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Lord Hutton
Chairman
Independent Public Service Pensions Commission
1 Horse Guards Road
London
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Dear Lord Hutton

Independent Public Sector Pensions Commission – Call for Evidence

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to your call for evidence of the first stage of your independent review of public service pension schemes.

Members of the Association are all qualified actuaries and are subject to the Actuaries' Code of the Institute and Faculty of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries in the UK, whilst the Institute and Faculty of Actuaries is the professional body.

Members of the ACA provide advice to thousands of pension schemes, including most of the funded public service schemes – most notably the 100 funds that make up the Local Government Pension Scheme or LGPS. Members however are also involved in advising some of the unfunded public service schemes such as the Police and Fire Schemes and the Civil Service Schemes.

We have considered the three main themes included in your letter of 28 June of:

- affordability, fairness, impact on mobility and plurality of current public service provision of the current public sector pension schemes;
- the objectives that should guide public service pension in future; and
- the case for delivering savings on public service pension ahead of the Government's spending review.

We note that this first round of evidence is designed to set about identifying the problem and establishing the framework for solutions. We understand that stage two of your review will be to look in more detail at the structure of the schemes including benefit design, levels of employee contribution etc.

We have, therefore, tried to keep our comments and observations at a fairly high level and we have not gone into too much detail at this stage. We are, of course, available to give oral and fuller written evidence, as required, as we did in respect of last year's review of Parliamentary Pensions conducted by the Senior Salaries Review Body ("the SSRB"). We understand that consideration of the SSRB report and its recommendations, published earlier this month, now forms part of your remit in so far as these will have a bearing on the review of public sector pensions as a whole. We have enclosed with this initial response a copy of the written evidence we gave to the SSRB, as many of the issues addressed apply equally to this wider review.

Before we set out our thoughts on the three areas raised in your call for evidence, we should perhaps just mention that whilst it is possible to consider some of the issues across the whole of the public service 'pensions space', a number of proposals or suggestions may differ depending on whether we are considering funded or unfunded schemes.

Funded schemes – principally the LGPS – have pools of assets built up over many years from employee and employer contributions to meet future pension liabilities. These assets may also provide greater flexibility in terms of how pension costs are met going forward and so provide more options in terms of how any changes to public service schemes are implemented.

We would therefore encourage you to consider some aspects of your review differently for the funded and unfunded schemes, albeit we commend that the overall out-turn is one where both public and private sector employees and retirees feel there is greater fairness in the scale of benefits offered across sectors and in the financing of those pensions into the future.

Current Private and Public Service Pensions Provision

Workplace based pension arrangements were first established in a meaningful way in the public sector some 150 years ago for civil servants. Schemes for other parts of the public sector followed, including for the then nationalised industries such as the railways. It was not until perhaps 50 years ago that employers in the private sector started to provide pension arrangements for their employees that aspired to match the benefits offered in the public sector.

These schemes were income replacement schemes where the pension provided was related to service and salary – what are now usually referred to as final salary, or defined benefit, schemes. The objective was the replacement income should bear some relationship to income levels at or near retirement and longer serving employees received larger pensions than shorter serving employees.

Smaller employers in the private sector however often provided (as they increasingly do now) what are now known as defined contribution schemes where the objective was not to target some level of income replacement, but to establish essentially a savings scheme which would build up a fund that the employee could turn to at retirement to provide a replacement income.

Final salary defined benefit ("DB") schemes in the private sector have however been in serious decline for the last 15 years or so for a number of reasons. The ACA's most recent survey evidence, in 2009, found 87 per cent of schemes were closed to new entrants, of which 18 per cent were also closed to future accrual. There is little doubt that these trends have continued (and probably accelerated) across all private sector industry groups and across all sizes of employer.

The principal reasons for the decline in private sector DB provision can be summarised as:

- the pensions promise made by employers has turned out to be more onerous than first estimated due to unanticipated and significant increases in longevity over a relatively short time-frame (exacerbated by historically low interest rates and, until recently, low inflation);

- the “safety valves” built into DB schemes, such as discretionary pension increases, which allowed employers to effectively share some of the many risks associated in making long-term pension promises, were turned into “guarantees” by Government legislation, thus removing a valuable flexibility as to how pension costs might be shared between employee and employer; and
- over the last twenty years, there have been further legislative and regulatory changes designed to increase members’ benefit security. Unfortunately, the impact of this ‘well intentioned’ legislation upon increasingly risk focused private sector sponsors has been to deter the continuation of DB provision.
- changes in the accounting of pension costs has focused on measuring long-term costs on a marked to market basis. Whilst this approach, it can be argued, has allowed for greater transparency, equally, concerns have been expressed as to whether the long term nature of pension liabilities is adequately recognised in the approach.

All of these changes have led to much higher funding costs, more volatile accounting costs and higher administrative costs of running defined benefit schemes for private sector employers. Many employers therefore decided that the cost/value trade off of providing defined benefit for employees could no longer be merited and started to look at alternative arrangements that were less costly or had more stable accounting costs.

Whilst some employers tried to scale down their defined benefit promise, many just turned to defined contribution schemes, passing all pension risks to employees. Without tailored advice many employees (especially lower and middle earners) were (and are) ill-equipped to make sufficiently well-informed decisions on their retirement planning. As we noted to the SSRB review of Parliamentary Pensions, most employees – but particularly those on modest incomes – will have found the volatility associated with DC pensions in recent years difficult to grasp or handle (‘the value of pension bought for a given level of saving fell by 77 per cent over a 12-year period’, see SSRB report page 29).

Due to the statutory nature of public service schemes, some of these changes did not apply to public service schemes, particularly the unfunded schemes. Increasing longevity of course applies across the public/private sector divide regardless of funded status. However due to the financing of unfunded schemes, where the objective is to collect sufficient income each year from employees and employers - and the Government if required – on a ‘pay-as-you-go’ basis to meet annual benefit payments to retired members, these known increases in future costs have, until recently, been dismissed on the basis (we believe) of optimistic HM Treasury forecasts that the annual public sector pension costs would remain a ‘modest’ 2 per cent of GDP long into the future and that somehow these pensions could therefore be easily afforded by future taxpayers.

As statutory schemes are backed by tax payers (or a combination of separate assets and taxpayers as is the case with the LGPS), benefit security was deemed not to be an issue.

Accounting rules for pensions can also be different for some public sector bodies. For example, most employers participating in LGPS funds disclose accounting numbers on the same FRS17 basis as required for private sector employers but most employers with unfunded schemes do not as it is argued that the information is not available to allow them to do so. The unfunded schemes therefore have not been subject to the same level of scrutiny as the LGPS or private sector schemes, albeit some greater transparency has occurred in the last few years, exposing – many would argue – serious under-estimates of the forward liabilities being built up, particularly in the light of the structural deficit and the sharp reduction in the support ratio in the years up to 2050.

Policy for public service schemes is, of course, a political issue where decisions may be made for very different reasons to those in the private sector. This plus a combination of some of the factors above has meant that public service pension provision has not changed at the same pace as we have seen in the private sector. Size has also been a factor – these are large schemes with many stakeholders (including generally a higher trade union presence/involvement than in the private sector) - so it is perhaps not surprising that change has not happened as quickly.

Some changes have been made to public services schemes already which should reduce the taxpayers' commitment going forward. However, the lack of transparency of pension costs and a lack of understanding of how these costs are met for the unfunded public service schemes has meant that taxpayers who earn a living in the private sector have seen their workplace pension provision reduce or disappear entirely, whereas their fellow taxpayers who earn a living in the public sector seem to continue to have much more generous pensions.

So called “pensions apartheid” is now a palpable political issue dividing the nation and no doubt was one of the principal reasons leading to this review.

Some argue that whilst in the past, it has generally been accepted that the overall remuneration package in the public sector has more of a “pension weighting” than in the private sector, this is no longer the case. Some statistics show that pay levels in the public sector for similar jobs now exceed those in the private sector. However these statistics have to be carefully examined. For instance, some of the largest parts of the public sector, such as education and health, are staffed by a high proportion of professional staff and any comparisons with the private sector must therefore be as near ‘like to like’ as possible.

In truth, levelling down public sector pensions too aggressively may also be short-sighted. Such an approach may just mean the need for more levelling up in future as more of our citizens will have to rely on State benefits, having not built up sufficient work-based pension provision.

With the burden on tomorrow's taxpayers already ballooning due to demographics and the current financial state of affairs, the key here is to establish a favourable climate and structure in the UK that encourages both public and private sector employees and employers to make their own retirement provision – essentially re-establishing the savings culture that many of today's retired population have benefitted from. Just as the public sector was essentially the pioneer of workplace based pension provision in the UK, there is the opportunity for the public sector to once again take the lead in re-designing the UK pension system through the outcome of this review.

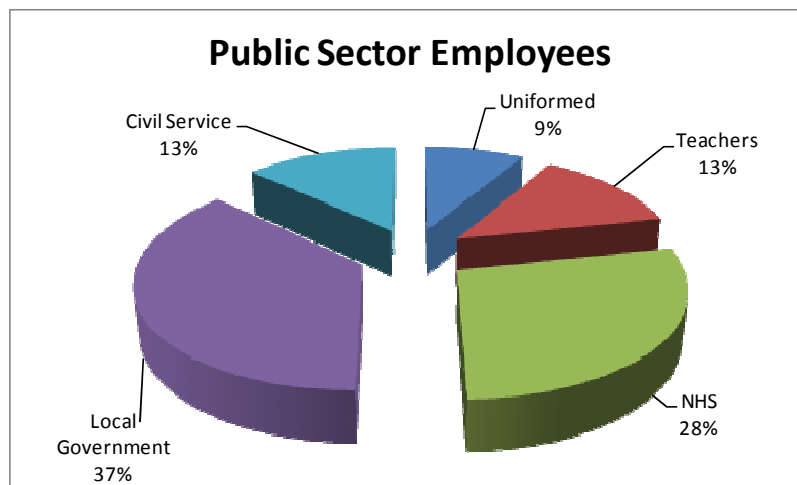
We do not anticipate a continuation of the current framework and would advocate in particular a greater emphasis on a system that has a greater degree of risk sharing for those able to bear some of the risk and more “safety valves” and flexibility in the system that can more easily deal with any future problematic issues, whilst retaining ‘good’ pensions long into the future.

Objectives for Public Sector Pension Provision

We believe that two key objectives for any ‘new’ system in the public sector are:

- **that it is generally regarded as a fair system by all of our taxpayers – both those working in the public sector and the private sector, and one where there is not an unreasonable transfer of an increasing unfunded cost falling on future generations of taxpayers; and**
- **that the objective remains that public sector pensions offered are sufficiently attractive to help recruitment and retention of good quality employees into the sector: i.e. pensions that will continue, in combination with the State pension, to provide a decent standard of living in retirement.**

There are around 5m active members of the main public service pension schemes with a diverse range of different skills sets and aspirations. The approximate distribution is as follows:



The mix of professional to non-professional staff will vary within each category and the skills, job description and remuneration package of, say, the uniformed sector will be very different to those of, say, the teachers or health professionals.

It is unlikely therefore, at least in terms of benefit design, that one size fits all and indeed this is the current case.

With the exception of recent recruits into the Civil Service and GPs in the NHS Scheme, all current employees have access to final salary defined benefit schemes. GPs and recent recruits to the Civil Service are offered a career average revalued earnings (“CARE”) scheme, where benefits are based on average income earned during membership rather than income close to retirement. The final salary design was developed many years ago and was aimed at “career (male) civil servants” who stayed in the same post for 40 years. It rewards those who stay at the expense of those who leave. A career average formula rewards leavers and ‘stayers’ (i.e. those who remain in schemes) in more equal measure and is now widely regarded as a fairer system.

It is also generally recognised that it is a better design for the lower paid who tend not to get the same level of incremental and promotional increases as the “high flyers”.

However a CARE scheme is still a “pure” defined benefit scheme with no element of risk and cost sharing. The current cost issues associated with public sector pensions and who pays would not be very different had we had a CARE system in the past.

Our suggested third key objective therefore is that we need some safety valves and flexibility in the system to cope with the stresses that any system will come under over time.

The ACA has long been advising the Government of the day that to encourage private sector employers back to the pensions table, we need “middle way” scheme designs – the pure defined benefits systems that we now have are too onerous and costly and pure defined contribution schemes are unlikely to deliver adequate or stable pension outcomes in retirement for the majority of our citizens, particularly those on modest and low incomes.

We can build in many different safety valves and there are many different scheme designs available that we believe would help revitalise workplace based pensions in the private sector. Introducing middle way designs into the public sector now would, we believe, help stimulate the wider recovery in voluntary ‘quality’ pension provision that is required.

We would be happy to expand further as part of the second stage of the review process but designs where retirement ages could be adjusted as longevity improves, with lower accrual rates, with greater flexibility over increases to accrued pensions and where cost increases could be shared by way of higher employee contributions, are all both feasible and capable of adaption to suit different groups of employees. Other designs, where certain risks are allocated rather than shared are also possible.

However, we would advocate risk sharing on a progressive level, where only those who are more financially able to manage the consequences of uncertain outcomes actually share in the risk. The lower paid are less well-equipped to accept such risks, whereas those on higher incomes are more likely to be able to take on some risk sharing. Therefore a design which has perhaps a core defined benefit on the first tranche of earnings together with a middle way solution on a second tranche may provide an improved balance.

In summary, therefore, we believe that a system which looks to ‘fairer’ pensions across the public and private sectors (identifying an affordable replacement income in retirement to target over a career), and which has a number of safety valves to control costs and benefits via middle way solutions that can be applied in similar ways in the private sector, is what the review should aim to deliver. Simple levelling-down would be a short-sighted approach both in the short and longer-term.

Additional issues for consideration

There are also a number of other important issues which are relevant to the terms of reference which we believe the review should consider:

Transferability – the Public Sector Transfer Club allows public sector employees to move their pension benefits between the various public sector schemes (and to some other schemes who are members of the Club). This certainly helps with labour mobility within the public sector. Those private sector schemes that were in the Club have left due to the rules of the Club which usually have meant that the receiving scheme incurred a cost from an incoming transfer value. This has reduced job mobility between the sectors.

We believe the Transfer Club works reasonably well between the various public service schemes although we believe the actuarial methodology of determining outgoing transfer values and incoming service credits should be reviewed so that the system is closer to being financially neutral for an employer who does not have an equal number of transfers in and transfers out.

Plurality of schemes – the different schemes already in place reflect the varied aspects of different public service functions with reasonable homogeneity in terms of job function and skills set of each active membership. However, if there is to be a standardisation of benefit and contribution levels across the public sector then there could be a case for combining some of the schemes.

Due to the physical nature of the job for those in the ‘uniformed’ schemes we suspect there might still need to be different terms (in particular retirement age and possibly rate of benefit accrual).

The Local Government Pension Scheme, or LGPS, is the only major funded public service scheme and is a collection of 100 locally administered funds. This structure is consistent with the principal of “localism” in that local decisions in terms of funding and investment strategy by the locally elected members are then reflected in the cost of the provision of local services. Merging some of the LGPS Funds has been considered before but this would then reduce local accountability.

There is a case for further sharing of services such as scheme administration although these funds are already large funds and any further economies of scale may be marginal.

Accessibility – a number of private sector employers participate in public sector pension schemes – primarily contractors who are providing outsourced public services on behalf of local authorities. No such provision exists for outsourcings from other parts of the public sector and contractors have to provide private sector broadly comparable (or lookalike) schemes. Due to tighter regulatory and funding requirements for private sector schemes this can often make similar pension provision more expensive. Allowing contractors access to the other public service schemes should result in savings to the taxpayer.

We would also suggest that contractors who have already provided broadly comparable schemes are allowed to make similar amendments to their schemes to reflect any changes to the benefit design of the relevant public sector scheme in terms of any reduction in risk and/or cost.

Costing pension promises – there are many different ways of measuring how much pension promises are costing or might cost in future. Pension liabilities are the amounts paid out in future pensions – essentially the future payments or cashflows out of the pension scheme. Where these liabilities are to be financed from a another set of cashflows with different timing, such as contributions paid into a fund, then to assess the adequacy of one set of cashflows to be able to meet the other, it is usual to discount these cashflows to determine their value. The choice of discount rate is a critical element in such a calculation.

For funded schemes, as the contributions are to be invested in a fund of assets, then one approach is to use a discount rate which bears some relationship to the expected return from these assets.

Another approach for both funded and unfunded schemes is to use the cost of borrowing the assets that would be required to meet the pension liabilities. The discount rate is then related to bond yields.

In assessing unfunded public sector pension costs, HM Treasury however use the “social time preference rate” which is defined as “the rate at which society values the present compared to the future”. The recommended rate is 3.5% more than inflation.

This may be appropriate when deciding on how to spend taxpayers’ money on say two different projects, but there is a view that it is not the appropriate rate to use in determining the cost of unfunded pension promises. Others argue that there is no real need to discount future pension liabilities and the key measurement is how much we are likely to spend going forward on public sector pensions as a proportion of our projected national income.

The review process will no doubt need to consider the costs of various alternative pension promises and we would anticipate some debate about the merits of the cost measurement methods adopted in these costings. Given the different measurement techniques we would suggest therefore that these are costed in a number of ways.

Funded v Unfunded Schemes – the pros and cons of funded versus unfunded schemes in the public sector is well documented. Funded schemes impose the discipline of cost recognition (or an estimate thereof) at the time the pension promise is made. If assets are set aside to meet future pension liabilities then there are risks that the assets will not prove to be sufficient and indeed there is the risk of loss.

Unfunded schemes however carry no asset risk but costs are generally not recognised until the liability falls due. Some unfunded schemes adopt notional funding to impose some element of cost recognition. However there are no assets set aside to meet liabilities which still require to be met from future taxpayers.

Funded schemes therefore can smooth out costs over long periods of time.

Moving from an unfunded arrangement to a funded arrangement costs more in the short term as tomorrow's pension costs have to be met at the same time as today's and so a long term transitional period is required. Moving from funded to unfunded is the opposite – less cost in the short term but even greater costs in the longer term, increasing the future tax burden and increasing inter-generational inequality.

It should also be remembered that funded pensions schemes are a source of capital for both Government and the private sector.

Short term savings

We have also considered any ways in which short term savings for the Government could be achieved. This is one aspect where we suspect there may be more options available to the funded LGPS than the other unfunded schemes.

As we mentioned earlier, for the unfunded schemes, the cash cost to Government is the difference between annual benefit outgo and the sum of employee and employer contributions.

An increase in levels of employee contributions would clearly save the Government cash in the short term. At a time of a proposed pay freeze in the public sector for most employees, this would be difficult to apply in parallel. Increasing employer contributions would reduce the Government's costs but ultimately not the tax payers.

The only other variable in the equation therefore is benefit outgo. The possibilities here are not allowing any more retirements for a while or reducing current pensions in payment – both of which are highly unlikely to be possible in practice. The change in the policy on pension increases from RPI linked to CPI linked is likely to help in the longer term but will not have much impact in the short term. Reducing enhanced early retirement benefits may however offer the opportunity for some shorter-term savings (which we believe is already actively under consideration).

However in the funded LGPS, the CPI change can be recognised immediately via levels of employer contribution rates. This, plus an increase in employee contribution rates would reduce the employer's share of the total cost. However this would not necessarily, as we understand it, produce savings for central Government as pension costs are met from the element of a local authority's income derived from Council tax rather than Government grant. Nonetheless, the total tax burden both local and central could reduce.

Accordingly we believe that it will be difficult for the Government to derive any significant short term savings to help with the structural deficit, although longer term it should be possible to reduce the long term costs by restructuring the overall scheme designs.

We hope that you find our comments of assistance. As we indicated earlier in this response, we are available to meet with you to build on these initial comments both ahead of your initial report and thereafter as you consider your fuller report and recommendations.

Yours sincerely

Graeme D Muir
ACA Main Committee Member
on behalf of the Association