

ITEM NO: 7

Report To: Pension Fund Management Panel

Date: 5 March 2010

Reporting Officer: Peter Morris, Executive Director of Pensions

Subject: **POTENTIAL SCHEME DEVELOPMENTS**

Report Summary: The report outlines potential developments regarding the Scheme and invites the Panel & Advisory Panel to resolve what the GMPF view should be, and how that view should be promoted.

Recommendations: The Panel & Advisory Panel are recommended to:

- (i) give their preferred view of the type of scheme they favour at this stage;
- (ii) support the costing, in conjunction with Hymans, of benefit options within a pension build-up regime;
- (iii) support there being one scheme for both councilors and employees; and
- (iv) support the vigorous promotion of the GMPF view.

**Financial Implications:
(Authorised by the Borough Treasurer)** Increasing longevity increases the cost of the Scheme. A balance must be struck between providing worthwhile benefits and affordability.

**Legal Implications:
(Authorised by the Solicitor to the Fund)** There are no direct legal implications arising from this report.

Risk Management: Maintaining a Scheme that is affordable in the longer term will reduce the risk to other services.

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: There are no background papers. For further information please contact Peter Morris, Executive Director of Pensions on 0161 342 2952, email: peter.morris@tameside.gov.uk

1. INTRODUCTION

- 1.1 The LGPS has been subject to regular review with changes made to the benefit package (including the normal retirement age), the scale of employee contributions and the share of costs between employee and employer, (the cap and share arrangements – cost sharing).
- 1.2 The Government is supportive of the provision of “transparent, affordable and sustainable, good quality public sector pension provision for local authority workers, and for those eligible to join the Scheme, and which must remain fair to taxpayers.”
- 1.3 In June 2009 the CLG published an informal consultation: *LGPS Delivering Affordability, Viability and Fairness*. This referred to a later exercise that would “consider new ways in which the LGPS could possibly be reformed to provide more workforce-focused pension provision for the 21st century”. This exercise has not taken place and now is not expected before the General Election.
- 1.4 After the election, the policy themes that CLG may seek to consult on include:
- (i) the LGPS benefit structure and how the costs are met by employees and employers; and
 - (ii) the scope for achieving economies of scale in fund management structures and benefit administration.
- 1.5 This report focuses on the basic options for benefit structure to help inform and develop the Panel’s views, and if appropriate the promotion of that view.
- 1.6 The delivery of a good standard of guaranteed pension provision to provide a fair income in retirement and the cost to the State of that provision is strongly influenced by:
- (i) the State’s pension system;
 - (ii) the impact of means tested benefits; and
 - (iii) the requirements to save for a second pension.

2. AFFORDABILITY

- 2.1 The cost of the Scheme is determined by the interaction of many factors such as
- the benefit structure, e.g. how the pension and other benefits are determined
 - the period for which a pension is received (life expectancy – age of retirement)
 - rate and timing of pay growth whilst in pensionable employment
 - rate of inflation
 - investment returns
- 2.2 The starting point of any review is reaching agreement on what is affordable to the employee and employer and the scale of volatility in cost with which both the employee and employer can cope.
- 2.3 Having reached broad agreement on what is affordable and the scope to cope with differences in cost compared to the expected cost and over what timeframe, the focus then moves onto the type of scheme that best suits the employees and employers. There are of course some “chicken and egg” elements to this debate.

- 2.4 Each of the principle types of pension provision could be delivered within the agreed sum, but the scale and distribution of benefits will differ to different groups of employees.

3. DEVELOPMENTS ELSEWHERE

- 3.1 The cost of the Scheme continues to rise, in part due to people living longer and the expectation of increasing life expectancies. More significantly, investment returns of the last decade have led to significant deficits in funds which need to be recovered. It is therefore expected that after the General Election the Government will conduct a review of the Scheme.

- 3.2 The Audit Commission are undertaking a study into the LGPS. The first phase will focus on performance issues aiming to:

- inform and stimulate debate on issues likely to be relevant to LG pensions over the next few years; and
- highlight areas where value for money could be improved.

Interviews with the Chairman and officers are planned for March 2010.

- 3.3 To try and influence the Government, the London Pension Fund Authority has appointed a firm of lobbyists. To quote from their press release:

“LPFA has appointed Penrose Financial as Public Relations adviser. Penrose will be assisting LPFA on a number of campaigns to ensure LPFA's voice is heard within the context of the ongoing debate surrounding local authority pensions.”

- 3.4 In December 2009 the Public Sector Pensions Commission was launched. To quote from its website:

“The Commission has been set up as a result of an initiative from the Institute of Economic Affairs, the Institute of Directors and other groups and is chaired by an independent actuary. Its terms of reference are to present to the next Government a realistic set of options for reform of the present public sector pension arrangements. It is increasingly clear that, with ever increasing longevity, reform is necessary to ensure that public sector pensions remain financially sustainable for the long term.

The Public Sector Pensions Commission will be taking evidence over the coming months with a view to producing a final report in the summer of 2010, following extensive consultation with experts from across the pensions spectrum.”

- 3.5 Many other organisations and special interest groups will be contributing to the debate on the future of LGPS. The Panel has previously indicated its intention to make a major, well informed contribution to the debate and help employers within GMPF to make a well informed contribution. The remainder of this report focuses on the advantages and disadvantages of alternative scheme designs and the subsequent promotion of the view that the Panel supports.

4. POTENTIAL SCHEME DESIGN

- 4.1 In principle there are two types of pension scheme, money purchase (also known as defined contribution) and defined benefit. Within the defined benefit category there are two types of scheme

- final salary;
- pension build-up (also known as career averaging).

4.2 There are also many variations and permutations of these types of scheme. As an example regarding final salary, since the 1970s the Scheme has provided that a member's final pay should be the best of the last three years. From the 1950s to the 1970s however the final salary was to be the average of the last three years, and from the 1920s to the 1950s the average of the last five years was taken. Some of the pros and cons of the different types of scheme now follow.

4.3 The norm for pension saving is that benefits earned are retained by the member and any changes to scheme design only apply to future service (or alternatively an actuarial equivalent of benefits earned) is transferred to the new scheme. Thus the outcome of any scheme review is only likely to apply to future pensions earned.

5. MONEY PURCHASE

5.1 Advantages:

- there is no employer risk;
- it is equitable;
- it provides flexibility at retirement.

5.2 Disadvantages/Consequences:

- typically provides the least amount of pension per £ invested because of employees being risk averse and higher administrative costs;
- the employee bears the investment risk and the annuity risk; and
- most employees don't understand the investment options/implications and as a consequence opt for the default option.

6. FINAL SALARY

6.1 Advantages:

- no employee risk;
- very good at rewarding long-serving members who see career advancement and encourages career progression;
- familiarity - the long-standing (82 years and counting) status quo.

6.2 Disadvantages/Consequences:

- inherent inequality in that the value of the pension earned is based on the number of years service and final pensionable pay;
- complicated to administer;
- can be too good at rewarding some long-serving members (those who see substantial career advancement, especially towards the end of their careers).

6.3 Final salary applies to standard employee members of the GMPF, of whom there were 102,000 in March 2009.

7. PENSION BUILD-UP

7.1 Advantages:

- provides equality in that 2 people undertaking the same role receive the same pension benefit for the period that they are undertaking that role;
- defined benefit;
- less employer risk (but still substantial);

- easier to understand and administer;
- most members would receive larger pensions as compared to a final salary scheme costing the same, i.e. those employees with greater career progression would be worse off, whereas those with relatively stable earnings would gain. The number of gainers would be greater than the number of losers v final salary assuming an equivalent cost of scheme.

7.2 Disadvantages/Consequences:

- suspicion of the reason for change from employees (in that a change in scheme type will be used to hide a reduction in benefits);
- senior, long serving members would tend to receive smaller pensions;
- possibly less motivation for promotions in later life.

7.3 Pension build-up applies to councillor members of the LGPS, of whom there were 170 in March 2009.

8. COST REDUCTIONS THAT CAN BE APPLIED TO DEFINED BENEFIT SCHEMES

8.1 In principle there are also three ways of making a defined benefit pension scheme cheaper to employers. These are:

- to reduce benefits;
- pay benefits later; or
- increase employee contributions.

8.2 Any review of the Scheme is likely to look at all three options, with a permutation of all three being a possible outcome, eg. the rate of accrual being reduced, the normal retirement date being put back (e.g. in line with the state retirement age) and members being required to pay more contributions.

9. NATIONAL DEVELOPMENTS

9.1 In the private sector most final salary schemes are closed to new members, and we are now seeing some close to existing members to prevent them building up any more membership. However such measures do not resolve the problem of existing/current deficits.

9.2 Where firms offer an open pension scheme it is usually a money purchase scheme with combined employee and employer contributions normally being less than for a defined benefit scheme.

9.3 Not all firms have replaced final salary schemes with money purchase. Some, eg. Tesco, have adopted a pension build-up regime. New entrants to the Civil Service have the choice of pension build-up or money purchase schemes, but not final salary.

10. PROMOTION OF THE GMPF VIEW

10.1 Guidance is sought regarding what the GMPF view should be regarding a new Scheme, and once this is determined it is proposed that this should then be promoted vigorously:

- via the Fund's own publications and website;
- to the press and trade press;
- to Greater Manchester councillors and MPs;
- to the Public Sector Pensions Commission;
- via speaking engagements; and
- any other opportunity that presents itself.

11. ADOPTION OF A GMPF VIEW

- 11.1 Two options are suggested. One is that the Panel & Advisory Panel decide in principle the type of pension scheme they would like to see. The other is that having decided in principle the type of preferred regime, if this should be either final salary or pension build-up, costs/benefits are considered in conjunction with Hymans to allow the basics of a scheme to be drafted, incorporating some case studies to highlight the implications at the individual member level.

12. SUMMARY

- 12.1 Although the predicted review of the Scheme is not now taking place, it is likely that this will arise at some stage after the General Election. Other organisations are making preparations to try and influence the review's outcome.
- 12.2 There are, in principle, two types of pension scheme and three ways in which to vary the cost of any defined benefit pension.
- 12.3 There have been major developments regarding pension coverage in recent years, with final salary being greatly reduced in the private sector, and pension build-up being adopted by others such as Tesco and the Civil Service.
- 12.4 There are very few councillor members compared to standard members.

13. RECOMMENDATIONS

- 13.1 The Management Panel & Advisory Panel are recommended to:
- (i) give their preferred view of the type of scheme they favour at this stage;
 - (ii) support the costing, in conjunction with Hymans, of benefit options within a pension build-up regime;
 - (iii) support there being one scheme for both councillors and employees;
 - (iv) support the vigorous promotion of the GMPF view.