

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Date:	19 November 2010
Title:	Hutton Independent Public Service Pensions Commission – response to second call for evidence
Reference:	2323
Report From:	County Treasurer

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1. Executive Summary

- 1.1. The purpose of this paper is to consider a draft response to the Independent Public Service Pensions Commission's second call for evidence.
- 1.2. The Commission, led by Lord Hutton, issued an interim report on 7 October 2010 in time for the Government's announcement of the Spending Review on 20 October 2010.
- 1.3. The Commission has since issued a second call for evidence for its final report which is due to be published in time for the Chancellor's Budget in March 2011. The deadline for responses to this second call is 17 December 2011.

2. The Commission's interim report

- 2.1. Lord Hutton of Furness' Foreword to the Commission's interim report and the Executive Summary are attached at the end of this report as Appendix 2. The full interim report of 170 pages is available from the Commission's website at http://www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm.
- 2.2. The key points in the Commission's interim report that are relevant to the Local Government Pension Scheme include:
 - long-term changes are required to make public service pensions more affordable and fair
 - but the public sector should not join the private sector in a "race for the bottom" in pensions provision

- if short term savings in the cost of public service pensions are required by the Government, raising employee contribution rates would be the most effective way
- there is no strong case for de-funding the Local Government Pension Scheme, or for moving the other pay-as-you-go public sector pension schemes to a funded basis
- the Commission's final report will consider whether administrative savings could be achieved by rationalising the number of Local Government Pension Scheme funds.

3. The Government's Spending Review

3.1. The Chancellor broadly accepted the findings of the Commission's interim report in the Spending Review announced on 20 October 2010. The Government said that it will:

- commit to continue with some form of defined benefit pensions for the public sector
- wait for Hutton's final recommendation before determining the nature of that benefit and the level of contributions required
- increase employee contributions to save £1.8 billion a year by 2014-15 from public service pensions, equivalent to three percentage points on average, to be phased in from April 2012.

3.2. At this stage, it is not clear what impact the Government's proposed increase in employee contributions will have on the Local Government Pension Scheme. The proposed savings in the Spending Review from public service pensions as a whole are phased as shown in following table.

	2011/12	2012/13	2013/14	2014/15
	£m	£m	£m	£m
Public service pensions				
- savings from increased employee contributions	0	160	1,270	1,760

3.3. This phasing suggests that there will be no significant savings for employers until 2013/14.

4. The Commission's second call for evidence

4.1. Hutton has indicated that his final report will look at the options for long-term structural reform of public service pensions, including career average schemes (instead of final salary), international experience and hybrid schemes combining elements of defined benefit and defined contribution models. It is possible that the later option has been closed off by the Chancellor's commitment to "some form of defined benefit" pensions.

- 4.2. In Hutton's view, public service pensions need to be able to respond more flexibly to changes in demographics and increased mobility between the public and other sectors. The system should be fairer between "high flyers" and others, and between the employer and employee.
- 4.3. In his interim report, Hutton established four principles against which he plans to assess the options for public service pensions:
- affordable and sustainable
 - adequate and fair
 - supporting productivity
 - transparent and simple.

5. Response to the Commission's second call for evidence

- 5.1. The text of the Commission's second call for evidence is attached as Appendix 1. It includes 25 questions for respondents to answer. Some draft suggestions for the response to these questions are included in Appendix 1 for the Panel to consider.
- 5.2. The response has been drafted on behalf of the County Council as both the administering authority of the Hampshire Pension Fund and an employer within the Fund. There are no particular aspects of the questions asked by the Commission where the County Council might have different views as either the administering authority or an employer within the Fund. There may be advantages in providing a single response but the option of two separate responses could be considered if the Panel or the County Council wishes. The final response will be agreed with the Chairman of the Panel and the Leader of the County Council.
- 5.3. All the other employers within the Fund have the opportunity to respond to the Commission in their own right, if they wish. The draft report will be forwarded to the Pension Fund's employers after the Panel's meeting, for information and to encourage them to respond to the Commission individually using the County Council's response if that is helpful.
- 5.4. Some of the key issues covered in the suggested response in Appendix 1 include:
- should the Local Government Pension Scheme change from a final salary scheme to a career average scheme?
 - is greater certainty for employers about the level of future employers' contribution rates necessary?
 - should the cost for employers of the pension scheme (excluding the past service deficit) be reduced from current levels?
 - if so, how should that reduction be achieved?
 - are higher employee contributions supported, as the Government has already indicated?

- should accrual rates be worsened to reduce costs?
- should the pension scheme still aim to provide a pension of two-thirds of the employee's pay, or with increased longevity, should that proportion be reduced?
- should the pension scheme cover salaries only up to a certain level, with employees required to fund the full cost of pensions related to salaries above that level, with no additional employers contributions?
- should there be a lower cost and lower benefit scheme to attract lower paid employees?
- should there be increased flexibility in the pension scheme, to make it more attractive to employees who work part-time and are likely to have breaks in their service during their careers?
- or is simplicity a key aim, to minimise administrative costs?
- should the Government nationalise or regionalise the Local Government Pension Scheme to save costs, or should that be left to local authorities in each area to decide?
- how can the pension scheme be made more compatible with the transfer of the provision of local government services to and from the private sector and the third sector?

These and other issues underpin the draft suggestions for the response in Appendix 1.

6. Recommendation

- 6.1. That, subject to any comments or amendments proposed by the Panel at the meeting on the draft response to the Commission attached as Appendix 1 to the report, that the Chairman of the Panel and the Leader of the County Council agree the response.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because a response should be made to the Independent Public Service Pensions Commission's call for evidence.
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Other Significant Links

Links to previous Member decisions:		
<u>Title</u> None	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u> None	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Hutton Review – Independent Commission on Public Service Pensions

Second call for evidence

The text of the Commission's second call for evidence is shown below in the boxes, followed by the Commission's questions on each issue.

The suggestions for the County Council's response follow each question.

Scheme Design

There are many different types of pension schemes that exist in the UK and throughout the world. Traditional models include:

- Final salary schemes, which generate a pension based on salary towards the end of employment;
- Career average schemes, where the amount of pension received is usually based on salary across a period of employment;
- Defined contribution (DC) schemes, where the amount of pension usually relies on the level of contributions paid into a fund, the investment performance of the fund and the annuity rate which converts the fund into an income in later life.

There are also a range of hybrid schemes, which usually combine elements of final salary or career average schemes (defined benefit or 'DB' schemes) with elements of defined contribution (DC) provision. Some possibilities include:

- 'Capped schemes' - a DB scheme up to an income level, with a DC scheme for any income over that level;
- 'Combination schemes' - a scheme where a member simultaneously earns benefits that are part DB and part DC on the same income;
- 'Nursery schemes' – where a member starts in a DC scheme and then earns DB benefits after a number of years in employment.

There are also examples of different types of scheme design that operate in different countries. These include:

- Collective DC schemes – which are similar to DC schemes but where an attempt is made to manage investment risk across generations in an effort to improve returns on average across generations;
- Notional DC schemes – which are unfunded DC schemes and protect members from some of the investment risk associated with typical DC schemes.

**Q1) What is an appropriate scheme design for public service pensions?
Why?**

Response to Q1:

‘Scheme design’ should flow from decisions to be taken on the principles adopted for public service pensions. From the County Council’s perspective, the Local Government Pension Scheme should:

- be considered as part of the overall reward package for employees
- provide, as a minimum, adequate levels of resources in retirement for employees
- be affordable for employees, employers and taxpayers
- provide greater certainty for employers over the levels of contributions they will be required to make in the future
- be fair and equitable between categories of employees, generations of employees, and generations of taxpayers
- be transparent and as simple as possible to administer.

In whatever future proposals are agreed for the Local Government Pension Scheme, the entitlements already earned by existing pensioners and by contributors for past service should not be affected. The County Council’s supports the Commission and the Prime Minister in the commitments they have given to that principle.

Existing pensioners will already be affected by the Government’s decision to use the CPI instead of RPI for uprating benefits. There should be no further changes to worsen the position of existing pensioners.

The County Council accepts the commitment made by the Chancellor in his Spending Review announcement on 20 October 2010 to “some form of defined benefit pension” for public service workers.

That would appear to rule out changing the Local Government Pension Scheme to a defined contribution basis for the main part of the scheme.

The County Council accepts the arguments in favour of a career average scheme for the Local Government Pension Scheme, in place of the existing final salary scheme. This would improve the perceived fairness between contributors with lower and higher earnings. It would be necessary to reconsider whether existing tiered employee contribution rates are appropriate if a career average scheme is introduced.

The Commission’s view that the existing final salary scheme favours ‘high flyers’ seems questionable, although that might be a question of the terminology used by the Commission. A final salary scheme will benefit employees whose pay rises significantly in the years immediately prior to their retirement. Not all ‘high flyers’ will be in that position, if ‘high flyers’ is shorthand for employees on higher salaries, as many of them may be

appointed on spot salaries and will not necessarily receive significant increases in their pay prior to retirement.

Capped schemes may help to respond to current media concern about large 'pension pots' for higher paid staff in public services. But pension provision is an important part of the reward package for all staff, including senior staff. If the pension provision is capped, it is likely that over time senior staff will require higher salaries to enable them to make their own provision for pensions at levels they consider to be adequate.

Savings in costs from introducing a capped scheme, if any, are likely to be short-term only. Such costs are better controlled by managing the numbers of senior staff employed in the public sector and their overall reward package.

Reducing the cost to the employee through lower employee contributions may not be a significant factor for lower paid staff in deciding whether they opt in or opt out of the Local Government Pension Scheme. Providing a low cost scheme, with lower benefits, or a 'nursery' scheme for the lower paid may not be cost effective in terms of administration costs for employers.

The alternative of enabling staff to choose the Government's National Employment Savings Trust (NEST) scheme might be more effective.

Equally, a basic scheme could be offered with a further option for employees to pay more in contributions to receive higher levels of benefit, but without any additional employer contributions. That would respond to criticisms in the media that public service pension schemes provide very large 'gold plated' pension pots for some senior staff.

Whatever solution is chosen, it should be as clear and easy as possible for employees and pensioners to understand, and as simple as possible to administer.

The County Council supports the Commission's view in its interim report that the Local Government Pension Scheme should continue to be a 'funded' scheme.

As an employer in the Local Government Pension Scheme, the County Council wants to see more certainty over the level of employers' contributions in the future. Although fund actuaries are required to take into account the smoothness over time of employers' contribution rates, there have been too many increases in rates in recent years as funds coped with increased longevity and lower than expected investment returns.

The 'cap and share' arrangements that were introduced as part of the 'new look' Local Government Pension Scheme in April 2008 have not yet been

implemented in practice. Those arrangements, or something similar, will have an important role to play in transferring some of the risks of the Scheme, currently born solely by employers, onto employees. The practical consequences of implementing a 'cap and share' scheme are considered further in the response to Q2.

Risk-sharing

As well as the overall scheme design, there are certain parameters such as normal pension age, indexation factors and contribution rates that can be used to manage risks in different types of pension schemes.

There are different risks involved with saving for retirement that are faced by members of pension schemes or by employers who provide the pension scheme. For example, there is a chance that pension scheme members will live longer than expected when the scheme was established which will result in either increased costs for the employer or reduced benefits for scheme members. Other risks associated with some forms of pension saving include risks that investment returns deviate from what has been expected or that earnings grow at a different rate from that assumed.

Generally speaking, in pure defined contribution schemes the scheme members bear most risks and in final salary schemes employers bear most risks (and ultimately in the case of public service schemes, taxpayers). I am seeking views on how risks should be managed between scheme members and public service employers. Specifically:

Q2) Which risks associated with pension saving should the scheme members bear, which by the employer and which should be shared? Why?

Response to Q2:

If the Local Government Pension Scheme continues as a defined benefit scheme, either in final salary or career average format, the 'cap and share' arrangements currently being developed by the Government will play an important part in sharing risks.

In terms of the 'sharing' part of cap and share, the County Council supports the proposals that employers should bear the risks from investments, pension increases, actuarial methodologies and financial assumptions. Employees should bear the risks from future changes in longevity, pay increases and changes in benefit structures.

Setting the cap at an appropriate and realistic level will be an important part of the process. It is also necessary to decide what should happen if the cap is breached or if the risks borne by employees result in significant additional costs to be met by employee contributions. There may be a limit

to how far employee contributions can rise and it may be necessary to agree in advance the process for reducing benefits, such as by worsening accrual rates.

- Q3) What mechanisms could be used to help control costs in public service schemes? For example, is there merit in flexible normal pension ages linked to changes in longevity? What indexation factor should be used in a career average type scheme to ensure a reasonable balance of risk between scheme members and taxpayers?**

Response to Q3:

Cap and share will be one means of controlling costs for employers.

The normal retirement age for the Local Government Pension Scheme (currently 65) should rise in line with proposed changes to the State Pension Age (for example, the current proposal to increase the State Pension Age to 66 by April 2020).

The indexation factor in a career average scheme, which is applied to employee's earnings during their careers, should reflect the rise in earnings, rather than inflation such as CPI or RPI. But there is likely to be a trade-off between the indexation factor and the accrual rate. A lower indexation rate, such as CPI, may be counterbalanced by a better accrual rate.

- Q4) Where and how have risks associated with pensions been effectively shared in private sector companies?**

Response to Q4:

No specific comments. However, the County Council supports the view expressed in the Commission's interim report that the public sector should not join the private sector in a 'race to the bottom' in pension provision.

It is important that pension provision in the private sector is improved as there is a risk that the public sector will find its costs rising in 10 to 15 years when many former private sector workers are unable to fund their own care in retirement.

- Q5) Which international examples of good practice in the area of risk sharing should the Commission consider when compiling the final report? Why?**

Response to Q5:

No comments.

Q6) What should the split between member and employer contributions look like?

Response to Q6:

This depends on the cost of the pension scheme, and assumptions about benefits, such as accrual rates and the level of pension provided, and the acceptable level of employee contribution rates.

The County Council has previously expressed support for an increase in employee contributions rates (from an average now of 6.5% of pay to, say 7%). The current ratio for the Hampshire Pension Fund between employers and employees is 2.2:1 (14.5% : 6.5%, at the last completed actuarial valuation in 2007). Ideally, the County Council would like to see that ratio fall but it would only be possible by reducing the level of benefits offered by the Local Government Pension Scheme.

This ratio excludes the existing past service deficit, which will continue to be payable by employers in the Hampshire Pension Fund whatever changes are made to the Local Government Pension Scheme for the future.

The robust position of the Local Government Pension Scheme should not be forgotten, both in terms of its 'funded' status and through local authorities' strong covenant and constitutional permanence.

The County Council supports retaining a funding target of 100% for the Local Government Pension Scheme, within the context of the Scheme employers' covenant strength and constitutional permanence.

The Commission can play its part in informing the media and the public about the robust strength of the Local Government Pension Scheme and the significance of information published following actuarial valuations or in accordance with the accounting requirement FRS17, so that deficits are not incorrectly characterised as "black holes".

Q7) Should there be different treatment of different professions (for example, lower normal pension ages for some public service employees)?

Response to Q7:

It would make sense to establish as much commonality as possible between the different pension schemes in the public sector. It would be difficult, however, to impose a single pension scheme across the public sector from the current starting point.

Different normal pension ages may be appropriate for different professions, such as the armed forces, police and fire services.

In seeking commonality, however, the ‘funded’ status of the Local Government Pension Scheme should be borne in mind. Solutions that may be necessary to resolve problems with the ‘pay-as-you-go’ public service pension schemes should only be applied to the funded Local Government Pension Scheme if they are relevant and appropriate.

Q8) Should there be different treatment for those at different income levels?

Response to Q8:

In terms of a pension scheme that is capped up to an income level or a ‘nursery’ scheme for the lower paid, this issue has been dealt with in the response to Q1.

Q9) What is the appropriate normal pension age for the different public service schemes? Should this vary across schemes and, if so, why?

Response to Q9:

The normal retirement age for the Local Government Pension Scheme (currently 65) should rise in line with proposed changes to the State Pension Age (for example, the current proposal to increase the State Pension Age to 66 by April 2020).

As indicated in the response to Q7, there may be a case for different terms for the pension schemes for the armed forces, police and fire services.

Adequacy

A key outcome for public service pensions is that they offer an adequate level of income in retirement, particularly where people have devoted the majority of their working life to public service.

There are different views about what an adequate level of income is in retirement and how this should be measured. Lord Turner’s Pension Commission produced some benchmark replacement rates but other approaches could include using poverty thresholds at lower income levels. Other commentators suggest looking at household resources rather than individual income, which could give a broader picture of potential standards of living in retirement.

Q10) How should the Commission think about measuring adequate levels of resources in retirement?

Response to Q10:

The average pension in payment from the Local Government Pension Scheme is only just over £4,000 per annum, according to the

Commission's interim report. This is partly because of the impact of part-time working and because most employees are not members of the Local Government Pension Scheme for their entire working lives.

But it is important not seek to provide occupational pensions that are just aimed at poverty thresholds.

Originally, the Local Government Pension Scheme sought to provide a pension equivalent to two-thirds of the employee's pay if they have contributed to the Scheme for their entire working life. That proportion of two-thirds was set when longevity after retirement was much shorter than now. It may be necessary to reconsider whether the two-thirds target is realistic if the costs of pension provision are to be contained.

Costs can only be reduced by employees working longer and retiring later (ie, raising the normal retirement age) or contributing more (through higher employee contribution rates) or receive lower benefits (through reducing the two-thirds target by worsening accrual rates).

If employees' maximum working life is 48 years (from 18 to 66, say), the accrual rate for the Local Government Pension Scheme would need to reduce from the current level of 1/60ths to 1/72ths, if the target of providing a pension of two-thirds of earnings is retained. This would be a considerable worsening of the Scheme from the employee's perspective. But it would help to reduce the cost of the Scheme for employers.

Reducing the two-thirds target to 60% of earnings would increase the accrual rate to 1/80ths, which would be a significant worsening from the current accrual rate of 1/60ths.

For an employee in a career average scheme who earned the minimum full-time level of £12,500 per annum throughout their career, a 60% target and an accrual rate of 1/80ths would give an occupational pension of £7,500 per annum if they worked the full 48 years. Most, of course, would not.

There may also be scope for short-term savings from reducing the rate at which pensions can be commuted into lump sums from the current level of 12 times.

Q11) What should be considered an adequate level of resources in retirement?

Response to Q11:

See the response to Q10.

Q12) Should a full state pension and a full public service pension ensure people have adequate resources in retirement? Or should room be left for individuals to make their own arrangements?

Response to Q12:

It would seem reasonable that, at the lowest level of earnings, the public service pension and State Pension should provide “adequate resources” in retirement. It seems unlikely that employees earning at that level would have the resources to “make their own arrangements”.

The question of whether employees at higher levels of earnings should be required to make their own provision above a certain income level has been dealt with in the response to Q1.

Q13) How should this change where people work part careers in public service?

Response to Q13:

It is important that public service pension schemes should not hinder the flexible movement of staff between the public and private sector. The County Council welcomes the Chancellor’s announcement in the Spending Review that he plans to launch a consultation on the Fair Deal arrangements, to report by summer 2011. The Fair Deal seeks to protect the pension provision of public sector workers that have their employment compulsorily transferred out of the public sector by requiring that their pension provision post-transfer is “broadly comparable”.

Employee understanding and choice

A principle against which options for long-term structural reform will be judged is that schemes should be widely understood. But this principle may require trade offs to be made with other principles outlined in the interim report such as fairness and sustainability. I would therefore welcome views on:

Q14) How much do workers value and understand pensions? Is there any evidence this differs between groups (for example, by age, by income)?

Response to Q14:

It is perhaps inevitable that employees become more aware of pension matters as they grow older and that knowledge increases with age.

It is easy to say that pension schemes should be “transparent and simple” but much harder to achieve in practice. The introduction of choice and additional options may be a desirable aim but it can add to the complexity

of the pension schemes, both for the employee and for scheme administrators.

There is web of complexity already in place, from the original Local Government Pension Scheme and the 'new look' scheme introduced as recently as April 2008. It is important that whatever is introduced now is simple and straightforward for employees to understand and for employers to administer.

Q15) Which forms of scheme design will encourage employees to save for their retirement? Is there any evidence from pension scheme reforms influencing opt out rates in the private sector?

Response to Q15:

There is likely to be a conflict between reducing opt out rates and reducing the cost to employers.

As suggested in response to Q1, offering the Government's National Employment Savings Trust (NEST) scheme might be an effective way of offering pension provision to employees who would otherwise opt out of the Local Government Pension Scheme – and of giving them a straightforward choice.

Q16) What best practice exists in the private sector around communication of benefits with scheme members?

Response to Q16:

The Hampshire Pension Fund, along with many other Local Government Pension Scheme funds and employers, places a strong emphasis on communication with scheme members, both contributors and pensioners using the full range of different media now available. This is set out in detail in a Communication Policy Statement which the Pension Fund is required to publish and revise each year.

The County Council is always keen to learn from the best practice by other pension funds.

Q17) Should any new scheme design offer members a degree of choice in the level of contributions paid and benefits received? For example, should members be able to receive a higher pension if they want to take the pension later? Why?

Response to Q17:

Flexibility is an important criteria in pension provision, particularly in the light of criticisms that the current Local Government Pension Scheme does

not meet the needs of many of today's workforce who work part-time or have breaks in service.

On the other hand, the impact on scheme administration costs and the transferability between sectors of the economy should be borne in mind if flexibility leads to a more complex scheme. More choice and flexibility may also be difficult for employees to understand.

The option of a scheme that offers higher paid employees an option of paying more in contributions for additional benefits is considered in response to Q1.

Benefits should be payable when the employee reaches the normal retirement age. They could be deferred if the employee chooses to continue working, but not otherwise.

Pensions and plurality of provision of public services

It is important that public service pensions support productivity and ensuring plurality of provision of public services is an important part of this. Different public service pension structures and eligibility for public service schemes may impact differently on the ability of providers outside of the public sector to supply public services. Therefore I would be interested in views on:

Q18) Whether and how public service pensions could be structured to support a more level playing field between the public and private sectors when tendering for contracts?

Response to Q18:

The Chancellor's planned consultation on the Fair Deal policy is referred to in response to Q13. The County Council supports the need for a review. The accrued pension rights of staff transferred to or from the public sector should be protected, but a more flexible approach to future pension rights in needed, possibly on a phased basis.

Q19) Which non-public service employees should be eligible for membership of public service schemes?

Response to Q19:

It would be difficult and potentially costly to change the existing arrangements for 'community admission bodies' (typically community bodies admitted to Local Government Pension Scheme funds by administering authorities) and 'transferee admitted bodies' (for employees of contractors for jobs transferred from local authorities to the private sector).

Beyond those categories of staff, no additional categories of non-public sector employees should be eligible for membership of the Local Government Pension Scheme.

Administration costs

There appears to be a wide variation in the administration costs across different public service schemes, and costs seem to be higher than those in the private sector in some cases. The final report will consider whether there is scope for rationalisation and cost reduction.

- Q20) What evidence is there on administration costs (excluding fund management costs) of private sector pension schemes? How do these compare with those in the public service schemes?**
- Q21) How do private sector schemes ensure that there is good quality and efficient scheme administration? Which measures can be applied to public service schemes?**
- Q22) Is there scope for rationalising the number of local government pension funds? If so, how could this be achieved?**

Response to Q20 to Q22:

It has been suggested that the 79 separate Local Government Pension Scheme funds in England could be amalgamated into a single fund that is invested and administered nationally.

The County Council does not support that option. It would not be consistent with the Government's localism theme.

There may be some scope for rationalising the existing funds, however, perhaps on some form of regional basis, for example in London. But the County Council believes that this should not be imposed by central Government.

Instead, arrangements should be put in place to allow local authorities to make local decisions on whether to amalgamate or provide jointly their pension funds on a case-by-case basis in their local areas, taking into account the scope for savings and improved efficiencies. This is the approach that many local authorities are applying to a wide range of their services and back-office arrangements as they deal with the issues raised by the Government's spending reductions.

The Government can help with this process by making any necessary changes to the legislation governing the administration and investment of Local Government Pension Scheme funds.

Transition issues

Ensuring there is a smooth transition from the current pension scheme structures to whatever new arrangements are put in place will be crucial if scheme members and taxpayers are to have confidence that the new arrangements are fair, suitable and sustainable in the long-term.

Q23) How can the Commission ensure an effective transition to the new arrangements?

Response to Q23:

Local authorities have recent experience of introducing the 'new look' Local Government Pension Scheme from April 2008. A key lesson learned then is to allow sufficient time for all the necessary changes to be implemented, including for the Government to make all the legislative changes required, correctly and on time.

Q24) What can the Commission learn about moving to a new scheme from best practice in the private sector and internationally?

Response to Q24:

Experience gained from the recent changes to pension schemes in the public sector in the UK, including the Local Government Pension Scheme, may provide adequate lessons.

Q25) How have accrued rights been protected or transferred during changes in schemes in the private sector?

Response to Q25:

The Government has already given a commitment that accrued rights will be protected in whatever changes are introduced. That was also the case when the 'new look' Local Government Pension Scheme was implemented in April 2008. That should provide sound guidance for any future changes.

In addition, I would also be interested in any further views respondents may have on any other issues relating to public service pensions that are not outline above, including those raised in my interim report.

Response:

No further comments.

Independent Public Service Pensions Commission

Interim Report published 7 October 2010

Forward and Executive Summary

Foreword by Lord Hutton of Furness

As we have all come to appreciate in recent years – whether we work in the private or public sectors – providing good quality pensions is becoming a much more challenging task given the increasing length of time that most people can now look forward to spending in retirement. This is particularly true of defined benefit pensions, where a pension is ultimately determined by the level of a person's earnings, rather than the level of their pension contributions. Defined benefit pensions make up most of the pensions on offer to public service employees and they raise substantial issues of affordability as well as risk sharing. As my interim report makes clear, there have been important attempts made to address the underlying drivers that have seen costs of providing public service pensions increase sharply in recent years. I welcome these reforms as they have helped to strike a better balance between employees and taxpayers in the distribution of pension costs. But as my report also makes clear we must satisfy ourselves that we have fully and openly addressed all of the underlying pressures that are still pushing up the cost of providing public service pensions. To do this properly we need to expose all the real costs of providing the current range of public service pensions as well as understand the real benefits they represent to employees.

The public sector performs functions that are vital to the security of our country, the success of our economy and the health of our society. There is therefore a compelling public policy objective in being able to recruit and retain the best possible people for these crucially important jobs. As many people have rightly pointed out in their evidence to me, we should regard public service pensions as part of an effectively designed overall remuneration system that will allow us to achieve this end. In doing so we need to keep firmly in mind the need for fairness and efficiency in the use of scarce public resources. And whilst it is right that taxpayers finance a proportion of public service pensions, as they are also the recipients of the services that are provided by employees, they are also entitled to expect that their hard earned money is spent wisely and to the best possible effect right across the public sector.

First and foremost, pensions are provided in order to ensure an adequate income when someone stops working which can help them sustain a reasonable standard of living without becoming a burden on the welfare state. If we lose sight of this when we consider the case for reform and end up pushing more people into a reliance on state benefits in retirement, we may well find that overall costs are likely to rise, whatever changes might be made to the design of public service pensions. Simple, sloganistic approaches are not the answer. Any reforms must try and avoid this obvious pitfall.

My interim report therefore attempts to establish a proper baseline from which we can answer the fundamental question – are public service pensions on a fair and sustainable footing that provides the best possible value for money to the taxpayer as well as adequate retirement incomes for public service employees? It is my clear view that the figures in this report make it plain that the status quo is not tenable. I believe we need to adopt a more prudent approach to meeting the cost of public service pensions in order to strike a fairer balance not just between current taxpayers and public service employees but also between current and future generations. In the short term, however, I consider there is also a strong case for looking at some increase in pension contributions for public service employees, to better meet the real costs of providing these pensions, the value of which has risen in recent years with most of these extra costs falling to taxpayers. Ministers should, however, proceed carefully and ensure adequate protection and proper safeguards to protect accrued rights, avoid undue hardship and minimise the risk of any rise in the number of employees who opt out of scheme membership. In particular, I would not recommend introducing contribution rates for the armed forces at this time. This issue should be dealt with in a way that is consistent with any long-term reforms.

In undertaking this review, I have been struck both by the enormous complexity of the subject matter, as well as by the degree of misunderstandings and confusions that surround any debate about it. My report tries to dispel some of these myths. It is mistaken to talk about ‘gold-plated’ pensions as being the norm across the public sector. In the most part, the pensions that are paid out to public service employees when they retire are fairly modest by any standard, although in part these reflect part-career or part-time working. For some people these modest pensions now look over generous because of the changes that have taken place in the private sector over the last 30 years or so, where pensions have become generally much less valuable than they used to be. Fewer people in the private sector are also contributing to a pension. I hope these negative trends can be reversed and I fully support efforts to do so.

This downward drift in pension provision in the private sector does not however provide sufficient support or justification in my view for the argument that pensions in the public sector must therefore automatically follow the same course. I regard this as a counsel of despair. In making clear I believe there is a case for further reform I have therefore rejected a race to the bottom as the only answer, and hope that reformed public service pensions can be seen as once again providing a benchmark for the private sector to aim towards.

My final report will therefore look at a wider range of radical solutions that might represent a better balance between the need for fairness between taxpayers and scheme members – allowing for increasing longevity – and the need to ensure adequate retirement incomes for those who have devoted some or all of their careers in the service of the wider community. It is for this reason and to ensure that public service pension schemes represent the best possible value for money to the taxpayer, that I have set out a set of general principles that should guide and govern the appraisal of all of the options for longer-term reform. Each of these options will be assessed against these general principles. I consider that the

public sector should continue to set a good standard as an employer and this includes a good standard of pension provision that seeks to avoid widespread opt-out of public service employees from these pension schemes. Promoting a responsible approach that encourages employees in the public sector to save for their retirement should be uppermost in our minds.

My interim report has also tried to tell the full story of who benefits most from the current system. Final salary schemes, which are the norm across much of the public sector, primarily reward high earners who progress rapidly through the salary scales. I am concerned that this may no longer provide a robust and fair mechanism for the majority of the public service workforce. I will return to this issue in my final report.

Pensions are long-term commitments and any reform I propose must protect the rights that public service workers have already accrued. The recommendations in my final report will ensure these rights are protected and I am taking advice on how this might best be defined. However I am clear that protecting accrued rights does not extend as far as protecting current terms for future pension accrual.

Finally, I have looked at the issue of how we currently deal with the pensions of those employees who move from the public sector when services are taken over by new providers. It would be unwise to allow the current arrangements to apply an unintended brake on the development of a more mixed economy of providers in the public sector. There is, at present, a danger of this happening. This issue will be dealt with in my final report and will form part of my appraisal of long-term reform options.

My final report will be completed next year. I am extremely grateful to all those who have submitted evidence to my Commission to date and to the panel of experts who are advising me in this work. I intend to conduct the widest possible consultation over the next few months as I now begin to examine options for long-term structural reform. I hope to build the widest possible measure of consensus about the way forward. I realise this will not be easy. But it is my belief that in finalising my recommendations, it will be possible to design a set of solutions that meet and address the principles I have set out in this interim report.

Lord Hutton of Furness

Independent Public Service Pensions Commission

Interim Report published 7 October 2010

Executive Summary

The importance of public service pensions

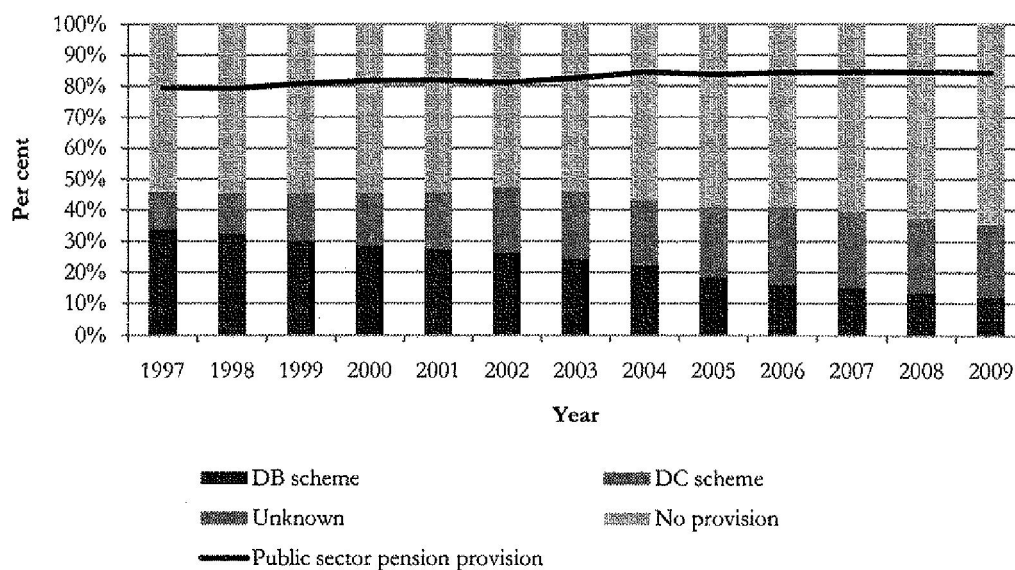
Ex.1 Public service pensions provide retirement incomes for millions of people in the UK. In total there are 12 million active, deferred or pensioner members and dependants of public service pension schemes. That is around one in five people in the UK. Each year schemes pay out billions of pounds to their pensioners – in 2008-09 payments were £32bn, about two-thirds of the cost of the basic State Pension.

Ex.2 Many of the current public service pension design features, including accrual rates, pension ages and the link to final salary, date back nearly 200 years, despite the enormous upheavals in demography and in the nature of work in our economy. In 1841, someone who reached the age of 60 might expect to live a further 14 years on average, but most people did not live to this age. By the early 1970s, when the schemes were substantially reformed, the life expectancy of a 60 year old had increased to about 18 years and this has now risen to around 28 years. In addition, many more people can now expect to reach 60.

Ex.3 In the past the public service pension schemes have provided a lead for employers in the private sector, but more recently there has been significant divergence. The pensions landscape in the private sector has been varied, but over the first two thirds of the last century the number of people in private sector pension schemes grew, almost all of which followed the defined benefit structure of the public sector. Over the last third of the century and the start of this century, the picture has been very different.

Ex.4 The general trend from the 1950s has been one of increasing public service provision – particularly once allowance is made for the inclusion of many nationalised industry scheme members within the public sector figures for the 1950s to the 1980s. This is set against a fall in provision in the private sector, especially in defined benefit provision, which is not fully offset by the increase in defined contribution provision.

Ex.5 The trend is increasing, with a sharp fall in defined benefit provision in the private sector since the late 1990s. Whilst the provision of defined contribution schemes has increased significantly, there are still a growing number of employees with no provision. In fact, around 85 per cent of public sector employees have some form of employer sponsored pension provision compared to around 35 per cent in the private sector.

Chart Ex.1: Private sector employees by type of pension provision

Source: *Annual Survey of Hours and Earnings, 2009*

Ex.6 This divergence between the public and private sectors is of concern, particularly in the context of mobility between the public and private sectors. However, it does not necessarily follow that public service pension schemes should be modelled in future on what has been happening in the private sector in recent years, especially given the decline in private pension provision and the concern that saving levels in the private sector are not currently optimal. It is important to take into account other issues as we consider future options, including the need to ensure public service pensions provide adequate retirement incomes for retirees.

Ex.7 The key question regarding public service pensions is whether they fit the needs of a modern flexible workforce, whilst being affordable, sustainable, adequate and fair to both taxpayers and employees.

The need for reform

Ex.8 The need to modernise public service pensions has been recognised for some time, in particular the need to deal with increasing costs: between 1999-2000 and 2009-10 the amount of benefits paid from the five largest public service pension schemes increased by 32 per cent.¹ This increase in costs was mainly driven by an increase in the number of pensioners, a result of the expansion of the public service workforce over the last four decades, longer life expectancy and the extension of pension rights for early leavers and women.

¹ Based on estimates by the GAD undertaken for the IPSPC. IPSPC analysis of schemes Resource Accounts

Ex.9 The previous Government recognised these issues and in 1997 started a series of significant reforms. These included:

- limited increases in pension age for groups such as the uniformed services, mostly for new entrants. In the civil service, NHS and teachers schemes existing members were allowed to keep a pension age of 60 if they wished, but new entrants have a pension age of 65 and pension ages lower than 65 will be phased out by 2020 in the Local Government Pension Scheme;
- sharing of risk arising from demographic change in the form of ‘cap and share’ rules. This spreads the cost of any future unexpected increases in contributions more equitably between employer and employees than previously, up to a cap after which any future increases would be borne by the members. Cap and share at present applies to the four biggest schemes – NHS, teachers, local government and civil service, although it has not yet affected employee contributions in any scheme and the Local Government Pensions Scheme does not yet have a cap set; and
- changed accrual rates for many of the reformed schemes, particularly for new entrants, but all except the civil service are still based on final salary. The change to a career average structure in the civil service scheme was not primarily undertaken as a cost saving measure, but as a response to the changing nature of the workforce.

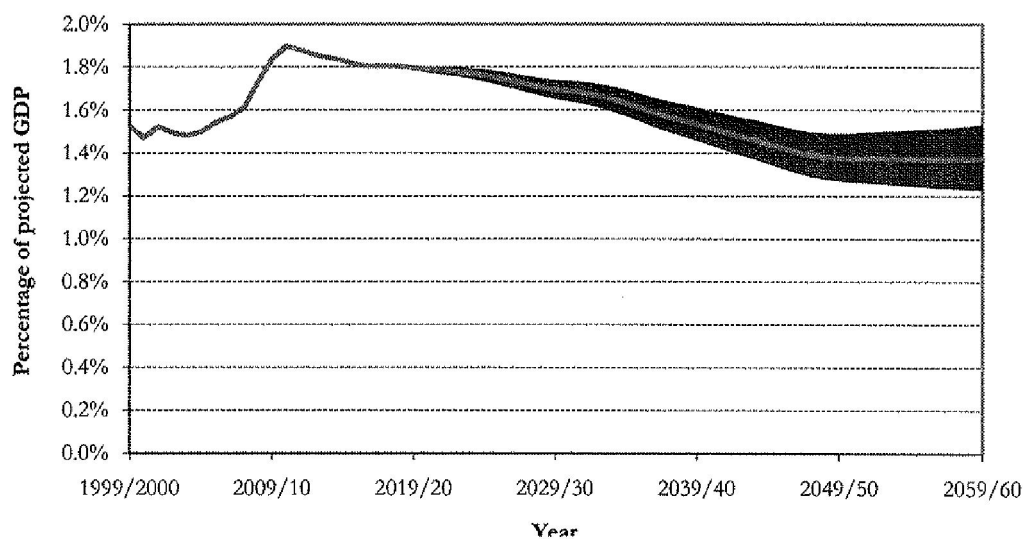
Ex.10 More recently the current Government changed the measure of annual price movements, so that from April 2011 onwards pensions uprating will move from the Retail Price Index (RPI) to the Consumer Price Index (CPI).

Ex.11 This change in the indexation measure may have reduced the value of benefits to scheme members by around 15 per cent on average. When this change is combined with other reforms to date across the major schemes the value to current members of reformed schemes with CPI indexation is, on average, around 25 per cent less than the pre-reform schemes with RPI indexation.

Ex.12 All these past reforms, the current pay freeze and planned workforce reductions will reduce the future cost of pensions. The gross cost of paying unfunded public service pensions is expected to fall from 1.9 per cent of GDP in 2010-11 to 1.4 per cent of GDP by 2060 as the central projection of Chart 1.B shows.

Ex.13 However, these measures will take many decades to fully affect the costs of pensions in payment, which are heavily influenced by existing pensioners, the vast majority of whom are still in pre-reform schemes. The Commission estimates that gross expenditure on unfunded public service pensions will remain close to current levels as a proportion of GDP over the next decade.

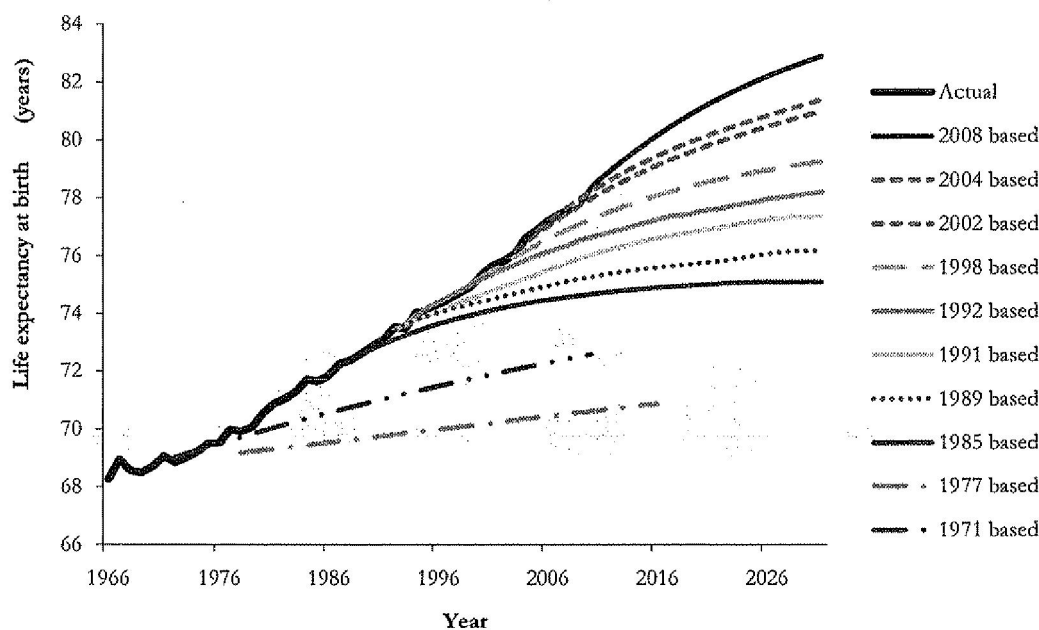
Chart Ex.2: Projected pension payments as a percentage of GDP – sensitivity analysis



Source: GAD analysis for the IPSPC

Ex.14 As Chart 1.B also shows, these costs are inherently uncertain and sensitive to assumptions on life expectancy, size of workforce, earnings growth and the implementation of planned reforms. How long pensioners will live has been systematically underestimated in the past, as Chart 1.C below shows. These issues could impact on the sustainability of these schemes in the future.

Chart Ex.3: Actual and projected period life expectancy at birth for UK males

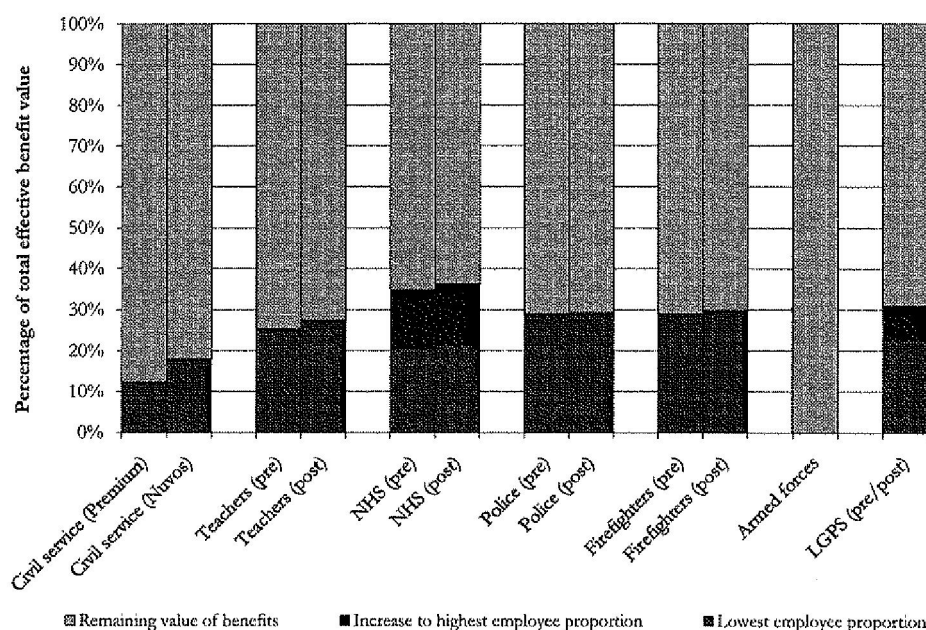


Source IPSPC analysis drawing on C Shaw 2007 and ONS 2008 population projections.

Ex.15 The expected proportion of adult life spent in retirement has increased as people live longer. A male pensioner in the NHS scheme who retired at 60 today is expected to spend 41 per cent of their adult life in retirement compared to 28 per cent if they retired in 1955. This means the value of a public service pension in 2003-04 is expected to be around a third higher than it would have been if assumptions about life expectancy were the same as those in 1955.

Ex.16 The increase in longevity also means that these pensions are now likely to be paid out for longer, increasing the overall costs. These extra costs, despite recent reforms, have not been equally split between employer and employees. Although the way costs are divided varies from scheme to scheme, the significant majority is met by the employer and by extension the taxpayer, as the Chart 1.D shows. This is not unique to public service pension schemes, but when many of the public service pension schemes were introduced employers and employees paid similar levels of contributions to the scheme – now employers pay around twice what employees contribute in most of the schemes and sometimes more.

Chart Ex.4: Employee contributions as a proportion of the overall cost of accrual (pre and post reform)



Source: IPSPC and PPI

Note: Figures based on effective employee benefit rates described in Box 5.8.

Ex.17 In addition, there is also uncertainty over whether the total contributions paid reflect the costs of the benefits received. The current discount rate used to set the level of total contributions in schemes was set in the late 1990s. Initial work by the Commission suggests that the current discount rate is at the high end of what is appropriate. The Commission is asking the Government to review this rate, ideally so that the findings can inform the final report.

Ex.18 In assessing fairness the Commission also found that the reliance on final salary in the majority of public service pension schemes tends to favour those who receive rapid promotion and those who stay in public service for their whole career. The promotion effect alone could mean that high flyers can receive almost twice as much in pension payments per pound of employee contributions than do low flyers.²

Ex.19 In addition, there is an issue of fairness between different pension schemes. This is particularly true between pre and post reform schemes given the protections given to most existing members when the schemes were reformed.

Ex.20 Public service pensions need to be considered in the context of the total benefits package for employees. There is no evidence that pay is lower for public service workers to reflect higher levels of pension provision. Consequently current pension schemes do not appear to offer best value for money.

Ex.21 Evidence to the Commission has also made it clear that current pension structures, combined with the requirement to provide comparable pensions ('Fair Deal'), are a barrier to non-public service providers, potentially reducing the efficiencies and innovation in public service delivery that could be achieved.

Ex.22 It has been suggested that extending access to public service pension schemes for non public service employees could be a solution to this problem. But it is not clear that this provides a solution either for the Government, which has to accept additional liabilities and long-term risk, or for some external organisations, which, depending on the scheme they are entering, may be required to pay a premium or indemnity for entry, take part in deficit recovery plans, or pay large exit charges.

Ex.23 When examining transparency it was clear that the debate around public service pensions has been hampered by a lack of consensus on what are the key facts and figures and a lack of transparency of the relevant data. This report seeks to provide as comprehensive a picture as possible in order to supply the basis for well-informed debate. In the final report the Commission will consider ways in which transparency and scrutiny can be improved.

Ex.24 The Commission has also come to the conclusion that it remains reasonable to continue to operate arrangements without actual funds as the basic financing model, given the risks, lack of obvious economic benefit and transition costs of moving to a fully funded model. Equally, there is no reason to de-fund existing funded schemes.

² 'Should Defined Benefit Pension Schemes be Career Average or Final Salary', Sutcliffe, C., ICMA Centre Discussion Papers in Finance, DP 2007-6, 2007.

The principles of public service pension provision

Ex.25 This is therefore an appropriate time to take overall stock of the situation and begin to address the underlying issues of scheme design and management of costs into the future. The Commission has identified a set of principles against which long-term options for reform should be judged. These are:

- *affordability and sustainability* – what level of pension cost is affordable is a political decision for the Government within the context of a range of priorities. But it is not an issue that can just be looked at in the short-term. In assessing affordability and sustainability we have identified a range of relevant cost measures to consider and the need for an agreed discount rate. Part of any assessment of cost must include the consequences of any reform on increased take-up of benefits such as pension credit. Critical to sustainability is the sensitivity of future costs to risks, such as changes to longevity and how these risks are managed as well as shared;
- *adequacy and fairness* – public service pensions should provide an adequate level of retirement income for public service workers with a reasonable degree of certainty. To assess reforms against this principle we need an agreed measure of what is adequate and what should be measured against the benchmark. We provide some ideas in this interim report. Adequacy is a measure of fairness, but we are also looking at fairness in the distribution of contributions and benefits between members of the same pension scheme; fairness between different schemes; fairness between generations of taxpayers; and fairness between the taxpayer and the public service employee;
- *supporting productivity* – to support productivity, public service pension scheme design should be consistent with an efficient labour market for employees. This should allow the taxpayer to be confident that public services are being delivered on a value for money basis. In general, scheme design should avoid barriers to the movement of employees between sectors. This needs to be viewed in the context of the whole remuneration package and whether the schemes support the recruitment and retention of the right people in the right jobs in a cost-effective way and deal flexibly with specific job issues. In particular, they should not be an unintended barrier to the outsourcing and mutualisation of public services that could drive greater productivity and efficiency in public services; and
- *transparency and simplicity* – public service pensions should be widely understood, both by the scheme members with regard to their own specific entitlements and possible future benefits; and by taxpayers who have a role in funding the schemes. The key design features and the costs to employers and employees need to be set out clearly and transparently. Assessment of reform needs to consider potential trade-offs together with implementation and transitional issues, including the means for protecting accrued rights and possibilities for more cost-effective administration. It is also important that public service pension schemes, like schemes in the

private sector, have a clear legal framework and have effective and accountable governance structures.

Options for change

Short-term options

Ex.26 The issues around fairness, sustainability, promoting productivity and the need for transparency and simplicity mean there is a need to consider long-term structural reform of public service pensions. However, that reform will take time. Increased longevity, the imbalance between employer and employee contributions and the fact that total contributions may be too low if the discount rate is too high suggests there is a case to make short-term changes, pending long-term reform.

Ex.27 The Commission considered a range of options that may provide short-term savings, specifically:

- changing the benefits structure;
- contracting public service pension schemes into the State Second Pension; and
- increasing contribution rates.

Ex.28 Of these, the most effective way to make short-term savings is to increase member contributions and there is also a clear rationale for doing so.

Ex.29 It is a matter for the Government to decide the manner and level of any increases in contributions necessary. However, the Commission feels that any increases should be managed so as to protect the low paid and, if possible, increases in contributions should be staged and need to be considered with a view to preventing a significant increase in opt out rates. The Commission does not recommend introducing contribution rates for the armed forces at this time.

Long-term options

Ex.30 The current public service pensions structure was not designed for modern working patterns and has been unable to respond flexibly to changes in this area and to demographic change over the past few decades. This has led to:

- rising benefits due to increasing longevity;
- unequal treatment of members within the same profession;
- unfair sharing of costs between the employee, the employer and taxpayers; and

- not realising the potential for plurality in the ways public services are provided.

Ex.31 Long-term structural reform is needed, as these issues cannot be dealt with through traditional final salary defined benefit schemes. But neither can they be dealt with appropriately through a funded, individual account, defined contribution model for all employees, which would place a major financing burden on taxpayers, ignore the ability of Government as a large employer to manage certain types of risk and increase uncertainty of post-retirement income for scheme members, which is difficult in particular for the low paid to manage.

Ex.32 In the Commission's final report a range of alternative structures will be considered. This will include a career average alternative to the current final salary defined benefit schemes. Drawing upon international experiences, alternatives such as Sweden's use of notional defined contribution schemes and the Netherlands' collective defined contribution schemes will be examined, as will risk sharing models, such as hybrid schemes that combine elements of defined benefit and defined contribution models. The Commission will also consider elements of scheme design, such as, ensuring normal pension ages are in line with the latest developments in longevity. This will enable the Commission to make a recommendation on a range of options to the Government, which can establish a more appropriate framework for public service pensions going forward.