The Costs of Final Salary Pension Schemes

We have long argued that operating a final salary pension scheme exposes employers to potentially significant costs and liabilities that are driven by factors outside their control. The current actuarial obsession with liability driven investment means that pension fund investments are condemned to undershoot their projected liabilities - unless the employer is able to make additional contributions to the pension scheme.

The fall in interest rates, Gilt yields and hence actuarial discount rates has increased the "cost" of future pension obligations and against this background it is no surprise that the costs of funding these schemes has risen sharply over the last few years.

We have seen many examples of this over recent months but this example from the 2013 accounts of the Bank of England's staff pension scheme is extraordinary. The Bank of England scheme is non-contributory for employees but the costs to the employer (and hence ultimately to the taxpayer) have now risen to over 57% of pensionable earnings *(our emphasis below in italics)*.

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There is no requirement for the Members to contribute to the Fund. The Actuary calculated the future service contribution rate payable by the Bank of England from 1 March 2011 as 24.1% of Pensionable Earnings (including allowance for current public sector pay guidelines),compared with 54.6% following the 2008 valuation. As part of the 2008 valuation, it was agreed that this rate would be reviewed annually in line with the appropriate single discount rate on the last day of February preceding the end of the Fund year. This is to reflect the index-linked gilt yield curve at the time. In addition, it was agreed that administration expenses, including the PPF levy, would (with effect from 1 March 2008) be met directly by the Bank of England.

The future service contribution rate payable by the Bank of England with effect from 1 March 2012 was 29.7% of Pensionable Earnings and the rate payable ***from 1 March 2013 was 57.3% of Pensionable Earnings***. The increase is primarily due to the cessation of the two-year pay freeze as well as the current gilt prices which impact on the calculations determining the annual contribution rates.

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It is hard to believe that this level of employer contribution could be sustained in the private sector.

It is also rather ironic that one of the main reasons for the increased in contribution levels has been the reduction in Gilt yields as a result of the Bank of England's Quantitative Easing programme. Quantitative Easing will also have had a significant impact on valuation of investments held within the pension scheme as over 85% of these are Gilts (source 2013 Bank of England Pension Fund financial statements).

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