

1 November 2010

Call for evidence for final report

On 7 October I published the interim report of my independent review of public service pensions. This reflected the large number of submissions of evidence received in response to my first call for evidence for which I was very grateful.

The interim report set out the landscape around public service pensions and considered the case for reform. My final report will look at options for structural reform. I consider such reform is vital, given concerns around fairness, increases in longevity, management of risk and the need to reduce barriers to different ways of providing public services and mobility between public and private sectors.

I would like to invite evidence and views from you by Friday 17th December that will assist me in considering the issues outlined below.

Scheme Design

There are many different types of pension schemes that exist in the UK and throughout the world. Traditional models include:

- Final salary schemes, which generate a pension based on salary towards the end of employment;
- Career average schemes, where the amount of pension received is usually based on salary across a period of employment;
- Defined contribution (DC) schemes, where the amount of pension usually relies on the level of contributions paid into a fund, the investment performance of the fund and the annuity rate which converts the fund into an income in later life;

There are also a range of hybrid schemes, which usually combine elements of final salary or career average schemes (DB schemes) with elements of defined contribution (DC) provision. Some possibilities include:

- ‘Capped schemes’ - a DB scheme up to an income level, with a DC scheme for any income over that level;
- ‘Combination schemes’ - a scheme where a member simultaneously earns benefits that are part DB and part DC on the same income;

- ‘Nursery schemes’ – where a member starts in a DC scheme and then earns DB benefits after a number of years in employment;

There are also examples of different types of scheme design that operate in different countries. These include:

- Collective DC schemes – which are similar to DC schemes but where an attempt is made to manage investment risk across generations in an effort to improve returns on average across generations;
- Notional DC schemes – which are unfunded DC schemes and protect members from some of the investment risk associated with typical DC schemes;

Q1) What is an appropriate scheme design for public service pensions? Why?

Risk-sharing

As well as the overall scheme design, there are certain parameters such as normal pension age, indexation factors and contribution rates that can be used to manage risks in different types pension schemes.

There are different risks involved with saving for retirement that are faced by members of pension schemes or by employers who provide the pension scheme. For example, there is a chance that pension scheme members will live longer than expected when the scheme was established which will result in either increased costs for the employer or reduced benefits for scheme members. Other risks associated with some forms of pension saving include risks that investment returns deviate from what has been expected or that earnings grow at a different rate from that assumed.

Generally speaking, in pure defined contribution schemes the scheme members bear most risks and in final salary schemes employers bear most risks (and ultimately in the case of public service schemes, taxpayers). I am seeking views on how risks should be managed between scheme members and public service employers. Specifically:

- Q2) Which risks associated with pension saving should the scheme members bear, which by the employer and which should be shared? Why?
- Q3) What mechanisms could be used to help control costs in public service schemes? For example, is there merit in flexible normal pension ages linked to changes in longevity? What indexation factor should be used in a career average type scheme to ensure a reasonable balance of risk between scheme members and taxpayers?
- Q4) Where and how have risks associated with pensions been effectively shared in private sector companies?
- Q5) Which international examples of good practice in the area of risk sharing should the Commission consider when compiling the final report? Why?
- Q6) What should the split between member and employer contributions look like?
- Q7) Should there be different treatment of different professions (for example, lower normal pension ages for some public service employees)?

- Q8) Should there be different treatment for those at different income levels?
- Q9) What is the appropriate normal pension age for the different public service schemes? Should this vary across schemes and, if so, why?

Adequacy

A key outcome for public service pensions is that they offer an adequate level of income in retirement, particularly where people have devoted the majority of their working life to public service.

There are different views about what an adequate level of income is in retirement and how this should be measured. Lord Turner's Pension Commission produced some benchmark replacement rates but other approaches could include using poverty thresholds at lower income levels. Other commentators suggest looking at household resources rather than individual income, which could give a broader picture of potential standards of living in retirement.

- Q10) How should the Commission think about measuring adequate levels of resources in retirement?
- Q11) What should be considered an adequate level of resources in retirement?
- Q12) Should a full state pension and a full public service pension ensure people have adequate resources in retirement? Or should room be left for individuals to make their own arrangements?
- Q13) How should this change where people work part careers in public service?

Employee understanding and choice

A principle against which options for long-term structural reform will be judged is that schemes should be widely understood. But this principle may require trade offs to be made with other principles outlined in the interim report such as fairness and sustainability. I would therefore welcome views on:

- Q14) How much do workers value and understand pensions? Is there any evidence this differs between groups (for example, by age, by income)?
- Q15) Which forms of scheme design will encourage employees to save for their retirement? Is there any evidence from pension scheme reforms influencing opt out rates in the private sector?
- Q16) What best practice exists in the private sector around communication of benefits with scheme members?
- Q17) Should any new scheme design offer members a degree of choice in the level of contributions paid and benefits received? For example, should members be able to receive a higher pension if they want to take the pension later? Why?

Pensions and plurality of provision of public services

It is important that public service pensions support productivity and ensuring plurality of provision of public services is an important part of this. Different public service

pension structures and eligibility for public service schemes may impact differently on the ability of providers outside of the public sector to supply public services. Therefore I would be interested in views on:

- Q18) Whether and how public service pensions could be structured to support a more level playing field between the public and private sectors when tendering for contracts?
- Q19) Which non-public service employees should be eligible for membership of public service schemes?

Administration costs

There appears to be a wide variation in the administration costs across different public service schemes, and costs seem to be higher than those in the private sector in some cases. The final report will consider whether there is scope for rationalisation and cost reduction.

- Q20) What evidence is there on administration costs (excluding fund management costs) of private sector pension schemes? How do these compare with those in the public service schemes?
- Q21) How do private sector schemes ensure that there is good quality and efficient scheme administration? Which measures can be applied to public service schemes?
- Q22) Is there scope for rationalising the number of local government pension funds? If so, how could this be achieved?

Transition issues

Ensuring there is a smooth transition from the current pension scheme structures to whatever new arrangements are put in place will be crucial if scheme members and taxpayers are to have confidence that the new arrangements are fair, suitable and sustainable in the long-term.

- Q23) How can the Commission ensure an effective transition to the new arrangements?
- Q24) What can the Commission learn about moving to a new scheme from best practice in the private sector and internationally?
- Q25) How have accrued rights been protected or transferred during changes in schemes in the private sector?

In addition, I would also be interested in any further views respondents may have on any other issues relating to public service pensions that are not outlined above, including those raised in my interim report.

I look forward to receiving your input by Friday 17th December emailed to pensions.commission@hmtreasury.gsi.gov.uk. Any responses received will be published on the Independent Public Service Pensions Commission website shortly after the publication of my final report.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Lord Hutton', with a stylized, cursive script.

Lord Hutton of Furness
Chair, Independent Public Service Pensions Commission

Independent Public Service Pensions Commission: terms of reference (issued 20 June 2010)

To conduct a fundamental structural review of public service pension provision and to make recommendations to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead, while protecting accrued rights.

In reaching its recommendations, the Commission is to have regard to:

- the growing disparity between public service and private sector pension provision, in the context of the overall reward package – including the impact on labour market mobility between public and private sectors and pensions as a barrier to greater plurality of provision of public services;
- the needs of public service employers in terms of recruitment and retention;
- the need to ensure that future provision is fair across the workforce;
- how risk should be shared between the taxpayer and employee;
- which organisations should have access to public service schemes;
- implementation and transitional arrangements for any recommendations; and
- wider Government policy to encourage adequate saving for retirement and longer working lives.

As part of the review, the Commission is invited to produce an interim report by the end of September 2010. This should 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. The commission is invited to produce the final report in time for Budget 2011.

Scheme coverage

- For civil servants:
 - o Principal Civil Service Pension Scheme
 - o Principal Civil Service Pension Scheme (Northern Ireland)
- Armed Forces Pension Scheme
- For NHS employees:
 - o NHS Pension Scheme
 - o NHS Superannuation Scheme (Scotland)
 - o Health and Personal Social Services Northern Ireland Superannuation Scheme
- For teachers:
 - o Teachers' Pension Scheme (England and Wales)
 - o Scottish Teachers' Superannuation Scheme
 - o Northern Ireland Teachers' Superannuation Scheme

- For Local Government:
 - o Local Government Pension Scheme (England and Wales)
 - o Local Government Pension Scheme (Scotland)
 - o Northern Ireland Local Government Pension Scheme
- Police Pension Scheme (administered locally)
- Firefighters' Pension Scheme (administered locally)
- United Kingdom Atomic Energy Authority Pension Schemes
- Judicial Pensions Scheme
- Department for international Development – Overseas Superannuation Scheme
- Research Councils' Pension Schemes

In addition to the schemes mentioned above, there are a number of smaller schemes and many established to cover only one senior appointment which do not specifically need to form part of the review but which will be required to act on the recommendations.