Independent Public Service Pensions Commission
Interim report: 7 October 2010

The Independent Public Service Pensions Commission has today issued its interim report.

The report says that public service pension schemes are part of the overall remuneration package and have their part to play in the public sector's ability to recruit and retain the best people to deliver vital services and in providing an adequate income when employees retire which can help them sustain a reasonable standard of living without becoming a burden on the welfare state. The report rejects the claims that public service pensions are 'gold-plated'. The average (mean) annual pension (including dependants' pensions) in the 5 largest public service pension schemes in 2009/10 was £6497 and in the Local Government Pension Scheme it was only £4052, although in part these figures reflect part-career and / or part-time working.

The report notes that the move to uprate public service pensions from April 2011 by the reference to the Consumer Prices Index (CPI) instead of the Retail Prices Index (RPI) may have reduced the value of benefits to scheme members by around 15 per cent on average. When this change is combined with other reforms to date across the major schemes the value to current members of reformed schemes with CPI indexation is, on average, around 25 per cent less than the pre-reform schemes with RPI indexation.

All these past reforms, the current pay freeze and planned workforce reductions will reduce the future cost of pensions. The gross cost of paying unfunded public service pensions is expected to fall from 1.9 per cent of GDP in 2010-11 to 1.4 per cent of GDP by 2060.

Nonetheless, whilst acknowledging the reforms that have already been made, including the cap and share arrangements in some of the schemes, Lord Hutton of Furness points out in his foreword to the report that the status quo is not tenable. Further reform is necessary in order to strike a fairer balance, not just between current tax payers and public service employees, but also between future and current generations. However, he does not believe there is justification for the public service schemes to follow the significant downward shift in pension provision in the private sector and rejects a "race to the bottom" approach.

Short-term

The Commission considered a range of options for making short term savings and has concluded that the most effective way to do so is to increase member contributions. The Commission believes it is a matter for the Government to decide the manner and level of any increases in contributions necessary but that any increases should be managed so as to protect the low paid. If possible, increases in contributions should be staged and need to be considered with a view to preventing a significant increase in the numbers of employees opting out of the pension schemes.

Long-term

For the longer term the report has concluded that the necessary structural reform cannot be dealt with via traditional final salary defined benefit pension schemes. These primarily reward high earners who progress rapidly through the salary scales and who may also have a longer life expectancy and it is felt that this may no longer provide a robust and fair mechanism for the majority of the public service workforce.

The long-term reform recommendations that the Commission will be making to Government will be based on a set of principles which are designed to deliver public service pensions which are:

- affordable and sustainable;
- adequate and fair;
- support productivity; and are
- transparent and simple.

The Commission's final report, to be produced early next year (prior to the 2011 Budget), will consider a range of alternative approaches to a final salary defined benefit scheme.

The Commission will examine innovative international models but will also be examining the whole range of schemes available where the risk is not solely placed on the employer or the employee.

These will include:

- career average defined benefit schemes;
- notional DC schemes with added protections that, while not being funded, still determine the value of pensions at retirement by an assumed return on contributions and an annuity rate or rates;
- collective DC schemes where all contributions are placed into one fund that is then managed on behalf of the members. As in standard DC schemes, members' pensions will vary according to the value of the underlying investments. However, within collective DC schemes there is the option to use inter-generational sharing to smooth the effects of market conditions;
- cash balance schemes where the employer puts a notional amount into the member's pot every year, which is then guaranteed. This credit can be expressed as a percentage of salary for each year worked. If cash contributions from the employee and employer, plus investment returns, do not match the promised 'notional credit' then the employer will have to meet any shortfall. On retirement the resulting 'cash balance' can be

used either to purchase an annuity or to make other arrangements for retirement;

- sequential hybrids (or nursery schemes) which are schemes with more than one section or part where a member may earn both a DB pension and DC pension during their career with an employer. Members, however, would be earning either DB or DC benefits at any one time;
- capped DB schemes, where there is a limit on the amount of salary that counts for pension purposes or on pension payments from the scheme; and
- combination hybrids, where members simultaneously earn benefits that are part DB and part DC. For example, a capped DB pension, based on earnings up to a certain level and a DC benefit on earnings above this level.

The Commission will also consider elements of scheme design such as:

- ensuring normal pension ages are in line with latest developments in longevity;
- reviewing rules concerning when pensions are drawn before or after normal pension age, in order to increase labour market flexibility;
- the implications of different indexation options for pension costs and incomes over time; and
- accrual rates in the different schemes.

In deciding what pension design or designs might be more appropriate for the future the Commission will also take account of decisions on the new framework for pensions taxation.

Likewise, when considering what pension ages might be appropriate and whether public service pensions might continue to be contracted out of the State Second Pension, the Commission will take into account any further developments in the levels of State pension benefits; the ages at which they are available; and the arrangements for contracting out of the State Second Pension.

The Commission will consider the case for and against greater simplicity in numbers and types of scheme and greater flexibility for individual employers to determine pension designs, as well as who should be eligible for participation in schemes.

Importantly, the Commission has concluded that the LGPS should remain a funded scheme.

The Commission will also be considering pension scheme administration costs and the scope for rationalisation and cost reduction. This will include possible simplification and consolidation of functions across different schemes and units within a scheme. For example, the Commission says it has received evidence about the numbers of LGPS funds and how costs vary between them and possible efficiencies if that number could be reduced.

The Commission will be considering in its final report the role and importance of communications with employees regarding the significance and future values of their pensions within their total remuneration package.

Existing rights

As far as the accrued rights of existing members are concerned the Commission will be considering the extent of those accrued rights, their protection and the implications for future pensions terms. The Commission is clear that protecting accrued rights does not extend as far as protecting current terms for future pension accrual.

Pension awards already made would not be changed and neither would the years of pensionable service built up so far, based on a particular pension age, that have been accrued by those still building up pension rights.

However, after giving appropriate notice and meeting requirements for consultation on changes to scheme rules and any other legal requirements needed to manage the process of reform going forward, the Commission says it should be possible to make changes to pension schemes for existing members relating to their future service. But, when deciding on the timing and nature of any reforms, it will be necessary to bear in mind that some of the present benefits, such as for death and dependants, are a form of long-term insurance.

Fair deal

Pensions can have an impact on the different ways in which public services are provided. Evidence to the Commission has made clear that current pension structures, combined with the requirement to provide comparable pensions (‘Fair Deal’), are a barrier to non-public service providers, potentially making it more difficult to achieve efficiencies and innovation in public service delivery. The Commission has concluded that whilst some commentators have suggested that extending access to public service pension schemes (in the way that the LGPS offers admitted body status to contractors) would resolve this, it does not appear to offer a long-term, sustainable solution for the public service schemes as a whole.

Ultimately, it is for the Government to consider carefully the best way of moving forward with Fair Deal in a way that delivers its wider objective of encouraging a broader range of public service providers while remaining consistent with good employment practices. For its part, the Commission says it will focus in its final report on addressing the issue of how long-term structural reform to public service pensions can support greater labour market mobility and improved productivity.

Implementing change

The Commission says that when it considers options in the final report, it will need to ensure that both the transitional arrangements for moving from current to new structures and the longer-term structures result in:

- the protection of the range of accrued entitlements provided by pension schemes;
- effective transition to new ways of providing for retirement pensions and protections against risk of ill health, death and redundancy; and
- the ability to practically implement reforms, taking account of the wide range and diversity of public service groups that will be affected.

That will require appropriate planning, timetabling and administrative resources, both in personnel and systems.

For more information

The Independent Public Service Pensions Commission's press release and the full interim report are available on the HM Treasury website.