

ITEM NO: 9(a)

Report To: Pension Fund Management Panel & Advisory Panel

Date: 1 July 2011

Reporting Officer: Peter Morris, Executive Director of Pensions

Subject: **THE INDEPENDENT PUBLIC SERVICE PENSIONS COMMISSION'S FINAL REPORT (THE HUTTON REPORT)**

Report Summary: This report provides a summary of the above report.

Recommendations:

- 1) To note the content of this report.
- 2) The Panel's view is sought on whether any response should be forwarded to CLG at this stage or await the formal consultation process when the Government announces its proposals.
- 3) The Information Services Working Group review the communication strategy for the next 12 months.

**Financial Implications:
(Authorised by the Borough Treasurer)**

From April 2012 employee and for the following 2 years contribution rates are expected to increase. In later years, if Lord Hutton's recommendations are accepted, the existing LGPS will be replaced with a target implementation date of 2015. The cost of this replacement scheme is expected to become clearer during this year as the Government determines the "cost envelope" for the new scheme.

**Legal Implications:
(Authorised by the Borough Solicitor)**

It is important that the Panel engage in this consultation to ensure that evidence is provided to ensure concerns are raised about any long term damage that some changes could result in as a result of unintended consequences.

Risk Management:

A career average scheme will redistribute benefits from those that experience high pay growth to those that experience lower pay growth. This change is expected to result in lower volatility of cost than a final salary scheme, for the employer.

ACCESS TO INFORMATION

NON-CONFIDENTIAL

This report does not contain information which warrants its consideration in the absence of the Press or members of the public.

Background Papers:

A copy of Lord Hutton's Final Report can be viewed at www.hm.treasury.gov.uk/indreview_johnhutton_pensions.htm

or contact Ged Dale, Greater Manchester Pension Fund, tel 0161 301 7227, email ged.dale@gmpf.org.uk

1. INTRODUCTION

- 1.2 The purpose of this report is to provide a summary of the Pension Commission's Final Report, focussing on the recommendations. A Briefing Note that details all the Commission's recommendations, plus comments thereon, is attached at **Appendix 1**.
- 1.3 The report also gives an update on the Treasury/CLG's proposals for phased increases in employee contributions with effect from April 2012.
- 1.4 A presentation will be made to the Panel focusing on the key recommendations and commenting thereon.
- 1.5 The Government's timetable for progressing the Commission's recommendations are: Consultation on Fair Deal policy closes June 2011.
- 1.6 Decision on increases in employee contributions – Summer 2011, with increases phased in commencing April 2012.

Government's proposals re Scheme design and cost – Autumn 2011

- 1.7 At the last meeting of the Information Services Working Group detailed consideration was given to the Pension Commission's report focussing on the pension principles and scheme design being proposed. This report gives more attention to the recommendations on governance.
- 1.8 The Department for Communities and Local Government continues to seek responses from administering authorities (and others) on their views on the Commission's report.

2. OVERVIEW

- 2.1 Lord Hutton's report is comprehensive with 27 recommendations. These fall into 3 groups:

Pension Principles

- Government to finalise the cost of the scheme
- Adequate levels of retirement income
- Pension part of remuneration
- Framework for independent oversight
- Office of Budget Responsibility to report on the long-term financial impact
- Primary legislation to enable the new scheme to be introduced by 2015
- Consultation to be coordinated, centrally but the details to be set on a scheme by scheme basis
- Restrict access for non public sector workers (Fair Deal policy).

Scheme design

- Full protection of Accrued Rights (including final salary link and retirement age)
- Retaining a defined benefit arrangement for certainty of benefits
- Move to Career Average revalued with average earnings (from final salary)
- Indexation for employees based on increase in average earnings
- Pensions increased in line with CPI
- Tiered employee contributions to be retained
- Flexible retirement encouraged
- Normal retirement age linked to state pension age
- Fixed cost ceiling for employers
- LGPS to continue to be funded
- Regular benefit statements to be sent to scheme members.

Scheme Governance

- Creation of Pension Boards
- Pension Policy Group for each scheme
- Common data for schemes to be published
- Establish and benchmark administration standards
- Encourage LGPS procurement / service sharing
- Best practice governance arrangements.

2.2 The above recommendations provide the framework for developing the new LGPS. However, the key decisions on how the proposals will be judged have yet to be consulted on. The starting point will be the Government's determination of the "cost envelope" – how much does the scheme cost. From this decision the rates of accrual (how the pension builds up) and other benefits can be discussed / assessed.

Additional Comments on specific recommendations

2.3 Recommendation 3 – adequate levels of income in retirement

- The design of a pension scheme is sometimes determined by what an employer can afford. The Commission however has looked at what people need in retirement and then recommended that this should be provided, but *after a full career and including the State pension*.
- As for what people need in retirement, the Commission accepted Lord Adair Turner's findings in his 2004 report. For median earners (£21,430 to £30,610 in today's money) this was that their total pension should equal two-thirds of final pay. This would mean that someone in this band who was retiring at age 65 would see a reduction in gross income of 33%, but only a reduction of 17% in net income. This is because pensions are not subject to National Insurance or pension contributions. The smaller gross pay would also lead to less income tax being paid.
- The first caveat however is that the Commission is basing its recommendation on a full career. Someone who joins the Scheme mid-career should not therefore expect a full pension unless they have saved in their other jobs. Secondly, public sector pensions do not exist in isolation – employees also accrue State pensions. Consequently when determining the design of the former, the latter will need to be taken into account.
- The mid-point of Lord Turner's median earners' pay band, at current prices, is £26,020. Meanwhile the Government is considering replacing the existing State Pension, with a flat-rate State pension of £140 pw. This equates to £7,280 pa.
- Two-thirds of £26,020 is £17,350. Clearly there will be a lengthy transition period and the interaction between the State pension and work pension needs determining and implementing. But, if this were a reasonable interpretation of the proposals this would lead to a materially lower cost scheme. The Government's announcement on this matter is due in the autumn.

2.4 Recommendation 4 – fully protect accrued rights (the pension earned)

- When a final salary scheme is replaced there are two main ways of protecting the accrued membership. One is to award deferred benefits that are then linked to inflation. The other is to link the accrued membership to eventual final pay. The latter is usually the more expensive option as pay usually increases at a faster rate than prices. This option results in those that benefit from career advancement seeing the benefit in their pension.

- The Commission favours maintaining the link to final pay. This is likely to be a contentious item with some employers favouring inflation protection.

2.5 Recommendation 6 – publish data to help compare funds (and public sector schemes)

- The Commission believes that scheme members, the public and Parliament should be able to “access scheme data to enable them to determine the performance, viability and key facts associated with the different schemes. ”A great deal of such information is produced but by various bodies in various reports and accounts and on various websites. The Commission therefore recommends that all this information be collated using common standards, and published centrally.
- From the LGPS perspective, the various Governance recommendations are aiming to improve decision making and to encourage best practice. Whilst no changes are proposed to LGPS funds in England, the possibility of mergers and amalgamations will increase if improvements in performance are not achieved in the future.

2.6 Recommendation 10 – Flexible retirement to be encouraged

- The Commission is a supporter of greater choice for employees regarding when and how much of their pension that they draw upon. It notes that in Sweden, once members reach their minimum pension age they can draw upon none, 25%, 50% or 75% of their pension, albeit actuarial reductions for early payment apply. It also believes that flexible retirement should be encouraged, but if someone who has retired returns to the workforce, he should not be penalised for so doing by having his pension abated. [There is an administering authority discretion not to abate pensions upon re-employment, which has been applied in the GMPF since it was introduced in 1988].

2.7 Recommendation 16 – undesirable for non public service employees to have access to public service pension schemes.

- The Commission recognises the advantages of out-sourced employees being allowed to remain in public sector pension schemes, not least that this can “facilitate the transfer of staff to new employers and can also maintain the cash flow of contributions into scheme. But it also sees that if private sector employees remain in public sector schemes, then it is the taxpayer who bears the risk of paying for any shortfall in assets. It believes that the latter outweighs the former and thus out-sourced employees should not be allowed to remain active members of public sector schemes.
- The GMPF reply to the Fair Deal consultation supported the opposing view, i.e. that out-sourced employees should be allowed to continue as contributors. A copy of the response to the Treasury is a separate item on this agenda.

2.8 Recommendation 17 – a properly trained and competent board with member nominees.

- The Commission notes examples of good practice, and that most LGPS administering authorities have some form of member representation in their governance arrangements. However only a minority of these have full voting rights leading the Commission to believe that members may not feel adequately involved in decisions concerning their pension scheme. The Commission therefore believes that “scheme members in all the public services should be able to nominate persons to pension boards and committees along similar lines to the rights of members in the private sector to nominate persons to sit on boards of trustees. Pension boards should therefore include independent professionals and scheme members in similar proportions as apply in the private sector to boards of trustees”.

- The Panel has a long history of supporting employee representatives on the Advisory Panel. The advisors have also played an important part in supporting the Panel in its investment decision making. Thus the Panel is well placed to respond to changes arising from this recommendation.
- The report emphasises the importance of board member training and the Panel has started the process of reviewing and developing its approach.

2.9 Recommendation 19 – independent oversight of the governance of schemes

- A great deal of scrutiny of public sector pensions schemes is undertaken, sometimes by auditors, sometimes by the sponsoring Government department. The Commission believes however that there should also be some external scrutiny on behalf of members, regarding the services provided, and on behalf of the taxpayer, regarding value for money. The Commission suggest the Pension Regulator be considered for this role.

2.10 Recommendation 20 – the Office for Budget Responsibility (OBR), should provide an analysis of the fiscal impact of the main schemes

- In considering the long-term sustainability of public service pension schemes, the report concludes that “...there is a need for fiscal policy to take account of the sustainability of such commitments over the long term, looking at the schemes’ long term impact on public finances in the context of other pressures on public spending”
- Assessing the long-term costs of the funded LGPS and the unfunded other schemes is complicated. It proposes that this role should be given to the OBR who should be empowered to demand information from appropriate sources to allow them to carry out this function.

2.11 Recommendation 21 – data collection for all LGPS funds.

- The Commission notes that: “...each individual LGPS fund follows a fund-specific strategy which sets out how its pension liabilities are best met, in terms of investments and reasonable risk parameters”. However it also notes that funds: “... could in theory gradually build up ever larger deficits, in effect accepting higher long-term costs in order to secure short term affordability for employers and employees”. It therefore believes that there is a strong case: “...for making sure that ministers, Parliament, commentators and taxpayers can understand the trends regarding the funding of liabilities, for example, whether or not there is an established or developing trend to defer unfunded liabilities into the future”.
- In a similar vein to Recommendation 6, having collated the information, it should be published to allow LGPS-wide comparisons and assessments.

2.12 Recommendation 22 – raising standards of administration.

- In 2009/10 the LGPS in England paid £115 million in administration costs (excluding investment management). The Fund’s unit costs of administration compare favourably with other LGPS funds as is reported annually in the Fund’s Annual Report and accounts. The Commission is again striving to improve best practice both in terms of unit costs and standards of administration. It recommends that the government should specify the required standards based on independent expert advice again with the Pensions Regulator possibly having a role to play. Once standards have been established all schemes should be required to take part in a national benchmarking exercise.

- The Panel recently established 25 performance standards for the Pensions Office. These can be reported during any consultation exercise.

2.13 Recommendation 23 – encourage greater collaboration and shared services between LGPS funds

- The Commission noted that there is “...clear evidence that the administration of pension schemes can benefit from economies of scale, particularly where existing schemes are below 100,000 members”. It welcomed the collaboration that is currently being progressed by some authorities, e.g. with procurement.
- The Fund meets regularly with the other metropolitan funds to share good practice in administration, but cooperation is more informal on investment matters. This is an area for further consideration and discussion with other funds regarding the opportunities for cost or effectiveness improvement.

3. INCREASING EMPLOYEE CONTRIBUTION

3.1 In his foreword to the Final Report, Lord Hutton writes that he has taken as a given that a rise in employee contributions is imminent. This stems from the Commission’s Interim Report, as part of which the Commission was asked to “...consider the case for delivering savings on public service pensions within the spending review period – consistent with the Government’s commitment to protect those on low incomes – to contribute towards the reduction of the structural deficit”.

3.2 The Commission concluded that “...it will be more effective to increase member contributions rather than alter the benefit structure”.

3.3 In January of this year the CLG advised that employee contribution increases would:

- be phased in over three years, commencing in April 2012;
- be progressive so that those on higher salaries paid higher contributions;
- protect low earners;
- minimize the consequences of increases in opt-outs.

3.4 The increases in employee contributions are required by the Treasury to produce an additional £900 million by 2014/15, being the equivalent of a 3.2% increase in employee contributions.

3.5 The CLG have considered a number of options to raise the sum sought by the Treasury. One **illustration** from CLG shows how contributions might increase as follows:

Band	Salary	Current rate	2012/13	2013/14	2014/15
1	> £12,600	5.5%	5.5%	5.5%	5.5%
2	£12,601-£14,700	5.6%	5.6%	5.6%	5.6%
3	£14,701-£18,000	5.9%	5.9%	5.9%	5.9%
4	£18,001-£24,000	6.5%	6.5%	6.5%	6.5%

5	£24,001-£31,500	6.5%	7.8%	9.1%	9.7%
6	£31,501-£42,000	6.8%	8.5%	10.2%	11.0%
7	£42,001-£75,000	7.2%	9.5%	11.8%	13.0%
8	£75,001-£100,000	7.5%	10.1%	12.7%	14%
9	£100,001-£150,000	7.5%	10.3%	13.1%	14.5%
10	£150,001 >	7.5%	10.5%	13.5%	15%

- 3.6 The Government has said that it will report its decision regarding employee contributions during the summer.
- 3.7 The Chairman submitted a response to the Chancellor and Secretary of State which was considered at the last meeting suggesting that a more appropriate way forward for the LGPS would be a package of increasing employee contributions, increasing retirement age in line with State Pension Age and amending the benefit package. A copy of the letter can be obtained by contacting Ged Dale, Head of Pensions Administration, on 0161 301 7227 or via email: ged.dale@gmpf.org.uk.

4. SUMMARY

- 4.1 The Panel has long been a supporter of Pension Build Up (Career Average) as its preferred pension design (with final salary retained for those who are willing to meet the cost).
- 4.2 Until the Government decides the fixed cost ceiling, and the resultant benefit package that flows from it, it is difficult for employers and employees to determine a view on the proposals. However, the potential outcomes adopting the Commission's recommendations are:
- later retirement;
 - higher employee contributions (or a change in the mix of employee : employer contributions); and
 - a lower cost benefit package than the current scheme.
- 4.3 From an administering authority perspective and a desire to encourage good secure pension provision, it is important that these changes introduce some long term stability and sustainability to the LGPS.
- 4.4 Looking forward, developing and maintaining the fixed cost ceiling will be a challenge as has been the experience with the current cap and share proposals.
- 4.5 At previous meetings the "perfect storm" scenario for the administration of the Fund has been discussed, with the impact of public expenditure reductions on scheme membership and the impact on viability of some employers. Lord Hutton has been very concerned regarding the prospect of an increasing number of members opting out as a result of these changes and in particular the increase in employee contributions. This is a serious concern for administering authorities and employers with the impact of reducing membership being an increase in volatility of cost to employers and a significant increase in the maturity of the liabilities. The exclusion of scheme members transferring to "outsourced employers" will add to the "sustainability" problem. The Fund has supported the continuation of "Fair Deal" in its response to the Treasury.

- 4.6 These are challenging times for an administering authority and an important role is to keep scheme members and employers aware of the changes. It is particularly important that members of the scheme have a through understanding of the issues if they are considering their ongoing membership in the scheme.
- 4.7 A significant number of the recommendations related to governance issues. The aim is to develop best practice, encourage co-operation and joint working between funds, reduce costs and improve effectiveness. If this does not occur, the implication is that the Government should look to other means of intervention. The Panel has started to examine its practices on some of those matters raised in the recommendations.

5. RECOMMENDATION

- 5.1 To note the content of this report.
- 5.2 The Panel's view is sought on whether any response should be forwarded to CLG at this stage or await the formal consultation process when the Government announces its proposals.
- 5.3 The Information Services Working Group review the communication strategy for the next 12 months.