

Public Sector Pensions Briefing Note – March 2011

Independent Public Service Pensions Commission: Final Report 2010 Budget – Pensions Issues

Introduction

Following the release of his interim report in October 2010, on 10 March 2011 Lord Hutton released his final report on the work of the Independent Public Service Pensions Commission, setting out 27 recommendations to the Government for the reform of public sector pension arrangements. The report followed a fundamental structural review by the Commission of public service pension provision using a framework of principles determined in the interim report that public service pensions should be:

- affordable and sustainable
- adequate and fair
- supporting productivity
- transparent and simple

In summary, there were few surprises and the recommendations did not go as far as perhaps some feared (or hoped!) they might. Lord Hutton concluded that he believes that it is possible for public sector employees to continue to have access to good quality, sustainable and fairer defined benefit pension schemes that deliver decent retirement incomes and are affordable in the long term, but that in order to do so there will need to be comprehensive reform. He reiterated the importance of reform not being a race to the bottom, that pension rights that have been accrued should be honoured and that there should be a fair process of change.

Summary of the proposed changes

Lord Hutton believes that his report provides a balanced deal that will ensure the provision of good pensions for public sector workers while providing tax payers with the confidence that costs are controlled. In summary, he is recommending that:

- the Government should replace the final salary pension schemes with new career average schemes, moving over time to a common framework as far as possible



Lord Hutton

- existing members move to the new schemes for future accruals, maintaining the link to final salary for calculating the value of their pension rights accrued under the current schemes
- normal pension age be linked to the State Pension Age and rise over time accordingly, with the exception of the police, firefighters and armed services where this would rise to age 60
- ministers set a clear cost ceiling for the new schemes as a percentage of pensionable pay paid by the taxpayer with automatic stabilisers built into the design to keep future costs under control
- governance arrangements be enhanced with workforce representatives and minimum administration standards
- the LGPS remain funded and the others not, and access to the schemes in future be restricted to public service workers
- new schemes be introduced before the end of this Parliament.

It is for the Government to decide how they will take forward Lord Hutton's recommendations. However, in respect of future service, public sector employees can expect to pay more, work longer and receive less.

Initial Government reaction

In its 23 March Budget, the Government announced that it accepts Lord Hutton's recommendations as a basis for consultation with public sector workers, trades unions and others, recognising that the position of the uniformed services will require particularly careful consideration, and that it will set out proposals in the autumn that are affordable, sustainable and fair to both the public sector workforce and the taxpayer. It also says that it will not cherry pick the recommendations which sounds encouraging... provided all the recommendations are of course sensible.

In his Budget the Chancellor also confirmed that employee contributions to public sector schemes will rise by 3% although no detail of how and when and who may or may not be affected. He also announced that the discount rate used in unfunded schemes would be linked to GDP growth expectations and this will be set at 3% more than CPI compared to the current 3.5% more than RPI. This is likely to be rate used to determine the value of the revised pensions package that finally emerges from Lord Hutton's report. With a lower real discount rate this means that say 20% of pay towards pensions for example will not buy the same benefits as it used to.

The recommendations

Lord Hutton's recommendations are detailed below, together with our initial thoughts.

No.	Recommendation	Barnett Waddingham's Comment
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.	✓ a worthy aim, which if not fulfilled will likely result in more dependence on State support in retirement, funded by the tax payer.
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.	✓ a sensible approach, which will be assisted by recommendation 18 to provide regular benefit statements to all.
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.	✓ a sensible approach to avoid reliance on the State in retirement. However, additional costs to employers could be an issue at a time of cost cuts in the public sector. There is a risk that this recommendation could be undermined by others in the report if care is not taken.
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.	? while this will be welcomed by members and smooth the transition process, significant administration issues and complexity will arise and full cost savings will be delayed. The more radical option of essentially increasing accrued benefits in line with the CARE revaluation rather than actual pay increase would have simplified things and produced additional savings depending on the final revaluation approach adopted (see recommendation 8 for more comment).

No.	Recommendation	Barnett Waddingham's Comment
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.	✓ a defined benefit pension will ensure that retirement incomes remain predictable. However, with much detail yet to be decided and negotiated, a quick move may not be so easy.
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.	✓ this will add further bureaucracy and record keeping, but may help to dispel the many myths and mis-reporting that abounds.
7	A new career average revalued earnings (CARE) scheme should be adopted for general use in the public service schemes.	? the LGPS came close to moving to a CARE scheme in 2008 and this proposal was widely expected to emerge as the preferred scheme design. Such a change from final salary schemes will probably mean lower pensions for the high fliers and larger pensions for the low fliers. No mention of the other key variable of accrual rate as the amount of pension is a function of both accrual rate and revaluation method. If a reduction in total cost is an objective then with earnings revaluation, a lower accrual rate looks likely. An alternative approach of perhaps CPI revaluation with a higher accrual rate (a la NUVOS Scheme in the Civil Service – although maybe not quite as high an accrual rate) might have been viewed as fairer when comparing with CARE schemes in the private sector.
8	Pension benefits should be up rated 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.	
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.	? a single benefit design will aid simplicity, but a CARE scheme reduces the justification for tiered contributions with each year banked at a value in relation to the contributions paid rather than later increased through pay rises. Significant concerns are emerging on the unintended consequences of high contribution rates for the higher paid and the rate of potential opt outs. The principle that all schemes become contributory and the speed at which contributions are raised to set level may cause other pay inflation issues in the currently non or low level contributory schemes.
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.	✓ not much change for the LGPS here.

No.	Recommendation	Barnett Waddingham's Comment
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.	✓ a sensible approach reflecting the reality of increasing longevity and length of time spent on pension.
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.	? the concept of a cost envelope is already established in the LGPS and other public service scheme. Given all the debate in the run up to the report about risk sharing and safety valves, this is perhaps the most disappointing aspect of his report where there are no real risk sharing proposals. Risk sharing is about agreeing what risks should be shared before, rather than after, the event.
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.	✓ a sensible approach.
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.	✓ a sensible approach.
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.	✓ a sensible approach.
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.	? with non public service employers not defined, the effect of this is not yet clear for example on the contracting out of services and the rate at which public sector schemes mature and the period that they may remain viable.
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.	✓ already in place in many LGPS Funds, this is a sensible move. Really a case of the other schemes catching up with the LGPS.

No.	Recommendation	Barnett Waddingham's Comment
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.	✓ already a requirement of the LGPS, the provision of benefit statements to all active members across all schemes will help them to plan for the future and to understand the value of their pension and their employer's contribution. The use of technology varies greatly across administrators but provides opportunity for cost savings and for joint working to share best practice and development.
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.	✗ as statutory schemes, and in light of the other recommendations around governance and reporting, this may simply be another layer of cost adding bureaucracy.
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).	✓ if it includes consideration of reliance on State support in retirement that would arise other than for the pensions being paid under these schemes, then this is a sensible approach.
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.	? this links closely with recommendation 6. The LGPS already collates and publishes key data centrally through the DCLG, although this will revise some of the data reported. Experience to date highlights the need for clear guidelines to be given to ensure that data is provided on a consistent basis to enable useful comparison to be made. Local issues can reduce usefulness of the resulting comparisons.
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.	✓ the LGPS already includes provision for the setting of administration standards and the levying of additional costs where these are not met.
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.	✓ a sensible approach.

No.	Recommendation	Barnett Waddingham's Comment
24	The Government should introduce primary legislation to adopt a new common UK legal framework for public service schemes.	? one for the lawyers.
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.	✓ a sensible approach.
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.	✓ an admirable aim fraught with potential difficulties. With the Olympics in 2012 and the lead into elections towards the end of the Parliament, the time frame becomes somewhat reduced and success will depend on the appetite for potential workforce disputes at these high profile times.
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.	✓ increased trained staff resource will be required over the period.

"Lord Hutton's recommendations are in line with what was well signposted. He has gone for the easy option for accrued rights by recommending maintaining the final salary rather than linking accrued benefits to the same revaluation rate under the career average formula. This is probably a missed opportunity and will keep life nice and complicated for some time to come.

"Using average earnings rather than CPI in the career average formula is also likely to attract some attention - this will be perceived by some as not that different to the final salary formula.

"The next step will be the real challenge - agreeing the detail of each scheme's design - we would hope the various government departments try and work together in an attempt to achieve some element of consistency across the schemes."



Graeme Muir, Head of Public Sector Consulting



The unknowns

Despite the lengthy report and 27 recommendations, a great deal of detail is left for the Government to consider. The missing detail will determine just how much change members of the schemes will see to their retirement arrangements and anticipated pensions, and how much change in costs the employers and the tax payer will see.

The unknowns include:

- the proposed rates of accrual in the new schemes which have yet to be defined
- the level of the cost ceiling and the default change where it is exceeded and change cannot be agreed
- member contribution rates
- the definition of average earnings by which active members entitlements will increase as they accrue under CARE
- the definition of non public service employees

Further information

The full 215 page report can be found at http://www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm

Other issues brewing

Following Lord Hutton's interim report, the Government accepted its conclusions, made a commitment that it would maintain a form of defined benefit pensions for public sector workers, and commenced acting on recommendations.

It commenced consultations to review the discount rate used in the unfunded schemes and to review the Fair Deal policy that protects the pensions of those transferring out of the public sector following contracting out of their work, both issues interlinking with the wider pension reforms now triggered by the final report.

While the Fair Deal consultation remains ongoing until 15 June, in the March Budget Statement the Government confirmed that the discount rate for the unfunded schemes would be 3% above CPI, be reviewed every five years and the methodology every ten. It confirmed that this change would not lead to further increases in member contribution rates.

However, it is the effect of the Government's proposals to increase by an average 3% in response to the recommendation in the interim report to increase members' contributions while protecting the lower paid that is currently causing concern. In making his recommendations, Lord Hutton has taken as a given that the rise in employee contributions is imminent, but in order to protect the lower paid, the increases for the higher paid would be substantial with the risk of mass opt out of the scheme a real concern triggering a range of unintended consequences. Although in his Budget speech, the Chancellor appears to have confirmed that the average 3% rise will proceed, the more detailed announcements expected seem to have been delayed. We understand that alternative ways of saving equivalent sums, perhaps through scheme design may be under consideration.

Thus we have a complex situation with a number of interlinking consultations and issues ongoing.

Conclusion and next steps

Lord Hutton has produced a report that on the face of it sets out a way forward in a largely sensible and constructive manner. However there are many significant unknowns and the devil will be in the detail. It is now up to the Government to take matters forward and already the unions are massing and the threat of widespread strikes loom among the six million affected public sector workers.

While Lord Hutton duly delivered his report in time for Budget 2011 it appears in the face of unrest, that the Government has postponed a detailed reaction to later in the year. One thing however is clear; we are heading for a period of significant change in public sector pension provision and a period of potential workplace turmoil. Communication to members to help them pick through sensationalised reporting and to understand the proposed changes and the affect on them will be key. As the “unknowns” become “knowns”, we will continue to keep you informed.

Further information

For more information please contact Graeme Muir in our Glasgow office 0141 243 4400 or email publicsector@barnett-waddingham.co.uk

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