National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Evaluating the government balance sheet: pensions

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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.