

AVON PENSION FUND SUBMISSION TO THE HUTTON COMMISSION (July 2010)

Thank you for the opportunity to Comment and provide evidence to the Hutton Commission. This note summarises the views of the Avon Pension Fund and is written from the perspective of the Fund. Some employers that are linked to the fund may have different views.

The Avon Pension Fund is part of the Local Government Pension Scheme (LGPS). Our submission, from the perspective of an Administering Authority, addresses the principles that should be considered when establishing the framework for all public service pension schemes and then refers to specific issues relevant to the LGPS.

We have been struck by the press comment in recent weeks and concerned about the lack of understanding about the position of the LGPS compared with other (unfunded) public sector pensions. In our case the latest actuarial review is not indicating the need for significant increases in employer contribution rates for the main local government employers, the four unitary authorities in the West of England. The fund has positive cash flow and pension costs can be met well into the future. That said it is recognised that there are significant affordability issues for employers as public spending is cut.

The Audit Commission report issued today helpfully recognises the strengths of the LGPS whilst also acknowledging the need for change.

(1) Economic importance of pensions - The significant contribution of private/occupational pensions to the economic wellbeing of the country should not be underestimated and any review of public service pensions should be made within this context. A reduction in occupational pension benefits especially for the low paid (which is particularly relevant to the LGPS where many members are part-time) to reduce the current tax burden, will only lead to a greater tax burden in the future as such pensioners rely more on public funds, in terms of welfare benefits and healthcare, to support themselves in retirement.

(2) Long term cost model - It is acknowledged that the long term cost of providing public service pensions needs to be addressed. Across the public sector there are different schemes and benefit structures and each has advantages and disadvantages. Therefore each must be reviewed independently to ensure they remain fit for purpose for the employers and employees of that particular service. There are some high level principles that can be applied to all:

- **Reasonable cost** - A conclusion must be made as to what is a reasonable cost for providing public service pensions over the long term: this must also consider the equitable split between employer and employee contributions. Once this has been agreed the different scheme structures should be modified on a consistent basis within the framework.
- **Total remuneration package** - Any evaluation of the value of public service pensions should be made in the context of the total remuneration

package, especially when compared to the private sector, where the gross package may include remuneration elements not available to many public sector employees.

- **Retain salary link** – This is a difficult and controversial issue. The basic point remains that from the perspective of employees a defined benefit scheme gives certainty and an ability to plan ahead. It is a key part of the contractual relationship between employees and their employers and is certainly not an approach to be given up lightly. As a Fund we have considered what is in the interests of our scheme members and balanced this with the views and needs of employers as well as unions that are on the Fund's committee.

The view we have taken is that benefits should be linked to salary, whether a final salary, career average or hybrid scheme structure. Pension schemes linked to salary can be attractive to employers in terms of the recruitment and retention of staff. However, it may be the case that a career average scheme may potentially be more relevant to public services such as local authorities where the majority of staff are relatively lowly paid.

It is recognised that the nature of the scheme needs to be adjusted to ensure it remains affordable and sustainable. A long term view needs to be taken. The draft results of the current local triennial actuarial review (2010) are helpful in that they indicate that, for most of the major scheme employers, a contribution rate increase is likely to be avoided.

- **Common retirement age linked to state retirement age** - There should be a common normal retirement age across all public service schemes and applicable to all members (not just new members) which should be linked to the state retirement age. Limited exceptions for the uniformed services may be considered but, on the basis that their skills are transferable, such an exception would presume that the staff could not find alternative employment which is not necessarily a true reflection of the position.
- **Fair to all** - Any changes must ensure that each public service scheme remains competitive in the employment market and that all members are treated equally i.e. members of one scheme working alongside those of another scheme are not treated less well (this is currently the case with varying retirement ages across schemes and within some schemes between existing and new members).
- **Recognise the longevity issue** - Public sector pension schemes and indeed those in the private sector have been based on historic expectations of longevity. The increase in liabilities due to improvements in longevity has been a factor in the closure of many private sector Defined Benefit schemes. This has resulted in the significant transfer of employees to Defined Contribution schemes, and consequently, all risks have transferred to the employees. In developing a fit for purpose scheme the fact that people will generally live longer needs to be factored into the contribution structure. It may also be necessary to consider what the

minimum pension should be in this context to determine the distribution of costs between employer and employee.

Comments specific to LGPS

The following comments relate to specifically to the LGPS and should be considered as part of the process of identifying the “problems” and establishing the framework for public service pensions in the future:

- **It is a funded scheme** - It is important to recognise that the LGPS is a funded scheme and thus substantially different to the other **unfunded** public service schemes. It represents a viable and sustainable scheme; however, its funded nature makes the costs far more transparent than for the other unfunded schemes. The LGPS is cashflow positive in that income from contributions and investments exceeds expenditure on benefits by £4-5 billion p.a. and has assets in excess of £100 billion which is sufficient to pay benefits for over 20 years given the current scheme structure. There would be no apparent justification to change the LGPS to an unfunded scheme.
- **Retirement Age** - The normal retirement age (NRA) is already 65 years and all changes in NRA to date have been applied to existing members (with limited protections) not just new members as with most of the other public service schemes.
- **Locally administered** - The scheme is regulated nationally yet administered locally. Although some administering authorities face more challenging situations than others, the cost of administration is immaterial and should not be a driver for changes in the overall scheme structure.

The significant long term savings will come from modifications to the contribution and benefits structure. Given the large number of employers (another significant difference with the other public service schemes), merging funds will not generate significant economies of scale or savings. The local funds are governed by locally elected members, so the governance and possibly the funding structure would need to be altered should funds merge. However, there may well be scope to merge some operations in some areas. In addition, funds are collaborating more to reduce administration costs, especially in procurement of professional services.

- **“Gold Plated?”** - There is much mis-information in the press that the LGPS is a “gold-plated” pension scheme. It can only be considered so when compared to the somewhat inadequate provision of private sector schemes. The facts to bear in mind when considering the adequacy of the LGPS pension benefits are:
 - The average pension paid under the LGPS is approximately £4,000 p.a. or c. 23% of gross average pay in local government. This is

around half the average pension paid by all open Defined Benefit schemes.

- The normal retirement age is 65 years which is comparable with many private sector schemes (the limited protections that exist will be phased out by 2016).
 - For the Avon Pension Fund, 70% of pensions paid are less than £5,000 p.a. and 86% of pensions paid are less than £10,000 p.a.
 - The strength of the covenant underpinning the LGPS allows for long term planning and enables any deficit that arises to be repaid over a longer period, given the positive cashflow aspect of the scheme.
- **Affordability** - There is an issue regarding short term affordability in terms of the annual costs borne by the employers represented by the employer contribution rate. This comes about because of the need for radical public sector budget cuts. However, this does not mean the LGPS is not sustainable in the longer term in its current structure if some modifications are implemented. Such changes are required to ensure the scheme remains fit for purpose as well as sustainable.

As the LGPS is currently structured, the employers bear the investment risk. Regulations are already in place to cap and share demographic risks, underpinned by the principle that employees should pay for the increased benefit they receive from demographic improvements, such as improvements in longevity. However, any cap on employer contributions must be around the current level of contributions of 14-15% if the cap and share mechanism is to work. (This is close to the historical average employer contribution rate for Defined Benefit schemes).

The other issue of affordability relates to the way that contribution rates are calculated and whether the approach reflects the long term nature of the liabilities. The traditional actuarial methodology produces significant volatility over the short term making medium term planning by employers for pension costs particularly difficult. The calculation is also extremely sensitive to small changes in the assumptions (especially interest rates and inflation) and to volatile investment markets. Perversely the approach encourages employer contribution rates to remain unchanged or even reduced during periods when increases could be manageable, and in difficult economic periods, contribution rates can be forced to rise when they are inherently less manageable. However, if more consideration was given to cashflow over the short term, the employer contribution rate could be more stable (by making any changes over a longer timeframe linked to cashflow projections), especially if longevity risk is gradually passed to employees through higher employee contribution rates.

- **Employee contribution rates** – Employee contribution rates are tiered to reflect salary levels ranging from 5.5% to 7.5%, with an average rate of 6.3% (which compares to 5% on average for private sector DB schemes). The government has already indicated a 10% rate for those earning more than £100,000. The average employer rate for future service is c. 14% (which compares to 14-15% in private sector DB schemes). Therefore

what is the equitable split between employers and employees assuming the employers rate is capped? If the historical split in the LGPS of 1/3rd employees to 2/3rd employers were to be targeted, it would require the average employee rate to rise to around 7%. Clearly in the light of the public sector cuts this ratio needs careful consideration. Any significant changes in employee contribution rates could be gradually implemented via the existing cap and share mechanism.

- **AVCs** – Scheme members should be encouraged to make additional savings using AVCs to provide extra income on retirement and such savings should be accessible prior to the NRA to bridge the gap between early retirement and the NRA for those that wish to retire early on an actuarially reduced pension.
- **Club Transfers** - Club transfers are in place to allow mobility between public sector employers. However, these can create significant liabilities and should be ended with any transfers within the public sector “club” being undertaken as actuarially calculated transfer values. A career average scheme would also mean that club transfers cease to incur increased liabilities.
- **Appropriate for all employers?** – The LGPS admits non local authority employers and members. However, many of these bodies are under significant financial pressure and it raises the question as to whether the LGPS is suitable for them, in either its current or modified form. This is particularly relevant given the expectation of an increase in outsourcing and use of 3rd sector bodies to provide services. Therefore any review should consider whether the LGPS is fit for purpose for such employers. It should also consider what measures are in place to mitigate financial risks for such employers and the Fund itself.