

RAILWAY PENSIONS SCHEME TRIENNIAL EVALUATION 2016

Introduction

The draft results of the three yearly evaluation of the 106 sections of the Railways Pension Scheme (RPS) were published to employers in June 2017.

Those results relate to the period 1st January 2014 to 31st December 2016 and, as a result, the valuation is referred to as “the 2016 valuation.”

In this Bulletin we will be looking at the reasons for the 2016 Valuation and the implications that that can have to members and employers. We will also be considering what reps should be doing.

Why has the RPS been valued now?

The Railways Pension Scheme is a defined benefit (DB)ⁱ scheme and by law it must be evaluated at least every three years. In accordance with these requirements, the last Valuation of the RPS was for the three year period ending on 31st December 2013 (“the 2013 Valuation”).

Why do DB pension schemes have to be regularly valued?

The reason for the valuation is to ensure that the Scheme can meet its “statutory funding objective.”

Having a statutory funding objective means that the DB scheme must have appropriate assets to cover its accrued liabilities (known as “technical provisions”). To achieve this, it must also have:

- a “statement of funding principles” setting out the policy for meeting the statutory funding objective;
- a “schedule of contributions” covering payments due to the scheme.

In the event the scheme doesn’t meet its statutory funding objective after being valued (ie, it is shown to have a deficit), it must put in place a recovery plan.

What does this mean in practice?

Actuarial valuations are a measure of a scheme’s ability to cover its liabilities, mainly made up of

- pensions currently in payment
- pensions accrued at the time of the valuation but payable in the future.

Pensions in general and actuarial valuations in particular are complicated and highly technical in nature. To complicate matters further the RPS

has to carry out two valuations (done in parallel):

- Technical provisions funding to meet the legal requirements of the Pensions Act 2004;
- Rules funding to meet the criteria set out in the RPS' rules.

Funding levels under both tests show a broad range of valuations between sections. In the past, funding levels on the Rules funding basis have been generally a bit higher because of the effect of higher (deficit) contributions payable from previous valuations.

Details of individual sections' valuation results will be available at company level at the appropriate time and will no doubt be the subject of negotiations/consultation within the relevant collective bargaining machinery.

Who carried out the Valuation?

DB schemes are required to have a named scheme actuary appointed by the trustees or managers of the occupational pension scheme. It is that actuary who conducts the actuarial valuation and is able to advise on policy issues such as drawing up the statement of funding principles and the choice of appropriate assumptions for the valuation.

In the RPS, the appointed actuary who carries out the Valuation and gives the appropriate advice is from the firm of Willis Towers Watson.

An overview of the draft results

The RPS' Actuary has identified the

Scheme's Sections as falling into three categories:

- Fully Funded:
Meaning that either the Technical Provisions (TP) and Rules funding level are greater than 100% or the current Schedule of Contributions is sufficient to meet the shortfall
- Higher Contribution Rates:
 - TP funding level and Rules funding level less than 100%
 - Shortfall capable of being met through higher contribution rates for a reasonable period
- Alternative Solutions:
 - TP & Rules funding levels less than 100%
 - Shortfall too large to be met through an increase to contribution rates alone

While each Section will need to be dealt with separately, the main concern/challenge obviously relates to the last of the above categories in which case other funding solutions will need to be brought into play, taking the following into account:

- Primary solution is to meet the shortfall through additional contributions:
 - Higher contribution rates or a longer recovery plan;
 - Lump sums payable by the employer.
- If these are still insufficient then the Trustee is open to alternative solutions
- Trustee will be looking to ensure that the final funding plan represents an appropriate balance between:

- Covenant support
- Investment strategy
- Contributions

This is in accordance with the Pension Regulator's integrated approach to funding.

The draft results in some more detail

With this in mind, the draft results of the 2016 Valuation have revealed that on a TP basis:

- 51 RPS Sections are 100-125+% funded (40 Sections are 105-125+% funded)
- 55 RPS Sections are 60-100% funded (30 Sections 60-90% funded)

On a Rules basis, the situation is:

- 56 RPS Sections are 100-120+% funded (of which 44 Sections are 105-120+% funded)
- 50 RPS Sections are 65-100% funded (of which 16 Sections are 65-90% funded)

These results are irrespective of the individual Sections' Employer Covenant rating.

What is the Covenant rating?

The Pensions Regulator describes the Employer Covenant as "the employer's legal obligation and financial ability to support their defined benefit scheme now and in the future." Put another way, it is a rating based on the financial strength of the employer and the risk of insolvency.

At the time of the Valuation and as part of the funding approach, the Actuary must understand the current strength

of the employer covenant and how it could change in the future. Part of the Actuary's assessment is to decide the appropriate level of risk when setting the investment strategy, funding target and, where necessary, the recovery plan.

Within the RPS 2016 Valuation, Sections have been split into eight categories on the basis of their Covenant strength:

- Covenant 1 (Open TOC)
 - 27 Sections
- Covenant 1 Other
 - 8 Sections
- Covenant 2 Open
 - 7 Sections
- Covenant 2 Closed
 - 33 Sections
- Covenant 3
 - 16 Sections
- Covenant 4
 - 7 Sections
- Covenant 5
 - 6 Sections
- Covenant 6
 - 1 Section

The best Covenant rating is Category 1 which is defined as:ⁱⁱ

"The sponsoring employer's ability to support the pension liabilities of the Section on an ongoing basis benefits from specific legislative, contractual or other structural support from the rail industry or the UK government..."

The other Covenant Ratings are defined as:

- “2” The employer has a reasonable level of profitability and a sound financial position in the context of its current and potential future obligations to the scheme.
- “3” An employer’s covenant would be “2” but for specific identified concerns which, if addressed, could allow the covenant to be rated “2”.
- “4” The employer’s covenant has general performance and/or balance sheet weakness. Insolvency unlikely in the short/medium term but significant improvements needed to move to a rating of “2”.
- “5” Based on information provided, the covenant is very weak as a result of performance and/or balance sheet issues. There is likely to be limited asset cover for the RPS coupled with poor performance and, in some circumstances, there may be a risk of insolvency in the medium term (12-36 months).
- “6” Information presented raises significant concerns about potential insolvency within 12 months.

Why is the level of funding important?

The level of funding is of fundamental importance to the health of the various sections of the RPS. Sections that are under 100% funded are said to be in deficit and action must be taken to remedy the situation by agreeing and implementing a recovery plan over a

specified period of time – the recovery period. This may include increasing contributions and/or changing benefit entitlements. Because the RPS is a shared cost scheme this has an impact on the amount both employers and members have to pay.

Future Service Joint Contribution Rates (FSJCR)

The Valuation of the Railways Pension Scheme not only assesses the value of the liabilities up to 31st December 2016, it also calculates the level of contributions needed to meet future funding costs from 1st January 2017. These contributions are expressed as the “Future Service Joint Contribution Rate,” or FSJCR.

The RPS is what is known as a shared cost scheme, with members paying 40% and employers paying 60% of the Joint Contribution Rate (JCR). The JCR is expressed as a percentage of pay on which pension contributions are payable. For example, if the JCR is 25% the employee pays 10% and the employer 15%.

The funding levels of the various sections of the RPS are extremely important because it plays a big part in how much it costs. For instance, as a result of the 2016 draft Valuation results, it appears that whilst there are twelve Sections where the FSJCR will remain unchanged when compared to the 2013 level, most others are likely to either increase or decrease.

In general the FSJCR for RPS sections that have been closed to new members by employers have been higher than for those that remain open.

There is nothing to suggest that this position will change.

Because the RPS is a jointly funded scheme the contributions members and employers pay must also make good any shortfall identified in the valuation through deficit contributions. This can vary significantly from section to section and can increase contributions.

It is difficult to be any clearer on what contributions will need to be paid because, amongst other things, this will depend on the recovery period over which they will need to be paid. Where a section is in deficit, its valuation report will illustrate additional deficit payments required to eliminate this over different time periods.

What are some of the key features of the methodology used by the Actuary in carrying out the Valuation?

In a seminar in June that was open to employers, trustees and trade unions, the Scheme Actuary explained the technical details of how the Valuation was carried out. Some of the approaches are highly technical but in seeking to advise reps about them it is hoped that it will give some background information that may be useful in negotiations with employers. Included in the methodology are:

- Discount rateⁱⁱⁱ structure varied between that applied to TOCs ('single discount rate'^{iv} structure) and that used for all other open Sections ('dual discount rate'^v structure). Closed Sections have had a

'flexible discount rate'^{vi} structure applied;

- Future improvements in mortality are reflected by the adoption of the latest Institute and Faculty of Actuaries core mortality improvement projection model, known as CMI_2016, which has led to a typical impact of an increase in funding levels of around 1% to 2% (ie, helping to cut any deficit).

What are the next steps?

The Pensions Regulator has set a target of 31st March 2018 for each of the individual Sections of the RPS to have finalised their 2016 Valuation. It would appear that the Regulator has signalled its intention to be tough on those employers that do not meet this deadline.

Working back from the date in 2018, employers, working with RPMI, will need to have put in place arrangements, including recovery plans that cover any deficit situations (eg, such as changes to contribution levels, benefit arrangements (like accrual rates), etc) prior to carrying out a 60 individual consultation with members in their Section of the RPS.

Employers should also be consulting with representatives of the members and have responsibilities in this regard under the pension legislation. They are also likely to have responsibilities under agreed collective bargaining arrangements (reps should check this point out for their individual company).

TSSA would argue that collective consultation must take place BEFORE

the 60 day consultation both so that there is a proper engagement with TSSA where questions and counter proposals can be discussed) and so that members are individually consulted on a final proposal.

Please note: Any agreements that may be made at Section Committee level between employer and employee trustees (where recognised unions normally have a seat) are separate and additional from the trade union/employer discussions. Part of the reason for this is that trustees have a different role to union reps.

Reps Action

There are various things that reps should be doing and in part this will depend upon whether you are a Company Council or Local Rep:

- Consultation and negotiation on matters related to the valuation (eg, when dealing with a deficit) are likely to involve Company Council reps working with their Organiser. This is an opportunity to ask questions, present counter proposals (and ask for them to be properly considered by an actuary from RPMI) and potentially come to an agreement;
- Reps and Organisers need to make sure that their employer keeps them informed about the Valuation and how it will effect members (perhaps table it as an item on the Company Council Agenda or write a letter to the appropriate person in the company).
- Whilst many employers will discuss the Valuation with the union reps – perhaps after an informal initial approach – there are some who are reluctant to share information or to even actively seek to avoid engaging with the unions;
- It may also come to a stage when what the employer is seeking to consult the members on is unacceptable. In this case, reps and organisers need to consider how they organise and empower members to take action;
- All reps should familiarise themselves with the content of this Bulletin and share it with other members as the issue will affect them if they are also members of the RPS. Pensions can be regarded not just as a future investment for your retirement, but also as unpaid wages (remember the employer contribution under the shared cost arrangements) that are received upon claiming your pension and as such all employees need to be kept informed;

Definitions: some additional clarity

Recovery period: if an actuarial valuation shows that the statutory funding objective is not met, the trustees will have to prepare a recovery plan setting out the specific steps to be taken, over what period of time to make up the shortfall. The recovery period is the period of time over which the shortfall in funding must be made up.

Protected persons: someone is a protected person if at midnight on 4th November 1993:

- They were in the BR Pension Scheme and they were employed by the British Railways Board or one of its subsidiaries (the Board), or
- They were not at the time working for the Board but have since exercised a statutory or contractual right to return to employment with the Board or one of its successors. In this case, they must have been a member of the BR Pension Scheme when they were last employed by the Board and they must not have taken a transfer payment from the BR Pension Scheme in respect of that previous period of employment (i.e. their pension rights should have remained preserved (“frozen”) in the BR Pension Scheme and not transferred to an alternative scheme or arrangement). (The statutory or contractual right extends principally to those absent on

ⁱ The Pensions Regulator defines a **defined benefit scheme** as one in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring, and the length of pensionable service.

DB schemes are also known as 'final salary' or 'salary-related.'

ⁱⁱ Detail taken from “RPS: ACTUARIAL VALUATIONS AS AT 31 DECEMBER 2016 Initial consultation and discussion paper for the Shared Cost Sections,” published October 2016.

ⁱⁱⁱ **Discount rate** is defined by the Regulator as “the assumed investment return used in a present value calculation of assets” **Present value** is “a method used to calculate the current value of a series of future pension payments and future receipts, such as contributions and investment returns.” Willis Towers Watson define a discount

maternity leave or seconded to another employer.)

Acknowledgements

This Bulletin has been prepared using information from:

The Pensions Regulator’s Website:
<http://www.thepensionsregulator.gov.uk/>

Presentation by the Railways Pension Scheme and Willis Towers Watson under the title of “Railways Pension Scheme 31 December 2016 valuation: Pension Committee & Trade Union Consultation and discussion seminar 14 June 2017”

Further reading:

Pension Consultation obligations:
<http://www.thepensionsregulator.gov.uk/docs/employer-duty-to-consult-on-scheme-changes.pdf>

rate as “the rate used to place a present value on future cash payments or income, and is made up of future investment return assumptions.”

^{iv} The RPS’ Actuary defines the ‘**single discount rate**’ structure as a “means [for] adopting the same investment return assumption for the period before and after members retire.” The Actuary believes the ‘single discount rate’ structure is “a better fit because changes in membership profile do not result in changes to the investment return assumption.”

^v A “**dual discount rate structure**” entails adopting “one investment return assumption...for the period after retirement for all categories of member, while a different assumption was adopted for the period before members are assumed to retire.”

^{vi} A “**flexible discount rate structure**” is one in which “an ‘initial’ discount rate is set based on the Section’s short-term investment strategy, and a ‘target’ discount rate is set based on the Section’s

expected long-term investment strategy when all members have retired. The discount rate used to calculate the liabilities is structured to transition

from the 'initial' discount rate to the 'target' discount rate over an appropriate period."