

Briefing Update, October 2010

Public service pensions: The Hutton Review and the Spending Review - a summary for trade unions

Background

Lord Hutton of Furness, chair of the Independent Public Service Pensions Commission, published his Interim Report on 7 October 2010. The Government's response to the Commission's interim recommendations was set out in the Spending Review published on 20 October 2010.

The Commission's Interim Report outlines progress made so far in the review of public service pensions and in particular considers options for short term savings and long term structural reform.

This briefing summarises the key points of the interim report and highlights the impact it could have on members across all public service pension schemes.

We also draw out some of the detail from the Spending Review on the Government's plans for public sector pensions and State Pensions going forwards, noting that George Osborne states the Government will seek engagement with all stakeholders including trade unions.

The public service schemes covered by the Hutton Review include:

For Local Government and admitted bodies:

- Local Government Pension Scheme (E&W)
- Local Government Pension Scheme (Scotland)
- Northern Ireland Local Government Pension Scheme

For civil servants:

- Principal Civil Service Pension Scheme
- Principal Civil Service Pension Scheme (Northern Ireland)

For NHS employees:

- NHS Pension Scheme
- NHS Superannuation Scheme (Scotland)
- Health and Personal Social Services Northern Ireland Superannuation Scheme

For teachers:

- Teachers' Pension Scheme (E&W)
- Scottish Teachers' Superannuation Scheme
- Northern Ireland Teachers' Superannuation Scheme

Armed Forces Pension Scheme

Police Pension Scheme (administered locally)

Firefighters' Pension Scheme (administered locally)

'Gold plated' pensions

The Interim Report dispels some of the myths surrounding public service pensions. Hutton comments that "...it is a mistake to talk about 'gold plated' pensions as being the norm across the public sector..." with the average (mean) pension across the public service schemes at just £7,800 a year. This figure is skewed by a number of very high pensions and the median pension (below which half of all pensions fall) is £5,600 a year.

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Recent reforms to public service pensions

Lord Hutton states that the need to modernise public service pensions has been recognised for some time and highlights a series of significant reforms introduced by the previous Labour Government, including:

- Increases in pension age and lower accrual rates, mainly for new entrants;
- 'Cap and share' mechanisms for sharing risks between employers and scheme members for the NHS, teachers', civil service and the LGPS schemes;
- Career-average and defined contribution structures introduced for new entrants in the civil service schemes; and

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- Increased contributions from members and employee contributions tiered by earnings level in some schemes, including the NHS and the LGPS.

The Public Services Forum (PSF) Agreement of October 2005 between the previous Government and trade unions allowed existing members in the civil service, NHS and teachers schemes to keep a pension age of 60 if they wished, while the pension age of new entrants was set at 65. Pension ages lower than 65 will be phased out by 2020 in the LGPS, so compulsory changes to pension ages were not limited to new entrants.

More recently, the current Government stated the measure of indexation will change from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI). The Interim Report states that this change may have reduced the value of benefits to scheme members by around 15% on average. Taken together with previous reforms, the cost of future benefits has been reduced by around 25%.

These past reforms, the current pay freeze and planned workforce reductions will reduce the future cost of pensions, with the gross cost of paying unfunded public sector pensions expected to fall from 1.9% of GDP in 2010-11 to 1.4% of GDP by 2060. However, Lord Hutton states that these savings will take many decades to emerge and gross expenditure will remain close to current levels as a proportion of GDP over the next decade.

Private sector pension provision

Only one-third of private sector employees have some form of employer sponsored pension provision compared to around 85% of public sector employees. The introduction of the National Employment Savings Trust (NEST), and the implementation of automatic enrolment from 2012, is expected to address some of this lack of provision.

Over the last two decades, there has been a substantial migration away from defined benefit schemes in the private sector and in particular from final salary schemes. However, Lord Hutton comments that although private sector schemes are moving to defined contribution based, several large companies are committed to keeping their defined benefit scheme open, often on a career-average basis.

Lord Hutton comments that "...this downward drift in pension provision for the private sector does not however provide sufficient support or justification in my view for the argument that pensions in the public sector must therefore automatically follow the same course...I have therefore rejected a race to the bottom...and hope that reformed public service pensions can be seen as once again providing a benchmark for the private sector to aim towards."

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The Principles

The Commission has identified four main principles against which long-term options for reform should be judged. These are:

- Affordability and sustainability;
- Adequacy and fairness;
- Supporting productivity;
- Transparency and simplicity.

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In assessing affordability, the Commission calls for the Government to review the use of the current discount rate of 3.5% above RPI inflation for valuing pension benefits, but recognises this is within the spectrum of appropriate rates albeit at the high end. The Interim Report concludes, however, that the current pay-as-you-go funding arrangement for many schemes should continue whilst the LGPS should continue to be funded.

Short-term savings

Given the Commission's remit to consider the case for delivering savings on public service pensions within the Spending Review period, Lord Hutton suggests there is a case to make short-term changes, pending more fundamental redesign of schemes.

The Interim Report sets out three options for providing short-term savings:

- Changing the benefit structure;
- Contracting public service pension schemes into the State Second Pension;
- Increasing employee contributions.

The Interim Report recommends the most effective way to make short-term savings is to increase member contributions. It suggests targeting contribution increases at high-earners, or introducing tiered contribution levels. Contributions should be staged to protect the low paid and to reduce the level of opt-outs.

Long-term structural change

Traditional final salary defined benefit schemes and a funded, individual account, defined contribution model for all employees are both rejected. In making its recommendation in its final report, the Commission will consider a range of alternative structures, including:

- Career-average alternative to final salary defined benefit schemes;
- Sweden's notional defined contribution schemes*;
- Netherlands' collective defined contribution schemes*;
- Risk sharing models, such as hybrid schemes;
- Ensuring normal pension ages are in line with the latest developments in longevity.

** The Spending Review states the Government will continue with a form of defined benefit pension*

Spending Review

The Spending Review acknowledges the Commission's report stating that it "...highlights the importance of providing good quality pensions to public servants, rejects a race to the bottom in pension provision, but concludes that there is a clear rationale for public servants to make a greater contribution if their pensions are to remain fair to taxpayers and employees, and affordable for the country..."

Further, it states that the Government accepts these conclusions and sets out their response to the Commission's interim recommendations, stating that the Government will:

- Commit to continue with a form of defined benefit pension;
- Await Lord Hutton's final recommendation before determining the nature of that benefit and the precise level of progressive contribution required;
- Carry out a public consultation on the discount rate used to set contribution rates in the public service pension schemes;

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- Implement progressive changes to the level of employee contributions that lead to an additional saving of £1.8 billion a year by 2014-15, equivalent to three percentage points on average, to be phased in from April 2012;
- Exempt the armed forces from this increase in employee contributions;
- Launch a consultation on the Fair Deal policy, which Lord Hutton noted can create a barrier to the plurality of public service provision and make it more difficult to achieve innovation, to report by Summer 2011, informed by Lord Hutton's final recommendations on structural reform; and
- Seek engagement with all stakeholders including trade unions.

The Spending Review also proposes to bring forward the increases to State Pension Age. This will mean women's State Pension Age will increase more quickly to 65 between April 2016 and November 2018. From December 2018 the State Pension Age for both men and women will start to increase to reach 66 by April 2020.

Comment – “pay more for less”?

Part of the remit of the Commission's review is to protect accrued rights, so any changes put forward by the Commission are only likely to impact the level and cost of future benefits.

Further, the Spending Review confirms the Government's commitment that public service pension schemes will remain defined benefit in nature, albeit that the Commission appears to favour a career-average structure over the current final salary model

However, coupled with the proposals in the Spending Review to increase the level of employee contributions from April 2012, equivalent to three percentage points on average, this could mean that public sector workers will be asked to pay more for lower benefits.

The Commission's review also opens up a debate about the discount rate used in valuing pension benefits. It is important that government can judge the value of different calls on its finances in a consistent and rational way. It has done this in the past by using the same discount rate (which represents a view of the value we as a society placed on the time value of money) to place a value on providing public sector pensions as it does for investing in public sector projects. If this consistency is not maintained, it is difficult to see how different projects could be rationally compared.

The Government has stated that it will seek engagement with all stakeholders including trade unions on future benefits and contributions and carry out a public consultation on the discount rate used to set contribution rates in the public service pension schemes. These are opportunities for interested bodies to put their views forward and influence the structure of public service pensions going forwards.

Who can I contact for more information?

Please get in touch with your usual contact at First Actuarial for further information.

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