The Future of Public Sector Pension Schemes
GMPF submission to the Independent Pension Commission

1. Greater Manchester Pension Fund (GMPF)

Tameside MBC is the administering authority of Greater Manchester Pension Fund. At 31st March 2010, the Fund had over 260,000 members, over 200 employers and assets in excess of £10.4bn. This makes GMPF the largest fund in the Local Government Pension Scheme (LGPS) in England and Wales and equates to about 8% of the LGPS by value of assets.

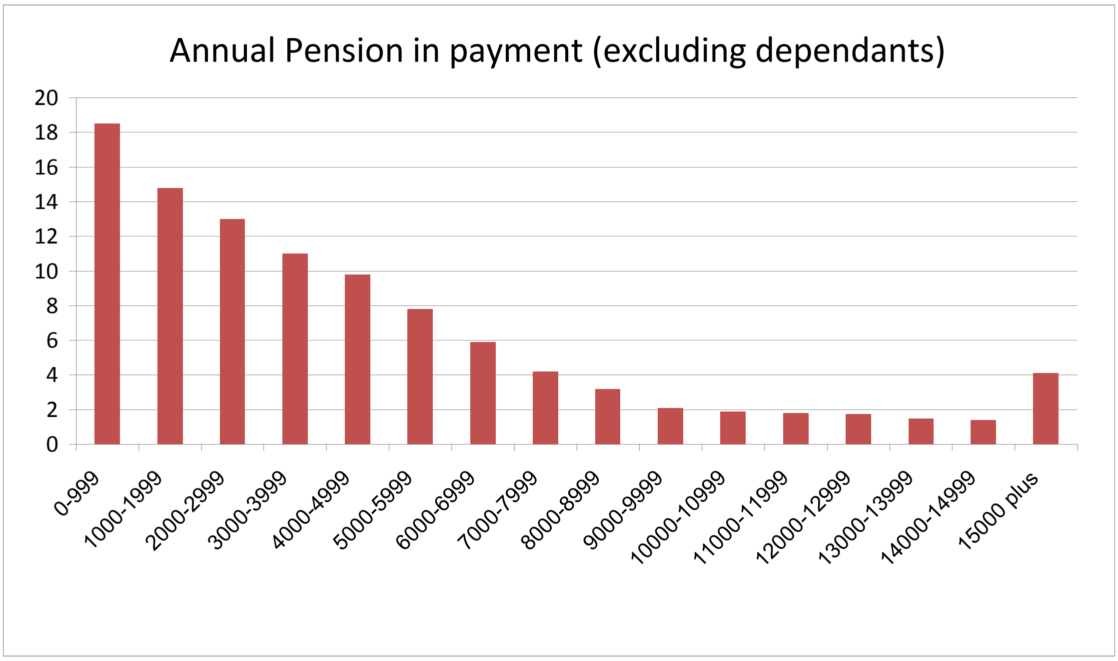
GMPF has an excellent long term investment track record resulting in it having a funding level amongst the best of local authority funds and average employer contribution rates at the lower end of the range (average GM local authority contribution rate of 15% for 2010/11).

This response is submitted from an administering authority perspective with the aim of helping to inform the debate. The focus on the response is primarily LGPS related, because this reflects our experience and secondly the funded nature of the LGPS makes it different.

2. GMPF – Background statistics and Matters Arising

The average retirement pension for GMPF is £4,384 p.a.

The chart below provides an analysis of pension in payment for GMPF pensioners (excluding dependents pensions).



It is interesting to note that ⅔ of our pensioners have a pension of less than £5,000 and 90% have a pension less than £10,000 and only 4% have a pension in excess of £15,000.

The pensions in payment reflect the work history of the Fund's members. Clearly it is not the norm to be a member of the LGPS for 40 or 45 years and retire on a pension (including lump sum) equivalent to ⅔ of pay. Many members are not well paid, work part time, take career breaks, may have short service etc and have not transferred pensions from other employment, in many cases, probably because they do not have pensions to transfer.

It is also worth noting that for Scheme employers such as local authorities, the employee is automatically enrolled in the Scheme and must take a conscious decision to opt out if they do not want to remain in the Scheme. Hence, the Fund experiences high levels of take up at Scheme employers.

An important element in the cost of the Scheme is the duration on pension. The LGPS now has a normal retirement age of 65. The average age of retirement has been increasing for GMPF members in recent years. The duration of a retirement pension has also been increasing as illustrated below. Clearly, there is a long time lag to influence the duration on pension, but the Actuary can make and has made assumptions to take account of any changes.

Table 1 – Duration of Pension

The duration of pension is a function of the age at retirement and the age at death. The table below summarises GMPF experience for members (but excludes widows and widowers):

Year	Duration of Pension
2002/3	16 years 44 days
2003/4	16 years 252 days
2004/5	17 years 40 days
2005/6	17 years 273 days
2006/7	17 years 315 days
2007/8	18 years 92 days
2008/9	18 years 120 days
2009/10	18 years 273 days

Table 2 – Average age of death of Retirement Pensioners

Year	Women	Men
2002/3	74.9	76.9
2003/4	75.9	76.3
2004/5	75.4	76.8
2005/6	77.9	76.4
2006/7	77.0	76.9
2007/8	77.3	77.3
2008/9	76.4	77.5
2009/10	76.9	78.0

The surprise in these statistics is that women are dying at broadly the same age as men, but widows' life expectancy is more in line with national trends.

The research published by organisations such as a Club Vita provides an analysis of the factors that influence longevity.

3. Context

The Pensions Minister, Steve Webb says that strengthening State pension provision is key to helping people develop a decent income in retirement.
He also comments that the State pension should form a strong foundation on which other savings could be built with workplace savings forming an important part.

The research published by the NAPF sets out the decline in workplace pension provision over the last decade. This decline in pension savings is a major concern. If workers do not save for retirement, the implications are a combination of poverty in old age and dependence on means tested benefits in retirement. The Turner Commission provided evidence on the numbers needing some form of means tested benefits in retirement. It also proposed the planned introduction of auto-enrolment into workplace pensions by 2012 to stop the position worsening.

The current and future state of the public finances and managing the consequences of people living longer and not necessarily healthier lives in their later stages sets some of the context for this review.

Our long term view favours a core State pension and employees that save for their retirement should reap the benefit of their savings.

At the moment, many members' LGPS pensions replace means tested benefits. For those that opt not to save for their retirement, the taxpayer meets the cost of means tested benefits. An important potential consequence of reducing public sector pension saving is increasing the demand for means tested benefits.

4. Public Sector Pension Schemes

The terms of reference for the Commission are "to conduct a fundamental structural review of public service pension provision and to make recommendations…. on pension arrangements that are affordable and sustainable in the long term, fair to both the public service workforce and the taxpayer……"

There are a number of schemes within the scope of this review. They have developed and they have been reviewed over time with the aim of making them affordable and sustainable. The estimated cost of the "New Look LGPS" by GAD was 18% - 20% of payroll with employees meeting around 6% of this cost and employers 13%. The outcome of the recent change to CPI from RPI for determining pension increases will significantly reduce the estimated cost of the Schemes. These Schemes have different rules, benefit structures and costs to employees and employers.

The nature of different public sector jobs necessitates some differences in scheme design. Where the type of work enables a comparable retirement age and capacity to do the job up to that retirement age, there may be a case for rationalising the

Schemes. The benefits of standardisation/rationalisation would need to be compared with the consequences of such an approach.

The key questions for all public sector schemes are :

- what cost (to the employer and employee) is considered affordable; and
- what variability of cost is acceptable?

These are questions best agreed between Government, employers and employees, but in later sections, there is further background information to help address these issues. From an administrator's perspective, it feels like the Scheme has been subject to constant change in pursuit of affordability and sustainability over the last decade. The new LGPS regulations, effective from April 2008 were aimed at delivering an affordable scheme. There is a danger that the feeling of constant change in what is effectively a long term savings arrangement could undermine the perceived value of the "pension package". It is important to provide long term stability to the system.

5. Funding

A key difference between the LGPS and other public sector schemes is that the LGPS is funded and other schemes are unfunded. This raises the question of the relative merits of funded and unfunded schemes.

The case for funding includes the following points:

i) In a funded scheme, the employee's pension promise is being provided for as it is being earned, whereas in an unfunded scheme today's employees and tax payers will be meeting the cost of today's pensioners.

ii) If you believe the real return that can be earned on pension fund investments is greater than the return the Government makes on its investment (and/or cost of debt) a funded scheme gives a lower cost.

iii) The stability of costs is likely to be better in a funded arrangement because in an unfunded arrangement, the cost is driven by the pensions in payment whereas there is much more scope for smoothing costs in a funded scheme.

iv) Funded pensions should mean that the level of taxes that the State has to raise to meet the cost of pensions should be less, and this should generate economic benefits.

v) Funded pension schemes provide capital and debt for companies and Governments and this should have a beneficial long term effect on the economy.

vi) Funded schemes have to be transparent about their funding position with independent actuarial valuations being undertaken every 3 years.

This raises the case for switching unfunded schemes to a funded basis. The issue is simply one of affordability, in effect if you switched to funded, the sum required from Government (and the tax payer) would need to meet existing pensions, the value of pension promises already earned and the value of pension promises earned in the year. It is unlikely that in the foreseeable future, the Government will be able to switch to a funded basis on affordability grounds or if it does pension costs will increase significantly.

In conclusion, the case for a funded scheme is strong, but for the foreseeable future the LGPS is likely to be the only scheme able to operate on such a basis. **This is a material difference compared to other public sector schemes.**

To support the funded nature of the Scheme, the characteristics and advantages of the LGPS means that:

i) it is administered locally by local Councillors within rules set by CLG;

ii) the size of administering authorities leads to low unit costs of administration and investment, albeit the larger schemes generally benefit from greater economies of scale;

iii) there is a regular assessment of the funding position which is published;

iv) the strength of the employer covenant allows long term decision making and this is helped by positive cash flow, which for GMPF was over £200m for 2009/10.

6. What has caused the problem?

The period 1975-1999 was exceptional for investment returns. Equities delivered real returns of around 12% per annum, around double the long term norm. This meant that the cost of defined benefit/final salary pension schemes was very cheap for employers with many employers benefitting from reduced contributions or contribution holidays, whilst their funds were also able to accommodate extra costs, e.g. pensions increase, the costs of early retirement and improving longevity.

The problems of the last decade for public and private sector funds are well documented. These include:

- investment returns have been very poor by historical standards and less than the actuarial assumption (see Table 3 below);

- interest rates have been at historical lows, increasing the assessed value of benefits earned and the estimated cost of the scheme;

- increasing longevity is adding to the cost/value of the pension promise;

- accounting standards relating to the reporting of pension liabilities have not been helpful. They have created the scope for enormous volatility in the funding position from year to year and this together with increased scrutiny has encouraged organisations to reduce the risk associated with the cost of their pension promises; and

- more recently, the recession has had an impact on affordability.

Table 3 – Historical Returns (% per annum) 10 years to 31st December 2009

Asset	10 year return
UK equities	1.6%
Overseas equities	1.6%
UK bonds	5.4%
Cash	5.2%
Property	6.2%
Total assets	3.1%
RPI	2.7%

The last decade has seen exceptionally low returns from equities, and this has dragged down total asset returns for pension funds. These have been only marginally higher than inflation, below increases in earnings and over 3% below actuarial assumptions. It is not surprising that funding levels have plummeted and there has been a need for significant increases in employer contributions. Increases in life expectancy have of course further added to costs.

This last decade has been a very difficult environment for pension funds providing defined benefit schemes. The cost to employers has increased significantly and for those with defined contribution provision, they would have done well to generate a return that matched inflation. This, together with very low annuity rates meant that their pension was much less than they had anticipated. **It is not possible to design an effective pension scheme in such an environment, but it does highlight the issue of how risks should be shared between employee and employer (and the tax payer).**

Looking forward, we need to ask what returns can we expect in future?

In Table 4 below, the long term historical returns from equities, gilts and cash are compared with prospective returns based on GMPF Fund Managers' forecasts.

Table 4 – Long term historical real returns (v RPI) prospective returns (5-10 years)

	Equities % per annum	Gilts % per annum	Cash % per annum
Long term historical return (source Hymans)	**6.0**	**0.9**	**1.2**
Prospective Returns (Manager Forecasts)	**5.5**	**0.5 – 3.5**	**0 – 2.5**

The conclusion is that real returns of 3.5%-4.0% per annum (that is, above CPI) are realistically achievable going forward. It is also worth noting for GMPF that 1% on investment return is the equivalent of 5% of payroll and if the number of employee members starts to fall as expected, the 5% of payroll will of course increase.

The importance of prospective returns is that it has a significant impact on the calculation of the cost of the pension promise (in a defined benefit scheme) or value of pension saving (in a defined contribution scheme)

7. Affordability

Many private sector schemes have closed and they have often been replaced by defined contribution schemes that have lower employee/employer contributions. The outcome of such a change is a lower and potentially significantly lower pension in retirement.

The wider Government policy is to encourage adequate saving for retirement and thus an outcome of this review could be to quantify an adequate retirement income and the inter-relationship with the State pension and means tested benefits. The quantification of adequate savings and benefits in the public sector can set a benchmark for the private sector. The interaction with means tested benefits and support for care costs are important long term inter-relationships. **The GMPF Management Panel does not believe pensions should be levelled down to the lowest common scheme, that would give short term savings but potential long term costs for the State.**

Affordability in the context of pensions is not an easy concept because of the uncertainty of cost in defined benefit schemes and the uncertainty of benefits in defined contribution schemes.

The GMPF Management Panel continue to be supporters of defined benefit pensions because of the likelihood of delivering better pensions at lower cost v defined contribution options.

The advantages of defined benefit schemes in the long term are:

i) lower costs re administration and investment management (the administration and investment costs of running GMPF are currently around 0.1% p.a. of Fund value);

ii) the scope for an investment strategy to deliver better returns on a defined benefit basis (where the employer covenant is strong) compared to defined contribution schemes where the decisions tend to be more cautious.

The table below was produced by our actuary (Hymans Robertson) to demonstrate the sensitivity of cost to the real discount rate (or projected investment returns) for a typical LGPS fund.

Table 5 – Sensitivity of Scheme Cost to Investment Returns/Discount Rate

Real Discount Rate	Total Contribution Rate
2.5%	24.4%
2.8%	23.0%
3.0%	21.3%
3.5%	18.6%
4.0%	16.2%
4.5%	14.2%

Notes:

1) The total contribution rate comprises both employee and employer contribution rates to meet the costs of future service. It does not include any provision for deficit recovery.

2) There is no allowance for expenses.

3) Pay is assumed to increase by 1.5% more than inflation.

Thus there is a 2%-3% reduction in cost for each 0.5% increase in the net discount rate.

The above illustrates the impact on affordability to the employer of the change in calculating inflation from RPI to CPI. The impact is to reduce the future service rate by around 2.5% as illustrated above and improve funding positions.

At the higher rates of investment return, the cost of the Scheme is likely to be perceived to be affordable. However there are no assets that guarantee such levels of return and thus the concerns arise if returns are materially lower, costs increase and deficits grow.

There are a number of other factors that can also lead to volatility of costs. These include:

i) increased life expectancy/spending longer on pension;

ii) pay increases in particularly with final salary.

Our actuary has also undertaken some calculations analysing the cost of the LGPS and the impact of making changes to the benefit structure. These analyses are of course very sensitive to the underlying assumptions, but highlight the significance of core benefits.

Table 5 – LGPS Current Contribution Rate Structure (assuming 2.8% real return)

Breakdown of cost by benefit	**% of pay**
Normal Retirement	10.6%
Withdrawal	7.4%
Ill Health Retirement	4.2%
Death In Service Lump sum	0.4%
Death In Service Pension	0.3%
Death in Deferment Pension	0.1%
Spouse’s Pension	0.8%
Children’s Pension	0.1%
Pension Guarantee	0.3%
Commutation	-1.2%
Total	**23.0%**

Note:

1) The proportion of the split above would remain relatively unchanged under a Career Average Revalued Earnings basis.

2) The bulk of the costs relate to the build up of core benefits arising at retirement from active or deferred status.

The Actuary then looked at the implication of changing some elements of the benefit structure. The outcomes are summarised below in Table 6. Again the underlying assumptions are very important but they provide a good indication of the scale of impact.

Table 6 – Impact of changes in benefit structure

Change	**Impact % of pay**
Change death in service benefit by 1 years pay	0.1%
Limit ill health enhancements to 5 years (Note 1)	-1.1%
Increase normal retirement age by 1 year (Note 2)	-0.3% to -0.4%

Notes:

1) This is very sensitive to the assumptions on the types of ill health retirement, the saving above is likely to be at the lower end of expected savings.

2) Increasing retirement age by 1 year would be expected to reduce liabilities by about 5% and give significant cost savings. However the potential benefits to contribution rate are offset by higher ill-health costs and potentially less commutation savings under the current structure.

The conclusions from the costing analysis are:

i) it is important that the benefits provided are valued by employees and employers. What needs should public sector pensions meet in terms of their level and flexibility?

ii) the bulk of benefits (and costs) are determined by the rate of accrual of benefits;

iii) the cost of the benefit package can be changed by altering the rate of accrual, changing the retirement age, changing the cost to employees;

iv) in the current environment, the consequences of increasing employee contributions needs to be carefully assessed and in particular the likely impact on Scheme membership of any such change.

8. Control of Volatility of Cost

Having agreed a target long term cost for employees and employers, the next stage is what should be the balance of financial risk between scheme members and their employers (tax payers).

These are complex matters.

Some elements of variability/volatility of cost can be dealt with by existing measures, e.g. demographic and experience changes can be dealt with by “cap and share arrangements.” Increasing life expectancy can be dealt with by later retirement (albeit later retirement will have other implications for those that are unable to work partially offsetting the gain from later retirement).

Volatility of cost can also be mitigated by transferring investment risk from the employer to benefit risk to the employee. The ultimate risk transfer is of course to defined contribution and there are a variety of scheme designs between final salary and defined contribution that “share the risk”.

Another means of risk sharing in defined benefit schemes is the use of discretionary benefits.

9. Distribution of Benefits

The GMPF’s Management Panel’s preferred option is a Career Average Revalued Earnings scheme (or Pension Build Up). The perceived advantages/consequences (assuming an equivalent rate of accrual to a final salary option) of such a scheme are:

a. “fairness” in that the value of benefits is built up throughout a career based on earnings rather than determined by final salary. The outcome is, those on more stable earnings “gain” and those with above average earnings growth, particularly later on in their career “lose”. The net effect is more gainers than losers;

b. there is less risk of adverse surprises re the cost of the Scheme;

c. it will generally reduce the value of the pensions of the better paid and increase the pensions of the less well paid, e.g. in GMPF, there would be virtually no pensions greater than £50,000 for career LGPS members with a CARE scheme.

The Panel also believes that there is merit in offering a final salary option for those employees that are prepared to pay more.

Another option considered by the Management Panel that was considered to have merit was a core defined benefit scheme up to a salary cap, thereafter a top up defined contribution scheme. Such an approach has similar consequences to a CARE scheme.

10. Summary and Conclusions

(i) Government policy is to encourage adequate saving for retirement and longer working lives.

(ii) Saving for retirement is by definition a very long term activity. There is currently too little saving. The GMPF Management Panel does not believe public sector pensions should be levelled down to the lowest common scheme.

(iii) The last decade has been an exceptionally difficult environment for pension funds for well documented reasons. It is interesting to contrast this period with the late 1970's through to 1999 which was an exceptionally good environment. The nature of pensions means that changes can have long term and potentially important unintended consequences.

(iv) To try and generate satisfactory pensions at an affordable cost requires some investment risk to be undertaken by either employee, employer or both.

(v) The starting point is agreeing what is affordable and the long benefit package that can be delivered for that cost. The greater the stability of cost required, the lower the likely benefit package.

(vi) The second phase is agreeing the sharing of risk and reward or how the volatility of cost can be managed.

(vii) The final stage is how the benefits are distributed, i.e. what type of scheme design.

(viii) GMPF believes the funded nature of the LGPS helps provide stability of cost. It is also a strong supporter of retaining defined benefit and favours the adoption of a CARE scheme (with final salary available for those that want to meet the extra cost). The key advantage of defined benefit is that it is likely to deliver pension savings/benefits at lower cost compared to defined contribution.

(ix) The impact of the change in basis of calculating inflation for pension increases will result in significant reductions to the cost of future service and improvement in funding levels. In these difficult times, if consideration is given to increasing employee contributions, an assessment of the impact of changes in scheme membership should be undertaken and the long term impact on encouraging adequate saving for retirement.