a range of funded public service pension schemes. In the four cases identified, government financial support totalled £1.4 billion.

Figure 18

Examples of government financial support packages for funded or previously funded schemes

Scheme (employer)	Reason for support	Nature of support	Support amount in 2014-15
Closed Environment Agency Pension Fund (Environment Agency)	The Closed Fund provides benefits for employees from predecessor water industry bodies. There were insufficient assets allocated to meet the future pension liabilities at the point of privatisation	Effectively financed as a pay-as-you-go arrangement with cash funding from the Department for Environment Food & Rural Affairs[1]	£74.3 million[2]
Royal Mail Pension Scheme (Royal Mail)	Royal Mail's historic pension deficit (around £10 billion) meant that the company was technically insolvent and so could not be privatised	The historic pension liabilities taken on by central government in setting up the Royal Mail Statutory Pension Scheme. Financed as a pay-as-you go arrangement as the assets taken on were sold to reduce public sector net debt	£1,289 million benefits paid[3]
Remploy Pension Scheme (Remploy)	Remploy left government ownership in April 2015	Additional grant-in-aid funding provided by DWP to contribute to the pension scheme deficit in accordance with the agreement made with the trustees	£33.8 million grant-in-aid funding received for pension contributions[4]
Forensic Science Service Pension Scheme	Due to the deficit in the scheme, without government support to prevent the scheme entering administration the scheme would have entered the PPF	Pension liabilities taken on by the Home Office	£42 million (provision in Home Office 2014-15 accounts)[5]

Notes

1 Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/442886/LIT_10133.pdf – p. 53.

2 Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/441268/50406_Closed_Fund_Annual_Report_Financial_Statements_14-15_v11_WEB.pdf – p. 1.

3 Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/446419/50660_HC_44_RMSPS_web.pdf – p. 12.

4 Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/446393/dpec-report-and-financial-statement-2015.pdf – p. 7.

5 Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/441282/HO-AR15_web.pdf – p. 150.

Source: National Audit Office analysis of Environment Agency Pension Fund, Closed Pension Fund; Royal Mail Statutory Pension Scheme; Disabled People's Employment Corporation (GB) Limited; the Home Office; *Annual Report and Accounts*

3.18 Where nationalised industries or companies have been privatised, the government has in the past provided a guarantee over certain pension payments in the event of insolvency. However, the scope of the guarantee can be subject to challenge, as illustrated by the BT pension scheme. The High Court ruled that government's crown guarantee (upon BT's privatisation in 1984) covered pension liabilities accrued after privatisation as well as before. WGA now discloses a potential future liability on the BT pension scheme guarantee that is equivalent to the size of the scheme deficit (£7 billion based on the actuarial valuation of the scheme as at 30 June 2014), although this will be influenced by interest rates, inflation and longevity and is subject to change.

3.19 While the government is exposed to a diverse range of financial risks through its commitments to private sector pension arrangements, the Treasury does not have full visibility of the financial risks which it could use to manage the government's current and future exposure. For example, it does not have a complete list of the government guarantees offered regarding pension schemes nor exact details of the scope of the guarantees. The Treasury cannot manage guarantees, or establish the government's risk appetite for further guarantees, without this information. Additionally, as with the BT scheme, there is a risk that the coverage of the guarantee may be unclear or more substantial than government expects.

3.20 In the main, although there is currently no expected cost to government from its guarantees, if any of the commitments are called upon there could be significant cost implications. Further, the government has little or no control over the factors that could lead to it having to pay out on its guarantees. For example, while there may be a low likelihood of privatised entities, such as BT, becoming insolvent, this depends on the company's performance. Also, the government's financial exposure will depend on the size of the pension scheme deficit over which it has no influence.

Limitations of the WGA

3.21 As with unfunded schemes (paragraph 2.20), the government needs to consider the appropriateness of the disclosure of the impact of the discount rate applied on funded schemes if the net liability figure from WGA is to be used to assess risks to affordability, particularly for funding levels. Although funded schemes use a discount rate that is based on the returns on corporate bonds which is relevant to the expected rates of financing of the schemes and is aligned with similar private sector arrangements, they have discretion over the exact rate they adopt and the expectation of inflation they apply. This reduces comparability between schemes. Although some variation between schemes may be expected due to differences in the average time until the benefits are paid, the 2014-15 WGA shows that discount rates for funded schemes vary between 3% and 4.4% across government and the inflation assumption varies between 1.8% and 3.8%.

3.22 In addition, changing the discount rate and inflation assumptions can have a significant impact on the liability estimate. To illustrate this, if the unfunded Teachers' Pension Scheme adopted the discount rate used by the Greater Manchester Pension Fund, the Teachers' Pension Scheme liability would be nearly 10% higher (**Figure 19**).

3.23 The WGA discloses the government's commitments to fund individual pension scheme deficits in the event of insolvency in a note to the accounts. However, aside from the BT pension scheme, it does not name the individual schemes nor quantify the scale of the commitment, thereby reducing transparency to the reader. Although the latest reported deficit on the BT pension scheme helps to quantify the amount that the government might have to pay out in the future, it does not provide an assessment of the likelihood of the employer insolvency nor an insight into the volatility of the deficit that could occur in the future.

Figure 19

Impact of changing the discount rate on a pension liability estimate

Assumptions adopted	Teachers' Pension Scheme	Greater Manchester Pension Fund	Difference
Nominal discount rate (%)	3.55	3.2	-0.35
Inflation (%)	2.2	2.4	+0.2
Real discount rate (%)	1.3	0.8	-0.5
Teachers' Pension Scheme liability on outlined assumptions	£276bn	Around £300bn	Around £25bn (9.5% of the liability)

Source: National Audit Office analysis of the *Teachers' Pension Scheme (England and Wales) Annual Report and Accounts 2014-15* and *Greater Manchester Pension Fund Report and Accounts 2015*

Appendix One

Our approach and evidence base

1 This study examined the pension commitments on the Whole of Government Accounts (WGA) balance sheet, the risks they pose to the UK's public finances, and how government is managing these risks. We reviewed:

- how the liabilities are valued and reported across government;
- the current size, profile and nature of the liabilities and how these are changing;
- the major long-term financial risks associated with pensions;
- the government's approach to managing pensions; and
- how the WGA could help to improve the government's understanding of and management of these liabilities.

2 We reviewed the pension-related information in all WGAs published since its inception in 2009-10 (mainly the public sector pension liability note to the accounts) and the individual financial accounts that are consolidated into the WGA. Much of our assurance comes from the significant body of financial audits that we carry out across central government. We reviewed fiscal sustainability reports published by the Office for Budget Responsibility to gain insight into the long-term implications of pension commitments and documentation regarding individual pension schemes to gain insight into the management of these schemes. We reviewed other relevant information in the public domain including publications by the Office for National Statistics, the Government Actuary's Department and HM Treasury, as well as local government pension funds.

Appendix Two

Accounting treatment

1 The government has two main sets of accounts: National Accounts and the Whole of Government Accounts (WGA). Differences in these accounts mean that different pension commitments in government have different accounting impacts. **Figure 20** shows, a breakdown of the pension obligations by what the commitment is, how that commitment is financed and the corresponding impact on the accounting treatment of pension liabilities in the WGA and National Accounts.

Figure 20

Pension commitments, how they are financed and how they are recorded in accounting frameworks

	Commitment	Financing arrangement	Visibility in the core National Accounts	Visibility in the Whole of Government Accounts
State pension	No contractual obligation to provide future pension. However, there is an expectation it will be provided	Unfunded pay-as-you-go arrangement	No liability on the balance sheet. Expenditure is benefit cash flow Included in National Accounts supplementary table	No liability on the balance sheet. Expenditure is benefit cash flow
Public sector pensions	Similar to a provision, there is a contractual requirement to provide this benefit	Either funded or unfunded (see below)	Treatment varies (see below)	Liability on the balance sheet. Expenditure is mainly the cost of new benefits being accrued
Unfunded public sector pensions	As above	Unfunded pay-as-you-go arrangement	No liability on the balance sheet. Expenditure is benefit cash flow Included in National Accounts supplementary table	As above
Funded public sector pensions	As above	Funded scheme with the aim that the accumulated assets are sufficient to pay benefits when they fall due	Net liability (net of scheme assets) on the balance sheet. Expenditure is cost of new benefits being accrued	As above; however, the liability is net of scheme assets

Figure 20 *continued*

Pension commitments, how they are financed and how they are recorded in accounting frameworks

	Commitment	Financing arrangement	Visibility in the core National Accounts	Visibility in the Whole of Government Accounts
Support to private sector pension schemes				
Financial Assistance Scheme (FAS)	Benefits payable to certain individuals when their private sector employer went insolvent	Unfunded pay-as-you-go arrangement	No liability on the balance sheet. Expenditure is benefit cash flow	Liability on the balance sheet. Expenditure is mainly the cost of new individuals joining the scheme Contingent liability for further pension schemes joining the FAS
Guarantees to private sector pension schemes (PPF)	Historically the process on privatisation of a nationalised industry or company was for the pension scheme to remain with the employer and a guarantee over the pension payments in the event of insolvency was made by the government	Schemes are funded (aim to set assets equal to liabilities) by the private sector entity	Contingent liabilities not in accounts	Only a contingent liability for BT pension scheme. Others not included individually
Pension Protection Fund (PPF)	Insurance-type arrangement to protect members of a pension scheme if the sponsoring employer becomes insolvent	Funded by contributions from pension schemes eligible for PPF protection (which include some public service schemes) as well as fund of schemes transferred into the PPF, the return on investments and the assets recovered from the insolvent sponsoring employer	No government commitment to pay the PPF benefits if the assets are insufficient	No liability for the government due to the PPF
Access to public service pension schemes				
Private sector access to public sector pension schemes	These are arrangements to allow private sector employers to obtain access for their staff to public sector pension schemes	Same as relevant unfunded or funded public sector pension scheme	No liability on the balance sheet. Expenditure is benefit cash flow	Liability and expenditure are included in the relevant unfunded or funded public sector pension scheme
Royal Mail	Instead of providing a guarantee on privatisation instead the government set up an unfunded pension scheme	Unfunded pay-as-you go arrangement	Transition from treatment as a funded to unfunded pension scheme	Treated as an unfunded pension scheme

Source: National Audit Office analysis

Appendix Three

Affordability measures

1 **Figure 21** sets out a range of different affordability measures, their relevance to four main groups of pension commitments and the information available to test against those measures.

Figure 21

A range of affordability measures

Measure of affordability	State pension	Unfunded public sector pensions	Funded public sector pensions	Financial Assistance Scheme (FAS)
Sufficient government revenue to pay benefits when they fall due in the long term	Office for Budget Responsibility (OBR) benefit projection	OBR benefit projection	None. No cost if scheme is fully funded	No OBR benefit projections
Current contributions are sufficient to meet current benefit expenditure	Government Actuary's Department (GAD) review of NI Fund	Government accounts. Contributions are set to reflect staff costs rather than benefit expenditure	Scheme accounts. As funded, assets can be sold if contributions are insufficient	No contributions
Current contributions are received to meet the accrual on additional benefits	No mechanism to track this	Actuarial valuation of the scheme	Actuarial valuation of the scheme	No future accrual of benefits
Assets held expected to be sufficient to meet liability	Unfunded. No assets held	Unfunded. No assets held	Actuarial valuation of the scheme. Also departmental accounts and the Whole of Government Accounts (WGA)	Unfunded. Assets largely sold for cash
Past contributions are sufficient to meet the past accrual of benefits	No mechanism to track this	Actuarial valuation of the scheme. Through the tracking of notional assets	Actuarial valuation of the scheme. Tracking of assets against liabilities.	Scheme assessment on transfer into FAS. Cost to taxpayer due to underfunding
Exposure limits	None. Within government control as can change benefits	No limits. Expected liability recorded in WGA. Cost-cap mechanism for schemes limits exposure to future build up	No limits. Expected net liability recorded in WGA	Legislation sets eligibility requirements. Includes estimates of exposure and cost to taxpayer

Source: National Audit Office analysis

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National Audit Office

£10.00

ISBN 978-1-78604-060-2

Design and Production by NAO External Relations
DP Ref: 11136-001