Division(s): N/A

PENSION FUND COMMITTEE – 3 DECEMBER 2010

INDEPENDENT PUBLIC SERVICE PENSIONS COMMISSION

Report by Assistant Chief Executive & Chief Finance Officer

Introduction

1. Following the General Election Results in May 2010, the new coalition government set up the Independent Public Service Pensions Commission under the chairmanship of Lord John Hutton. The Commission was tasked with conducting a fundamental structural review of public service pension provision, and reporting back to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead while protecting accrued rights.

2. This report updates the Committee on the Interim Report of the Commission, and highlights the issues where the Commission has called for further evidence. The Committee is invited to identify those issues that it would wish to include in any response to the Commission.

The Interim Report from the Commission

3. The Commission published its interim report on 7 October 2010. The 170 page report has been widely welcomed as a comprehensive and informed analysis of the issues. The report has set out the background to the current issues, sought to dispel a few wider held myths, set out the principles against which all future changes should be assessed, and some broad issues for debate on future reform.

4. Lord Hutton in presenting his report has noted and welcomed the recent reforms to public service pension schemes. However, it is his view that maintaining the status quo is not tenable. He argues for long term structural reform and a more prudent approach to meeting the costs of public service pensions.

5. Lord Hutton talks of the mistaken view that public sector pensions should be regarded as gold plated. He notes that the average public service pension of £7,800 is fairly modest by any standard. He also notes that over 50% of all pensioner members receive less than £5,600 per annum, and 90% of pensioners receive less than £17,000.

6. Whilst stating his view that these are modest sums, Lord Hutton does note the declining numbers of employees working in the private sector who have access to a pension scheme and the declining value of those pension arrangements that are available. However Lord Hutton dismisses “the race to the bottom” as an answer. He notes the critical role played in this country by the public services and recognises the compelling public policy objective in

ensuring we can recruit and retain a quality workforce to maintain these vital public services.

7. However Lord Hutton argues that there is a clear need for reform to reflect the changing pensions landscape since many of the current pension schemes were designed. In particular, Lord Hutton argues that there is a need to address unfairness between the costs and benefits for scheme members and tax payers, and between current and future generations. Lord Hutton argues that the final salary schemes are inherently unfair, rewarding primarily the high earners, and should not be the basis for schemes going forward.

8. In looking at developing proposals for reform, Lord Hutton has identified 4 principles against which he argues proposals should be assessed. These are:

- Affordability and Sustainability – Lord Hutton argues that it is a political decision to determine the level of pension costs that the Country can afford to pay but does state that any decision must be taken on a long term basis. Viewing pension costs as a % of GDP is seen as a reasonable measure. Lord Hutton though is clear that affordability requires a reasonable view of the discount factor used to discount future liabilities to determine current costs and states that current figures are at the high end of the spectrum. In terms of sustainability, Lord Hutton argues that any scheme needs to be flexible enough to cope with future uncertainty, particularly changes in longevity.
- Adequate and Fair – The Interim report does not define adequate but does refer to the need to maintain pensions at a level that avoids the burden on the welfare state. On fairness, the report highlights the need for fairness between those on different incomes, in different services, between employers/tax payers and employees, between generations and between the public and private sectors.
- Supporting Productivity – Lord Hutton is particularly concerned to avoid barriers to an efficient labour market, so allowing individuals to switch between sectors and services, and allowing employers more freedom in designing the structures for the delivery of their services. He draws attention to the barriers created by the current Fair Deal arrangements.
- Transparent and Simple – Lord Hutton has commented that the current debate on public sector pensions is hampered by a lack of clear and widely accepted information. He is also concerned that employees do not have sufficient understanding to make the choices open to them and understand the trade offs involved. The Commission also wants to see a future scheme which reduces the current level of administration costs (including the costs of investment management).

9. In examining any scheme changes, Lord Hutton has recognised the need to protect the accrued pension rights of public sector workers. The interim report though made clear that this does not extend to protecting the current terms for future accrual.

10. Lord Hutton has considered the differences between the LGPS, which is the only funded scheme in the public sector, and the other unfunded schemes.

The Commission has concluded that no changes should be made to the current funding basis. The transitional costs of moving the unfunded schemes to a funded basis are prohibitive, but there is no argument for removing the funding for the LGPS.

Short Term Reform

11. In the interim report, Lord Hutton has stated that there is a requirement for fundamental review of the schemes, which along with the need to protect accrued rights, will delay the addressing of the issues identified into the longer term. He has therefore proposed short term measures to address the issues of increased longevity, the perceived imbalance between employee and employer contributions and the concern that overall funding levels are too low.

12. Lord Hutton has determined that the only viable short term option is to increase employee contribution rates. In making this statement, the Commission has stated that it does not believe it to be appropriate to introduce employee contributions for the armed forces at this time. The Commission also argues for the need to protect the low paid, to avoid widespread opt out and fall back onto the welfare state.

13. The interim report stated that it was a matter for Government to determine the manner and level of any increases. Subsequently though the Chancellor has stated that he expects further proposals to be presented in the final report from the Commission.

14. A target figure of £1.8b has been identified as the consequence of an average 3% increase in contributions from the unfunded schemes. It is not clear how this would be achieved, given the significant differences in current contribution rates, which range from 1.5% in parts of the Civil Service, 1.8% in the Judiciary up to 11% in the police and firefighter schemes.

15. For the LGPS, an average 3% increase would raise an estimated £750m, allowing the Government to reduce the level of funding provided in the local government settlement. There is an issue of how this will be managed given the imminent publication of the 2010 Valuation results which set the employer contribution rates for the next three years. These would need to reduce in line with the increases in employee contributions to avoid the need for cuts in services.

16. It is not clear how any changes in employee contribution rates will be managed in the LGPS. The Government did consult in the Autumn of 2009 on changes in contribution rates which largely protected employees on salaries up to £30,000 with reductions for those on £12,000 - £15,000 and £18,000 - £22,000, increases on 0.2% to 0.3% for those on £30,000 to £75,000, increases on 1% for those on £75,000 to £100,000 and increases of 2.5% for those above £100,000. The Government’s own estimates suggested that the average increase in these proposals was just 0.1%. Any change which protects the low paid (whether the cut off is £15,000, £18,000 or £22,000) will therefore require significant increases in contribution rates for everyone else. Alongside the current pay freeze, and the changes to pension

tax relief, any significant increase could lead to large numbers of opt outs, particularly amongst the highest paid, and those with considerable service.

Call for evidence for Final Report

17. On 1 November 2010, Lord Hutton wrote to all stakeholders with a call for evidence for his final report. A copy of this letter is attached as Annex 1. The letter asks 25 specific questions centred around seven key topics.

18. Question one is around **scheme design**, and simply asks for comments on future scheme design, noting the Commission has already ruled out a scheme based on final salary, or solely based on an actual defined contribution scheme.

19. This Committee has previously called for a scheme based on career average salaries and may wish to repeat that response today. In addition, the Committee should consider the merits of introducing a cap on the salary at which funded pension benefits can accrue, or the option of a hybrid scheme which converts to a defined contribution option above the cap (with or without employer contributions, notional or actual).

20. In terms of adequacy, transparency and simplicity, the introduction of a cap or a hybrid scheme may not score highly. Adequacy can be defined in both absolute terms (in line with welfare payments) but also in relative terms. A previous Pensions Commission chaired by Lord Turner defined adequacy in terms of percentages of salary prior to retirement and the ability to maintain a previous standard of living. Introducing a cap will not impact on adequacy in absolute terms but will clearly penalise those on higher salaries in relative terms. This group is already targeted in terms of the changes to pension tax relief, and higher contributions, and any cap needs to be seen in this context.

21. The LGPS already allows members to increase their pension provision through Additional Voluntary Contributions for which the employer makes no contributions. Any hybrid scheme needs to take account of this to avoid over-complicating the pension arrangements for an individual.

22. Questions two through to nine cover **risk sharing** and a series of issues around fairness. The Committee has already considered this issue to an extent in the debate around cost sharing which is yet to be implemented within the LGPS. The letter specifically asks the question around the longevity risk and there does appear to be merit in linking the normal retirement age to longevity forecasts to try and standardise the period for which pension benefits are payable.

23. Alongside any movement in the normal retirement age, there needs to be a link to the accrual rates to ensure the level of pension remains at the targeted levels of income i.e. if retirement ages are increased, accrual rates should reduce to maintain the proportion of salary paid in final pension.

24. In terms of fairness between employees and employers/taxpayers, the initial models were set up with a funding ratio of 6:9 between employee:employer. It is argued that this is a realistic target to adhere to.

25. Also in terms of fairness, there is a much supported view that pension arrangements (benefits, contribution rates, retirement ages etc.) should be standardised for all non-uniformed public service workers, with a separate sub-set of arrangements for the uniformed workers, reflecting the nature of their work. The Committee is invited to comment further on this, including the standardisation of normal retirement age across public services.

26. The question on different treatment for those at different income levels has been covered above. The LGPS already differentiates through contribution rates dependent on full time equivalent salary (a change introduced by the previous Government based on differential benefits under the tax regime). Further differentiation will work against the objective of transparency and simplicity and may be difficult to justify in terms of fairness.

27. The third group of questions (numbers 10-13) is centred around **adequacy**. As noted above, adequacy can be (and should be) measured both in absolute and relative terms. Lord Turner's Pensions Commission set out benchmark rates for pensions as follows:

- Gross Income less than £9,500 — Pension 80% of Salary
- £9,500 - £17,499 — Pension 70% of Salary
- £17,500 - £24,999 — Pension 67% of Salary
- £25,000 - £49,999 — Pension 60% of Salary
- Gross Income above £50,000 — Pension 50% of Salary

28. Lord Turner justified these figures in terms of the costs that fall out on retirement (beneficial tax arrangements, national insurance contributions, travel to work, pension contributions, housing costs etc). If these figures can be viewed as a reasonable guide to relative adequacy, it would suggest that current accrual rates could be reduced. An accrual rate of 1/80th rather than the current 1/60th would provide a pension of 50% of average salary, with at the lower salary range the state pension bringing the overall pension above Lord Turner's benchmark figures. (NB The change to career average schemes would have an impact on these calculations, so more detailed calculations of the accrual rate would need to be undertaken).

29. It is argued that between the public services pension and the state pension, an employee should be receiving an adequate level of income. If individuals are left to make their own arrangements to ensure an adequate pension, it is likely that many will not, and the burden will fall back onto the welfare state. Individuals though should be free to make their own arrangements to increase their pension above what are deemed adequate levels (subject to the tax regime).

30. Questions 14 to 17 refer to **employee understanding and choice**. Our experience indicates that the majority of individuals do not consider their pension options until late in their careers when retirement is on the near

horizon. Most employees do not exercise any choice over their pension arrangements, remaining in the LGPS as the default option rather than opting out, and taking the old default option when going for an AVC. Allowing scheme members choice in shaping their own pension arrangements is unlikely to be widely taken up, and the additional administration involved and the potential difficulties in transferring the pension benefits between employers are likely to outweigh any advantage.

31. If the Government wants to ensure all employees make adequate arrangement for their retirement, they should consider making membership of the pension scheme a mandatory requirement of employment in the public service, with those wishing to opt out doing so on the basis they also opt out of future support from the welfare state in retirement.

32. There are two questions (18 and 19) on **pensions and plurality of provision of public services**. The Commission here is looking for potential changes to the Fair Deal arrangements to support a more level playing field between public and private sectors in tendering for contracts, as well as looking at which workers can join public sector schemes.

33. Given the Commission's wish to avoid a race to the bottom in pension provision, this is a difficult issue to reconcile. Relaxation of the Fair Deal arrangements which protect the pension benefits of those transferring to the private sector under TUPE are likely to accelerate a levelling down of pension provision, as part of the drive to reduce the costs of public service provision.

34. Relaxing the Fair Deal arrangements would appear to be inconsistent with opening up public service pension scheme to wider membership and indeed would indicate only those directly employed in public services would have the right to membership. If Fair Deal is preserved, then the current admission arrangements for the LGPS appear sufficient.

35. The Commission has asked three questions (20-22) on the **administration costs** of public service schemes. In particular, the Commission is looking at what scope there is for rationalising the number of local government pension funds.

36. There is arguably a conflict between the idea of fewer (presumably regional) schemes and the Government's drive to localism, and improving the local democratic input to service provision. However, current administrative arrangements are based on multiple employers within a single Fund, so an extension of this cannot be ruled out simply on principle.

37. A key issue to consider is the practical issues of administering a scheme for local employers (particularly some of the smaller admitted bodies) from a regional centre. To ensure efficiency savings from rationalisation, there is a clear need to improve communication channels, including the transmission of employee data between employers and administering authority. A review of the arrangements for the nationally administered Teachers Pension Scheme could point to appropriate arrangements going forward.

38. The final three questions (23-25) are in respect of **transition issues**. These questions primarily are looking to identify best practice from private sector arrangements. Key amongst transition issues is the protection of accrued rights and what this means. A number of options exist:

(i) Close the existing arrangements for new accrual, but allow the accrued benefits to move in line with previous Regulations i.e. the benefits accrued would still be valued on the basis of the individual's final salary, and be payable at their normal retirement age under the current Regulations.
(ii) Close the existing arrangements for new accrual, revalue the benefits on the basis on an agreed index (presumably CPI in line with the new arrangements for deferred benefits), with benefits payable in line with the regulations at the time of retirement.
(iii) Close the existing arrangements and transfer all accrued benefits into the new scheme on an equivalent basis.

39. The third option would arguably be the most transparent and simplest going forward, but could be subject to the greatest opposition from existing scheme members, especially those closest to retirement. The first option will mean the longest delay in seeing the benefits of the changes working their way through to employer contribution rates and therefore the tax payer. The Committee may therefore wish to consider option (ii) as its preferred way forward.

Employers' Forum

40. The issues covered by Lord Hutton and the Commission which he chairs are clearly of significance to those in the public services. Before finalising the response of the Oxfordshire Fund, it is therefore proposed to cover the issues included in this report as part of the Employers' Forum on 10 December 2010.

41. It is therefore proposed to submit a consolidated response to Lord Hutton's call for evidence after the Forum, in accordance with his deadline of 17 December 2010.

RECOMMENDATION

42. **The Committee is RECOMMENDED to note the findings of the interim report of the Commission, to consider the issues raised by Lord Hutton's call for further evidence, and to set out those views it wishes to see included in a final submission to the Commission, to be agreed after the Employers' Forum on 10 December 2010.**

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Background papers: Nil

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