

Local Government Spotlight

Independent Public Service Pensions Commission Final Report

10 March 2011



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Introduction

Lord Hutton of Furness published the final report of the Independent Public Services Commission on the review of public sector pensions today.

We do not propose to dwell on the specific contents of the report in this paper, beyond the summary of Recommendations provided in the Appendix. The contents will be adequately reported elsewhere, and the report itself is perfectly accessible and readable. Instead, we set out some thoughts on the implications of what is proposed from the local government viewpoint.

The Recommendations

The key recommendations can be summarised as follows:

- Accrued final salary rights to be retained, and to continue to be linked to salary.
- Future accrual to move to a common public sector CARE framework – no details of accrual rates provided, but revaluation to be in line with Average Earnings. (Note – this does not imply a common or single scheme, and differentials may exist such as for the uniformed services.)
- No differentiation of benefits by pay, but suggestion of differential contribution rates for members.
- More flexible retirement provisions, with Normal Retirement Age linked to State Pension Age for future accrual (set to age 60 for the uniformed services, subject to regular review).
- Cap and Share type approaches to be retained as the overall cost limitation mechanism.
- Unfunded schemes to remain unfunded. LGPS to remain funded.
- Limited or no admission of private sector workers to public service schemes.
- Stronger governance requirements with independent oversight and a common legal framework.
- Transition by 2015.

More generally the report recommends more clarity about the role of public sector pension schemes, suggesting that this is to ensure adequate levels of retirement income, and that more consideration needs to be given to total reward, combining both pay and pensions.

General overview

Compared with what might have been proposed, and what has been suggested by some commentators during the consultation phase, the proposals are significantly less dramatic. Confident predictions of pay caps, defined contribution top up arrangements and other cost control mechanisms have proven inaccurate.

From the members' viewpoint, this could therefore be seen as something of a 'result'. However, the devil will be in the detail. The value of the new scheme will depend critically on the, as yet unspecified, accrual rate and also the unspecified cost cap to apply in the 'cap and share' mechanism.

Implications for Local Government Scheme

In terms of the Local Government Pension Scheme, the recommendations are also less dramatic than might have been anticipated. A move to a CARE framework is, of course, a material change and brings some administration challenges with it, but the proposals appear significantly less complex than they might have been.

However, there are some recommendations of more direct relevance to the LGPS as follows:

- LGPS to remain funded.
- No proposals for merging Funds or regionalisation. Simply a proposal that joint cooperation and framework working be further explored.
- A comment that it is undesirable for non public sector workers to have access to public service pensions schemes – is this the end for Transferee Admission Bodies? Where would this leave other organisations like some types of Community Admission Body, or even Academies? Do we need to recover deficits more quickly?
- Some proposals for tidying up LGPS data and reporting on a national basis.

The first two recommendations here will no doubt be a relief to many different parties. The third is discussed in the following section, whilst the fourth seems non contentious and aligns with current drift anyway.

Fair Deal

Fair Deal is subject to a separate review and the consultation phase started a few days ago. Can we draw any conclusions from the comments that Lord Hutton makes? Well, if private sector employers are not able to access public service schemes this is mainly a change in respect of the LGPS – access to other public service schemes has only ever been possible in very limited circumstances.

So, not much changes outside of the LGPS unless Fair Deal itself is amended. Given that Fair Deal is potentially seen as a barrier to mobility, and public service schemes are likely to remain firmly defined benefit, it would seem reasonable to suppose that there could be a watering down of the broad comparability requirement to enable defined contribution type solutions. If not, it is hard to see how Fair Deal will remain anything but a material barrier to mobility, particularly in relation to small and medium sized employers. Notably, the Government has recently been seeking to elevate participation from that sector in delivery of services.

Political issues

There are many different points of view that can be applied to this area. Our initial perspective is to look at it from a principled, problem solving viewpoint. This seeks to identify the perceived concerns driving the review, and how they may be solved in principle.

Sources of political concern

It seems to us that there are four principal sources of concern which were driving this review. These can be thought of as sources of 'political heat'. The four are as follows:

- 1) The apparent inequalities that arise in a final salary scheme (eg 'fat cat' issues)
- 2) The absolute cost of public sector pensions
- 3) The divergence of the nature and value of pension provision between public and private sector
- 4) For the Local Government Pension Scheme, the volatility of costs

Suppose we test the proposals against these areas of concern.

A CARE scheme would certainly go some way to defusing concern 1). It is a natural function of this scheme design that the differentials between high and low earners are reduced. However, higher earners will still tend to get higher headline benefits, though tiered member contributions mean that they will pay a greater proportion of the overall cost.

As regards concern 2) the appearance of creating a solution runs out. As regards absolute cost, provision of a CARE scheme can be every bit as expensive as a final salary scheme – the incidence and sources of cost are simply different. A target retirement income (including State Pension) is proposed. However whilst uncertainty over the level of the State Pension remain, it is difficult to translate this target into an accrual rate. Without a recommended accrual rate there is no indication of cost.

To reduce cost, the benefit package as a whole would need to be reduced, either by reducing benefits or by deferring payment. This could have been done with the existing scheme structure. Arguably, cost reductions are easier as part of a wholesale change of nature of the scheme, but the accrual rate is likely to be the key battle ground.

A CARE scheme is a defined benefit scheme. It is not popularly adopted in the private sector. As such, there can be no realistic expectation of the private sector levelling up to this type of provision. The public/private sector pensions gap would be preserved. Whilst the size of the gap may be reduced, it remains, so concern 3) is not really addressed.

A funded CARE scheme would still be subject to most of the experience risks to which the existing LGPS is subject. This does not therefore represent a solution to concern 4).

Our principles based analysis, brief and superficial as it is, indicates that whilst the proposed changes certainly dilute some of the issues, the proposals are a poor solution to the perceived problems. In particular the political pressure around disparity of pension provision in the public and private sectors will remain, and unless local authorities take the opportunity to de-risk investment strategies, problems around volatility of pension costs will also remain.

Instead, alternative solutions which address all four concerns by sharing risks between members and employers in a manner which the private sector could embrace and level up to may be better.

We suspect that this is simply a political step too far for the Government at present, but leads us to wonder about the long term sustainability of these proposals.

In this context, we note that risk sharing arrangements prevalent in the public sector at present (cap and share) potentially achieve this in one form or another, but are not approaches available to the private sector.

Other issues

The recommendations in relation to governance proposals could represent some significant changes to the existing LGPS framework. Certainly, the requirement for member nominees on Pension Boards would be new for many existing Committees, noting that this change is at individual Fund level. This issue may get tangled up with the rather older issue of whether there is union representation on Committees.

The reference in Recommendation 19 to the Pensions Regulator is interesting. CLG appears to be being invited to consider whether it, or another body, would best perform the regulatory role. We suspect that CLG may already see themselves fulfilling that role.

The desire to make reporting across the LGPS more transparent could lead in a number of directions. Reporting on an agreed central basis, as well as on a local basis, could reduce the diversity of approaches currently visible at local level. As a Firm, we welcome greater rigour in this area.

Adequacy of provision

Adequacy of provision is, of course, a key element of any pension design. Without proposed accrual rates, it is hard to comment on this area beyond noting Lord Hutton's reference to the Turner Commission replacement rates which are quoted as follows:

Gross income (pa) (2004)	Benchmark gross replacement rate
< £9,500	80%
£9,500 - £17,499	70%
£17,500 - £24,999	67%
£25,000 - £49,999	60%
£50,000 +	50%

Presumably an accrual rate has not been proposed as there is further work to be done in the area of State Pension provision before the accrual rate can be set.

Transition

The proposal is to transition to the new benefit scale for future service by 2015. It is unclear whether there will be enough clarity in time for the 2013 valuations of the LGPS to anticipate such a change, and it may be that 1 April 2014 is a tidier implementation date.

The key transition challenges however are not so much actuarial valuations as consultation, communication and administration, and you will know better than us whether the proposed timetable is achievable. Notably, with preservation of accrued rights, there appears to be no need to seek retrospective pay information. However full protection of all provisions relating to historic rights will result in complicated administrative processes.

Appendix – The Recommendations

- Recommendation 1** The Government should make clear its assessment of the **role of public service pension schemes**. Based on its framework of principles, the Commission believes that the primary purpose is to ensure adequate levels of retirement income for public service pensioners.
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- Recommendation 2** Pensions will continue to be an important element of **remuneration**. The Commission recommends that public service employers take greater account of public service pensions when constructing remuneration packages and designing workforce strategies. The Government should make clear in its remits for pay review bodies that they should consider how public service pensions affect total reward when making pay recommendations.
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- Recommendation 3** The Government should ensure that public service schemes, along with a full state pension, deliver at least **adequate levels of income** (as defined by the Turner Commission benchmark replacement rates) for scheme members who work full careers in public service. Employers should seek to **maximise participation** in the schemes where this is appropriate. Adequate incomes and good participation rates are particularly important below median income levels.
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- Recommendation 4** The Government must **honour in full the pension promises** that have been accrued by scheme members: their **accrued rights**. In doing so, the Commission recommends **maintaining the final salary link for past service** for current members.
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- Recommendation 5** As soon as practical, **members of the current defined benefit public service pension schemes should be moved to the new schemes for future service**, but the Government should continue to provide a form of **defined benefit pension** as the core design.
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- Recommendation 6** All public service pension schemes should **regularly publish data which, as far as possible, is produced to common standards and methodologies and is then collated centrally**. This information should be of a quality that **allows simple comparisons to be made** across Government, between schemes and between individual Local Government Pension Scheme (LGPS) Funds.
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- Recommendation 7** A new **career average revalued earnings (CARE) scheme** should be adopted for general use in the public service schemes.
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- Recommendation 8** **Pension benefits should be uprated in line with average earnings during the accrual phase for active scheme members**. Post-retirement, pensions in payment should be indexed in line with prices to maintain their purchasing power and adequacy during retirement.
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- Recommendation 9** A single benefit design should apply across the whole income range. The differing characteristics of higher and lower earners should be addressed through **tiered contribution rates**. The Government should consider the trade off between affordability and the impact of opt outs on adequacy when setting member contribution levels.
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- Recommendation 10** Members should have **greater choice** over when to start drawing their pension benefits, so they can choose to retire earlier or later than their Normal Pension Age and their pension would be adjusted accordingly on an actuarially fair basis. **Flexible retirement** should be encouraged and abatement of pensions in its current form for those who return to work after drawing their pensions should be eliminated. In addition, caps on pension accrual should be removed or significantly lifted.
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- Recommendation 11** The Government should **increase the member's Normal Pension Age in the new schemes so that it is in line with their State Pension Age**. The link between the State Pension Age and Normal Pension Age should be regularly reviewed, to make sure it is still appropriate, with a preference for keeping the two pension ages linked.
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- Recommendation 12** The Government, on behalf of the taxpayer, should set out a **fixed cost ceiling**: the proportion of pensionable pay that they will contribute, on average, to employees' pensions over the long term. If this is exceeded then there should be a consultation process to bring costs back within the ceiling, with an **automatic default** change if agreement cannot be reached.
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- Recommendation 13** The Commission **is not proposing a single public service pension scheme**, but over time **public service pensions should move towards a common framework** for scheme design as set out in this report. However, in some cases, for example, the uniformed services, there may need to be limited adaptations to this framework.
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- Recommendation 14** The key design features contained in this report should apply to all public service pension schemes. The **exception is in the case of the uniformed services** where the Normal Pension Age should be set to reflect the unique characteristics of the work involved. The Government should therefore consider setting a **new Normal Pension Age of 60 across the uniformed services**, where the Normal Pension Age is currently below this level in these schemes, and **keep this under regular review**.
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- Recommendation 15** The **common design features laid out in this report should also apply to the LGPS**. However, it remains appropriate for the Government to **maintain the different financing arrangements for the LGPS** in future, so the LGPS remains funded and the other major schemes remain unfunded.
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- Recommendation 16** It is in principle **undesirable for future non-public service workers to have access to public service pension schemes**, given the increased long-term risk this places on the Government and taxpayers.
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- Recommendation 17** Every public service pension scheme (and individual LGPS Fund) should have a **properly constituted, trained and competent Pension Board, with member nominees, responsible for meeting good standards of governance including effective and efficient administration**. There should also be a **pension policy group** for each scheme at national level for considering major changes to scheme rules.
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- Recommendation 18** **All public service pension schemes should issue regular benefit statements** to active scheme members, at least annually and without being requested and **promote the use of information technology** for providing information to members and employers.
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- Recommendation 19** Governance and the availability and transparency of information would be improved by government establishing a **framework that ensures independent oversight of the governance, administration and data transparency of public service pension schemes**. Government should consider which body or bodies, including, for example, The Pensions Regulator, is most suitable to undertake this role.
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- Recommendation 20** When assessing the long term sustainability of the public finances, the **Office for Budget Responsibility should provide a regular published analysis of the long term fiscal impact of the main public service pension schemes** (including the funded LGPS).
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- Recommendation 21** **Centrally collated comprehensive data, covering all LGPS Funds, should be published including Fund comparisons**, which, for example, clarify and compare key assumptions about investment growth and differences in deficit recovery plans.
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- Recommendation 22** Government should set **what good standards of administration should consist of in the public service pension schemes based on independent expert advice**. The Pensions Regulator might have a role, building on its objective to promote good administration. **A benchmarking exercise should then be conducted across all the schemes** to assist in the raising of standards where appropriate.
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- Recommendation 23** Central and local government should **closely monitor the benefits associated with the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach, if appropriate**, across all local authorities. Government should also examine closely the potential for the unfunded public service schemes to **realise greater efficiencies in the administration of pensions** by sharing contracts and combining support services, including considering outsourcing.
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- Recommendation 24** The Government should introduce **primary legislation to adopt a new common UK legal framework** for public service schemes.
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- Recommendation 25** The **consultation process itself should be centrally co-ordinated**: to set the cost ceilings and timetables for consultation and overall implementation. However, the **consultation on details should be conducted scheme by scheme involving employees and their representatives**.
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- Recommendation 26** The Commission's view is that even allowing for the necessary processes it should be possible to **introduce the new schemes before the end of this Parliament** and we would encourage the Government to aim for implementation within this timeframe.
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- Recommendation 27** **Best practice governance arrangements** should be followed for **both business as usual and the transformation process**, for each scheme. And there will also **need to be the right resource**, on top of business as usual, to drive the reforms; particularly given the challenging timescale and scope of the reforms.
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