

# The Public Sector Pensions Commission – CIPFA response to the Second Call for Evidence

15 December 2010



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17 December 2010

Lord Hutton of Furness  
Chairman  
Independent Public Service Pensions Commission  
Room 1/20  
1 Horse Guards Road  
London  
SW1A 2HQ

Dear Lord Hutton

**Call for evidence – Independent Public Service Pensions Commission**

Thank you for your letter of 1 November 2010 in which you invited further evidence to inform your review of public sector pensions.

CIPFA is pleased to offer further comments in response to most of the specific questions posed in your Call for Evidence which are set out in the attached document and we look forward to continue working with the Commission further over the coming months as the future of public sector pensions takes shape.

Where relevant we have linked the conclusions in your initial report with headline views that we expressed in our original response. We have not responded to Questions 4, 5 and 16, as these are outside CIPFA's main area of focus.

I hope that you find these comments a useful contribution to the work of the Commission. If you have any questions regarding this submission, please contact Nigel Keogh, at [nigel.keogh@cipfa.org](mailto:nigel.keogh@cipfa.org).

Yours sincerely



Steve Freer  
**Chief Executive**



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## Summary of response

In our response to the Commission's first call for evidence, we suggested that in order to begin to explore what future pensions provision in the public sector should look like, its first aim should be to determine what is fiscally sustainable in the context of public sector pensions. Setting the scope of the funding envelope will then allow for the design of a pensions system that can be contained within the set funding level.

We have returned to this theme in the responses to the questions posed by the Commission which follow as much of the detail of the future shape of public sector pensions will be determined by how one addresses the questions of affordability and sustainability.

The Office for Budgetary Responsibility (OBR) in its June 2010 report has already highlighted the fact that there is no single widely accepted definition of 'fiscal sustainability' and concedes that to avoid being over-simplistic fiscal sustainability needs to take account of several dimensions, such as solvency, economic growth, stability, fairness and robustness. In a pensions context, there is also the added dimension of ensuring that the cost of pension rights accrued today do not fall disproportionately on future generations.

The question of what is affordable therefore can be viewed from a number of different perspectives. Achieving a common understanding of what is deemed affordable is key to setting the objectives for the future of public sector pensions.

CIPFA believes that changes are necessary to ensure that public service pensions remain financially sustainable and affordable in the long-term and in response to the questions posed by the Commission we have offered some thoughts on how this might be achieved.

However change should not be restricted to the public services. Pension provision in the private sector has deteriorated markedly in the last fifteen years and this too will have an impact upon the public finances in the years to come. We believe that the single most positive and constructive way of closing the gap between public services and private sector pensions is to reverse the decline in the provision of affordable and sustainable employer-sponsored occupational pensions in the private sector, and we share the Commission's aspirations to deliver a long-term solution for public sector pensions that can be held up as standard for the private sector to aspire to.

Reducing the retirement incomes generated by public service pension schemes to such a level that public sector employees are reliant upon state benefits in retirement simply replaces taxpayer-funded employer contributions to a pension arrangement with taxpayer-funded state benefits and in our responses we have cautioned against solutions that might result in such a scenario.

We agree that the structure of public service pensions has not kept pace with demographic and workforce changes and it is those changes - particularly increasing longevity together with the natural maturation of 'pay-as-you-go' schemes that are forcing up the cost of pensions across the UK. Changes are therefore necessary to ensure that these schemes remain able to meet the income needs of public sector workers in retirement, while being affordable for current employees and taxpayers, and avoiding transferring burdens to future generations. This last point will become increasingly important in the context of adverse factors such as increasing debt levels as a result of changes in higher education financing.

We are keen to see that change is guided by clear principles and objectives; a sound evidence base; recognition of the differences between the schemes and the sectors they serve, as well as the different financing dynamics of funded and unfunded public sector schemes; and a clear understanding of both the short and long term financial and non-financial affects any changes may bring. We are pleased therefore to see that the Commission's interim report reflected many of these ideas, and we would urge it to maintain a similar perspective when drawing together its final recommendations.

## SCHEME DESIGN

In CIPFA's response to your initial call for evidence we stated that:

In its interim report<sup>1</sup>, the Commission outlined the over-riding principles within which future public sector scheme design should be considered:

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

It further went on to say that, in its view, the two extremes of the pensions spectrum (final salary defined benefit and individual DC) would not meet these basic design criteria (final salary on the grounds of fairness; individual DC on the grounds of adequacy).

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

Commission recommendations on public service pensions must balance affordability and the needs of workers in retirement with the continuing ability of public sector employers to recruit and retain staff in key public service roles.

- 1 We therefore agree with the Commission's initial views and we are pleased to note that this is supported by the findings set out in the recent report by the Pensions Policy Institute (PPI)<sup>2</sup>.
- 2 Their research found that in final salary schemes, the value of the scheme to an employee who experiences salary growth at 1% above the average for the scheme is some 30% higher than to a standard scheme member. The PPI refer to this as the 'high flyer subsidy'. The same research also found that tiered contributions had little effect on removing this subsidy.
- 3 At the other end of the spectrum, the same PPI report concluded that even a generously funded DC arrangement (total 15% contributions with fund growth linked to the average earnings index) would be unlikely to meet the sort of income replacement rates suggest by Lord Turner's Pensions Commission (see Table 1 below) and accepted by the Independent Public Sector Pensions Commission in its interim report.

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<sup>1</sup> Independent Public Service Pensions Commission: Interim Report, October 2010 - [http://www.hm-treasury.gov.uk/d/hutton\\_pensionsinterim\\_071010.pdf](http://www.hm-treasury.gov.uk/d/hutton_pensionsinterim_071010.pdf)

<sup>2</sup> The Future of Public Sector Pensions, Pensions Policy Institute, 2010 - <http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=0276&>

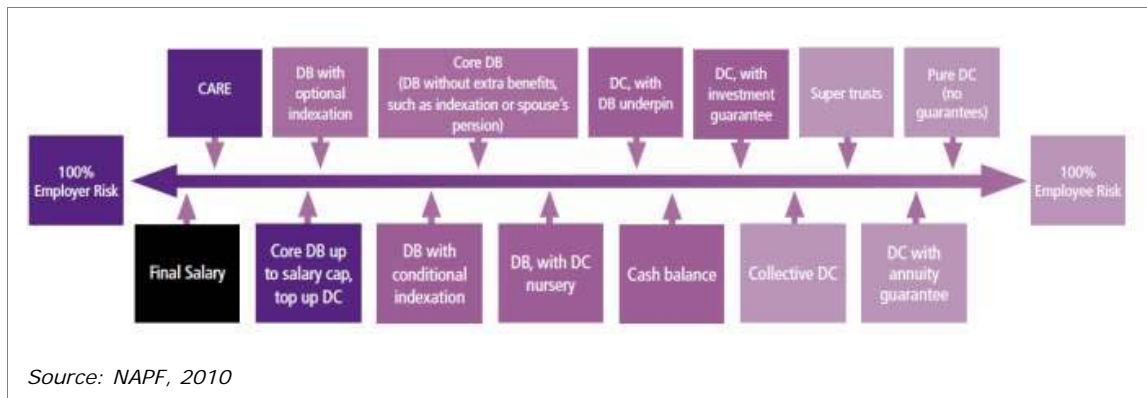
**Table 1: Benchmark replacement rates**

Pre-retirement gross earnings	Benchmark gross replacement rate (%)
Less than £9,500	80
£9,500-£17,499	70
£17,500-£24,999	67
£25,000-£49,999	60
£50,000 and above	50

*Source: Pensions Commission (2004), Pensions, Challenges and Choices - The First Report of the Pensions Commission*

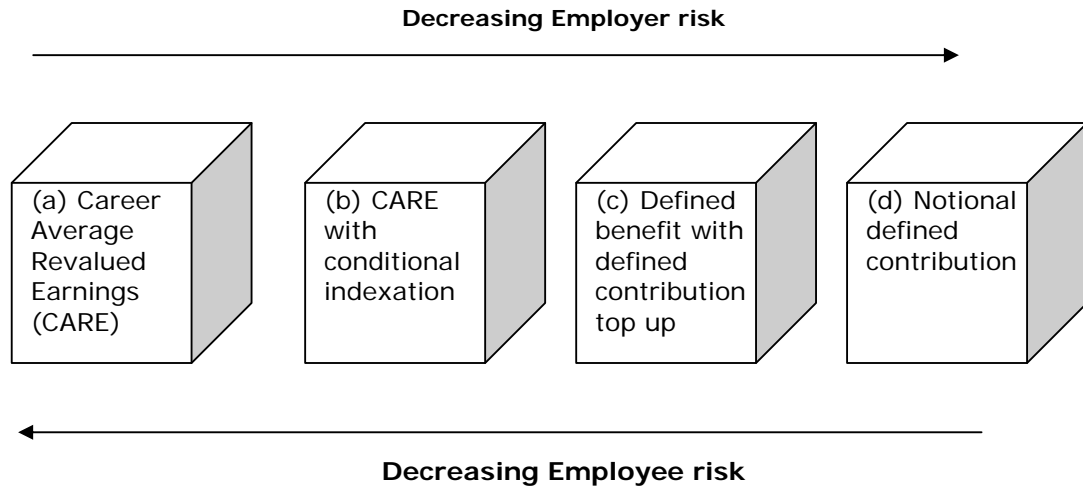
- 4 There is however a wide range of scheme design options between these two extremes on the pensions spectrum that could potentially provide the future model for public sector pensions, as exemplified in the figure 1 below:

**Figure 1: Range of scheme design options**



- 5 In order to narrow down these scheme design options, we have grouped the above options range into four categories and considered each category against the following criteria:

- Affordability and sustainability
- Adequacy and fairness
- Transparency and simplicity



**a) Career Average Revalued Earnings (CARE)**

- 6 This is a defined benefit scheme that gives individuals a pension based on a percentage of the salary earned in each year of their working life. The scheme would include benefits such as index-linking of pension, ill-health cover, survivor and dependents pensions.

*Affordability and sustainability*

- 7 It is possible to design a CARE scheme to suit any given set of financial criteria through varying elements of the benefits package, particularly the accrual rate and the normal pension age. Of these two, varying the accrual rate has the greater effect. This can be seen in the various costs of elements of the Social Housing Pension Scheme. In this scheme, reducing the accrual rate from 1/60<sup>th</sup> to 1/80<sup>th</sup> reduces the cost (expressed as a percentage of pensionable pay) from 14.9% to 11.9% - a 20% difference in cost.
- 8 The PPI reaches a similar conclusion in its recent report (Chart 11, Page 44 - The Future of Public Sector Pensions, Pensions Policy Institute, 2010).

*Adequacy and fairness*

- 9 A CARE scheme offers a fairer allocation of pension benefits than a final salary equivalent because the pension earned in a CARE scheme is based upon the entire pensionable pay history of an employee rather than the salary earned in the final few years of employment. This removes the 'high-flyer subsidy' found in final salary schemes and which is outlined at Question 1. Research by the PPI has also found that a CARE scheme also provides benefits that are more closely aligned to periods of service and does not unduly reward longer-serving employees over those who spend shorter periods in the scheme.
- 10 A CARE scheme can also be engineered to achieve fairness between taxpayer and employee through manipulating elements of the benefits package to arrive at an acceptable cost. By the same virtue a CARE scheme can also be designed in such a way as to provide an adequate retirement income, although achieving this balance remains a challenge.

*Transparency and simplicity*

- 11 A key advantage of a CARE scheme over the other scheme categories considered here is that (with possible exception of final salary schemes) it is relatively simple to administer and communicate to scheme members.

**b) CARE with conditional indexation**

- 12 As above, but with no automatic indexation of pensions. Future indexation would be subject to affordability.

*Affordability and sustainability*

- 13 As for the CARE scheme, it is possible to design a scheme of this nature to suit any given set of financial criteria.

*Adequacy and fairness*

- 14 As for the CARE scheme, this type of arrangement can be engineered to meet the fairness design principle.
- 15 It may also meet the adequacy design principle but this will be dependent upon the extent to which the option to modify indexation is employed. A sustained period of sub-inflationary increases could quickly undermine a pension's purchasing power and an adequate pension at the point of retirement may not always remain so.

*Transparency and simplicity*

- 16 Such a scheme is also relatively simple to administer and communicate although the matter of conditional indexation introduces an element of uncertainty over future pension value that may prove difficult to adequately communicate to members.
- 17 However the real difficulty that we foresee with conditional indexation is that the governance arrangements in public sector pension schemes, particularly those in the pay-as-you-go sector, lack the key factors required to make this a workable solution.
- 18 In private sector trust-based schemes, decisions on the application of conditional indexation fall to the scheme trustees, who must include 50% member-nominate trustees to represent the members interests. This is not replicated in the public sector, primarily because member benefits, including the index-linking of pensions, are defined by statute with no scope for scheme managers to make changes to the scheme that would be detrimental to the members' interests.
- 19 The introduction of conditional indexation would therefore require a major overhaul of public sector pension scheme governance to achieve a model closer to that in the private sector. This would increase complexity and cost, which would seem to conflict with the key criteria set down by the Commission.

**c) Defined benefit with defined contribution top up**

- 20 Within this hybrid scheme group there are a wide variety of possible combinations such as :

- Capped DB schemes
- Combination hybrids
- Cash balance
- Sequential hybrids

- 21 For this category we have considered a defined benefit CARE scheme with a defined contribution top up arrangement.
- 22 Under this approach a limit is placed on pension entitlement that can accrue on a defined benefit basis, for example by placing a ceiling on the amount of annual earnings that are pensionable or by limiting the amount of pension that might be awarded under scheme rules. This is accompanied by a defined contribution section of the scheme.

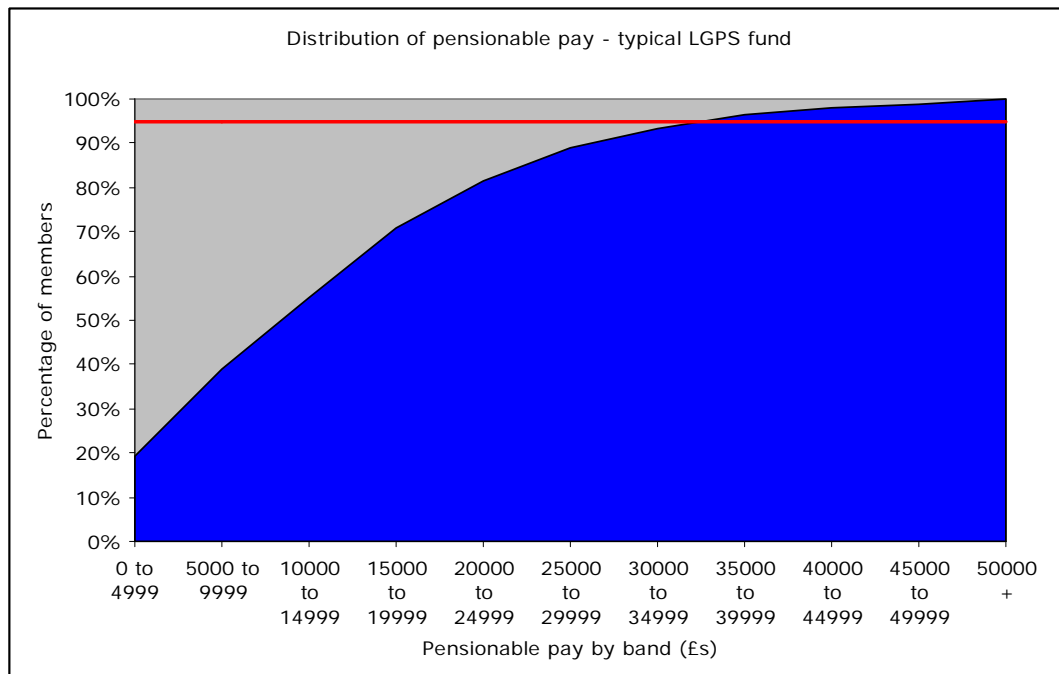
*Affordability and sustainability*

- 23 Hybrid schemes are designed to be tailored to meet an affordable contribution rate, with the accrual rate and pension age variables supplemented by the imposition of a variable pensionable pay cap.

*Adequacy and fairness*

- 24 Fairness (between employees and between employees and taxpayers) can again be achieved through changing the detail of the scheme to arrive at cost and risk management profile that is equitable.
- 25 However there are concerns whether such a scheme would produce adequate pensions unless the pay cap was set at quite a high level.
- 26 The research by the PPI referred to earlier concludes that a CARE scheme with pensionable pay capped at £37,000, topped up with a DC scheme into which employee and employer contribution 6.5% each would fall below the Pension Commission's benchmark replacement rate. This also assumes that every employee participates in the DC top-up arrangement (which cannot be taken for granted).
- 27 However, even using a cap of this level, it does not result in a significantly cheaper scheme. This is because, as Figure 2 shows, a salary level of £37,000 accounts for over 95% of employees in a typical local government pension fund:

**Figure 2: Distribution of pensionable pay in the Local Government Pension Scheme**



Source: CIPFA research, 2010

- 28 Of course, the cost of the scheme may be reduced by reducing the level of the cap but this would further reduce the adequacy of the pension generated.

*Transparency and simplicity*

- 29 Hybrid schemes, even simple examples such as the one outlined above, are far more complex to administer and communicate than pure defined benefit arrangements. This has consequences for administrative costs. The public sector pay-as-you-go schemes in particular have no facility for managing DC funds and would have to rely on third-party administrators. Management fees may alternatively be met from contributions into the DC arrangement but this again would have adverse consequences for the level of pension that would be generated by the DC element of the hybrid scheme.
- 30 Hybrid schemes also produce uncertainty as to the final pension outcome, as part of the pension is dependent upon the investment performance of the DC element.

**d) Notional defined contribution**

- 31 For this category of schemes the values of pensions at retirement are determined by an assumed return on contributions. This either be fixed or based on an annuity rate or statistical index (such as the Average Earnings Index).

*Affordability and sustainability*

- 32 Depending on the level of contributions of the four categories considered here, notional DC is by far the cheaper and least risk option for the employer. Once set, the contribution rate is stable and further stability can be built-in by specifying a fixed rate of growth rather than following a statistical index. It would also generate higher National Insurance contributions (the scheme would be contracted into SERPS), although this would be offset by higher state pension costs.

*Adequacy and fairness*

- 33 Whilst offering a cheaper solution for taxpayers in the short-term, the likely failure of a notional DC scheme to provide an adequate pension in retirement would almost inevitably result in public sector workers falling back on state benefits in retirement.
- 34 Research by the PPI based on a notional DC scheme with a 15% contribution (2:1 employer/employee ratio) and a rate of return based on the Average Earnings Index, showed that it would generate a pension well below the benchmark replacement rate. There also remains the question whether such a scheme would encourage employees to remain within the pensions savings net.
- 35 Experience from the private sector strongly suggests that when defined benefits schemes have been closed to future accrual, as they have in many cases over in recent years, those members no longer accruing benefits have failed to opt into DC pensions savings instead.
- 36 Figure 3 below demonstrates that whilst active DB membership has fallen, Occupational DC membership has remained relatively stable. However, personal pension scheme membership (such as stakeholder pensions) have fallen (by 25% in the last decade).

**Figure 3: Occupational and personal pension scheme trends**



Source: ONS Occupational Pensions Schemes Annual Report (2009) and HMRC data( 2001-02 to 2009-10)

- 37 There is no particular reason to believe that a move to DC for the public sector would not prompt a similar reaction from public sector employees. This decline would in theory have both long and short-term consequences for the public finances.
- 38 In the short-term this decline would seriously impact upon the funding of pensions in the pay-as-you-go schemes, as the employee contribution that currently funds around 30% of the cost of paying today's pensioners would dwindle with reducing membership. In the longer-term if individuals opt-out of pensions saving, there is an increased likelihood of them falling back on state benefits in retirement, which might not of been the case had they remained in an occupational pension scheme.

*Transparency and simplicity*

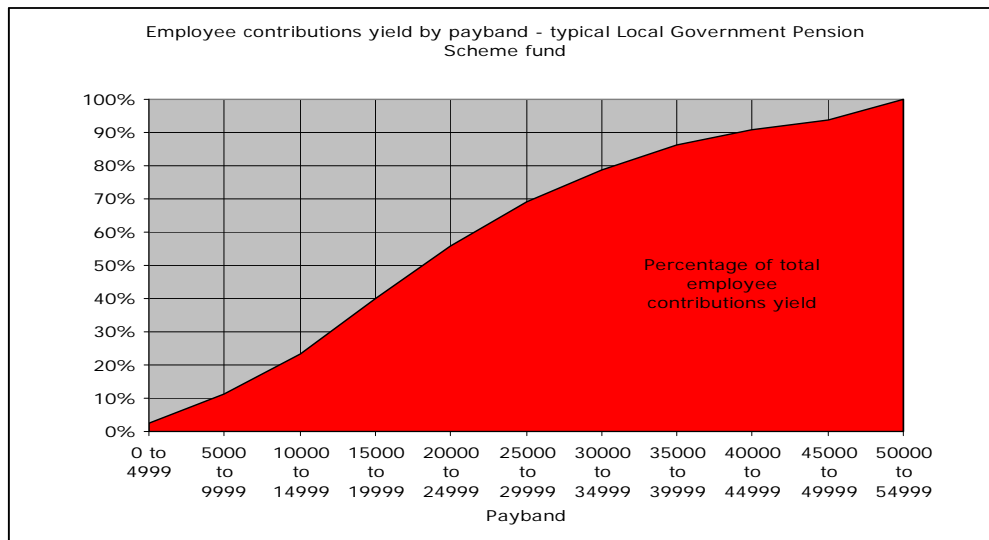
- 39 As a concept notional DC is relatively simple to communicate. However it would require a significant change to the administration base already established in the public sector. Current administration is based on service rather than contributions and transition costs to the latter approach are likely to be high. On an on-going basis, maintaining and reconciling contributions-based records for some 5 million public sector employees may well exceed current administrative, even if this option were to be pursued it would most effectively be delivered through a single national administrator (such as NEST or a an established private sector provider).

**Conclusions**

- 40 Some form of CARE arrangement provides the best balance against the Commission's design principle in terms of a long-term solution for the public sector. However the extent to which a CARE scheme delivered these principles in practice would depend to a considerable extent on the detailed scheme design. In particular accrual rate, contribution rates and retirement age.

- 41 We shall consider some of these further in responses to later questions, but as noted in our submission to the previous call for evidence, the key determinant remains fiscal sustainability. The size of the funding envelope will drive the detailed design of a pension scheme that can be contained within the set funding level.
- 42 in this context any future scheme design should be capable of generating an employee contributions yield consistent with the government forecasts set out in the Spending Review. The intention to raise employee contributions by an average 3% in the pay-as-you-go schemes will result in the average employee contribution in the NHS and Teachers schemes rising to 9%-10%; the Civil Service scheme to around 6%; and 13%-14% for the Police and Fire schemes (a similar prescription is being applied to the local government scheme by reducing central government funding to drive a 3% increase in employee contributions).
- 43 In order to realize and sustain this projected increase in yield, any future scheme must ensure that the forecast levels of membership are retained. This may prove challenging if scheme benefits are reduced to such a level that employees do not feel that the scheme is worth the increased contributions that they are being asked to pay.

**Figure 4: Local Government Pensions Scheme contributions yield distribution**



Source: CIPFA research, 2010

- 44 Indeed the Treasury's confidence that this additional contribution will materialise and not lead to a significant increase in opt-outs is predicated upon the assumption that 'given the generosity of the schemes, there is little economic rationale to do so'<sup>3</sup>.
- 45 In any event, many low paid employees may still feel that public sector pension schemes contributions of 10% are unaffordable. Given that the bulk of the employee contributions yield is derived from relatively low-paid employees (see above) there is a risk that many will choose to opt-out of scheme membership and fall back on state benefits in retirement. A significant reduction in scheme benefits may well exacerbate this situation.

<sup>3</sup> Spending Review 2010 Policy Costings, HM Treasury.

## RISK-SHARING

The Commission call for evidence for its final report states that 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).

### **Q2) Which risks associated with pension saving should the scheme members bear, which by the employer and which should be shared? Why?**

In CIPFA's response to the Commission's first request for evidence we commented that:

We are all living longer. To minimize the financial burden facing future generations of a shrinking taxpayer base, changes to public service pension schemes are essential. Public service employees will have to work longer, retire later and contribute more towards providing for their retirement alongside everyone else.

- 1 There are a number of different risks associated with pension schemes which can impact upon scheme costs:

- Longevity
- Investment (in the funded schemes)
- Interest rate/discount rate
- Price inflation
- Wage inflation
- Workforce growth
- Forecasting risk

- 2 The issue of risk-sharing was also extensively explored during the last round of public sector pension scheme changes. The consensus that emerged from this process was that employees should share the burden of demographic risks (mainly longevity risk) with the employer bearing other risks in full (including in the funded schemes, investment risk) and risk-sharing mechanisms have been embedded in local government, teachers and NHS schemes regulations and also in principle for the Civil Service scheme.
- 3 Whilst we have yet to see these arrangements working in practice, the experience so far has been that these agreements have proved complex and time-consuming in their negotiation and methodology. There is therefore an important question for the Commission to consider on whether it believes that these arrangements should be unpicked.

- 4 The financial impacts of the above risks manifest themselves in increasing or decreasing the cost of the scheme, expressed through the contribution rate. Bearing in mind that the key principles identified by the Commission include transparency and simplicity, approaching the issue of risk-sharing by looking at each risk element in isolation in an attempt to allocate in whole or in part to either employer or employee would seem contradictory. Therefore, if the Commission does decide its wants to move from the current risk sharing approach to avoid the complexity of addressing each risk in turn each time a change occurs, we suggest that the risks be shared through the application of a fixed employee/employer ratio covering the balance across all the risk categories.

**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?**

- 1 There are a number of mechanisms which can be employed to help to control the costs of public service pensions:
  - a) Changing the rate at which earnings are indexed in CARE scheme
  - b) Conditional indexation of pensions in payment
  - c) Reducing benefits
  - d) Altering contributions
  - e) Linking normal age to state pension age
- 2 Adopting option (a) would increase significantly the complexity of the administration of schemes and as noted in our response to Question 1 would also raise questions about the future shape of public sector pension scheme governance.
- 3 In the context of our discussion under Question 1, Option (b) should only be taken forward if questions around the long-term adequacy of public sector premium can be satisfactorily addressed. This consideration would also apply to Option (c) when the Government has already significantly reduced pensions through the move from RPI to CPI.
- 4 It is widely accepted that one of the main drivers behind the increasing cost of defined benefit pension schemes is the effect of improving longevity.
- 5 As the Commission's interim report highlights, increases in life expectancy have consistently outstripped forecasts over the last 40 years and more recently, improvements have accelerated markedly. In contrast, public service pension scheme design has remained relatively unchanged and has not responded to the shift in the length of time that pensions will be in payment.
- 6 Looking again to the design principles set out earlier, the future design of public sector pension schemes should encapsulate long-term financial sustainability. To this end, and in an attempt to future-proof public service pension schemes against demographic changes such as improving longevity, we would suggest that as a matter of principle, the normal pension age for public service schemes should in future be linked to the state pension age. This would provide an in-built safety valve to control costs arising from future longevity increases.
- 7 Option (e) is addressed in our responses to subsequent questions.

**Q6) What should the split between member and employer contributions look like?**

- 1 Ultimately the split of employer and employee contributions is a question of affordability for both the employee and the taxpayer.
- 2 One might argue if that if fairness is the key determinant, contributions should be split equally between employer and employee. However the level of contributions to be paid by employees should also be considered in the context of the ability and willingness to pay.
- 3 In 2008-09, UK public sector employees contributed over £6 billion into the unfunded public sector pensions arrangements across the UK. These contributions were used to defray the £25.7 billion cost of paying today's public sector pensioners – around 24% of the total cost. By the time we reach 2014-15, this will have risen to approximately £8.4 billion (based on the latest Spending Review figures):

**Table 2: Pay-as-you-go pension scheme budget date to 2014-15**

	£billions						
	Outturn 2008-09	Estimate 2009-10	2010-11	2011-12	Forecast 2012-13 2013-14 2014-15		
Gross Expenditure	22.5	24.3	25.4	26.8	28.3	29.9	31.3
Pensions receipts	-19.4	-21.2	-21.3	-21.6	-21.7	-22.8	-23.2
<i>of which</i>							
Employer contributions	-13.4	-14.6	-14.7	-14.9	-14.8	-14.8	-14.8
Employee contributions	-6.0	-6.6	-6.6	-6.7	-6.7	-6.7	-6.6
<i>plus</i>							
Increase in employee contributions announced in the 2010 Spending Review	-	-	-	-	-0.2	-1.4	-2.0
<i>less</i>							
Decrease in employee contributions resulting from measures in the Spending Review	-	-	-	-	0.0	0.1	0.2
Total employee contribution	-6.0	-6.6	-6.6	-6.7	-6.8	-7.9	-8.4
Net Public Service Pensions funding	3.1	3.1	4.1	5.2	6.6	7.1	8.1

*Source: CIPFA research; Spending Review 2010 Policy Costings, HM Treasury; Budget 2010: the economy and public finances – supplementary material, HM Treasury*

- 4 As we set out in our earlier submission to the Commission's first call for evidence, the latest UK spending forecasts place a great deal of emphasis on the employee contribution remaining intact throughout the course of this Parliament to avoid the contributions/expenditure gap widening further and therefore placing greater strain on the public finances. Indeed, this is further emphasized by the Chancellor's decision to seek to increase the contributions yield from public sector pension scheme members by a further £1.8 billion by 2014-15, the equivalent to an average 3% increase in employee contributions.
- 5 Conversely, it would take less than 15% of current pension members to decided that an extra 1% pension contribution (implemented at the same time as a pay freeze) was unaffordable, to negate the effect of a 1% increase in contributions and actually cause the total employee contributions yield to fall instead of rise. The

potential for this is noted in the extract in Figure 5 from the policy costings that accompanied the 2010 Spending Review:

**Figure 5: 2010 Spending Review key assumptions**

**Post-behavioural costing**

It is possible that a small number of individuals will choose to leave their pension scheme as a result of these changes, though given the generosity of the schemes there is little economic rationale to do so, and policy will be designed to mitigate these impacts. This costing assumes an increase in the opt-out rate equal to one per cent of total paybill.

**Areas of uncertainty**

The main area of uncertainty in the costing is the behavioural response. Assumptions about opt-out behaviour are inherently uncertain, and will additionally depend on the detail of how the policy is implemented. The details of the policy will be announced at Budget 2011.

*Source: Spending Review 2010 Policy Costings, HM Treasury.*

- 6 If pension scheme membership were to reduce significantly, and beyond that already assumed in the Spending Review forecasts, the sizeable contribution from employees which at present is supporting the cost of today's public service pension payments could be reduced, while reductions in pension scheme membership could also have longer term adverse consequences for the public finances, as discussed above. This possibility will need to be factored into any decision to change the contribution rates.
- 7 As in any other personal financial decision, there are large groups of public sector employees who are 'price-sensitive' to the cost of pension scheme membership. Experience in the Local Government Pension Scheme (LGPS) in particular shows that the low paid, part-time workers and younger employees are often reluctant to join the scheme due to the cost of contributions (and in the case of younger employees, other financial pressures such as student debt, etc).
- 8 LGPS scheme membership currently runs at around 80% of employees, despite efforts during the last round of scheme reform to encourage greater take-up amongst the lower-paid by reducing the lowest rate of contribution to 5.5% for employees whose whole time equivalent pay is less than £12,600 per annum.

**Q7) Should there be different treatment of different professions (for example, lower normal pension ages for some public service employees)?**

In our response to the Commission's first call for evidence we proposed that:

There are a wide variety of pension schemes in the public sector. The Commission's recommendations should recognize the vast differences in employment types and career structures in the public sector, from front-line soldiers to back-office workers that these schemes provide benefits for.

- 1 In our response to Question 3 we suggested that in response to improving longevity, the normal pension age (NPA) of public sector pension schemes should be linked to the state pension age.

- 2 We do however recognise that there are specific roles within the public sector which do not immediately lend themselves to extended working lives such as the armed forces, police and fire services.
- 3 In such cases we would suggest that those classes of employees could participate within the same scheme framework but would be able to take their pension at an age better aligned to their physical capacity (ill-health aside) to effectively perform their specific roles. The current NPA's for police, armed forces and fire-fighters range from 50 to 60, a range which would not appear unreasonable given the nature of these occupations, and the fact that physical performance tends to decline with age. However, we believe that further research is required on the impact in practice and whether a distinction should be drawn between 'front line' and other staff.

**Q8) Should there be different treatment for those at different income levels?**

- 1 The rationale for tiered contributions (insofar as they have been introduced in the public sector schemes) was that it would go some way to address the 'high-flyer subsidy' (as it is described by the Pensions Policy Institute) that was to be found in final salary schemes.
- 2 However this 'subsidy' was not in evidence in any of the other types of scheme modelled by the PPI in their recent research. It is therefore difficult to justify tiered contributions in anything other than a final salary arrangement.

**Q9) What is the appropriate normal pension age for the different public service schemes? Should this vary across schemes and, if so, why?**

- 1 As noted in the responses to Questions 3 and 7 above, we believe that there is a strong justification for the normal pension age for public sector pension schemes to mirror the state pension age as a measure to limit the costs borne by the taxpayer that arise from increasing public sector pensioner longevity. That said, as discussed in the context of Question 7 we believe that any scheme reforms recognise that this principle should be applied sensibly when considering those schemes whose members are engaged in activities which do not immediately lend themselves to extended working lives such as the armed forces, police and fire services. Schemes should also retain the current flexibilities that allow both employers and individuals to manage their retirements effectively in cases where there are large scale changes to the workforce or individual cases of capacity and capability to be addressed. These flexibilities, applied judiciously, can be a useful tool in managing workforce costs.

## ADEQUACY

The Commission's call for evidence for its final report states that 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. In CIPFA's response to the Commission's first call for evidence we commented that:

Making arrangements during employees' working lives for an adequate income during retirement is essential. If this isn't achieved through a pension scheme or private investments, the costs will fall on the taxpayer.

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?**

- 1 There are two key determinants that influence the adequacy of income in retirement:
  - Needs are driven by the personal circumstances of the individual (health, familial and social circumstances)
  - Income needs in retirement are not static and they change over time
- 2 Recent research by the Pensions Policy Institute (PPI)<sup>4</sup> revealed that the main variations in income needs occur between single and partnered pensioners, and single and multi-occupier households.
- 3 The same research also showed that income needs in retirement took on U – shaped curve:
  - Higher spending immediately post-retirement (age 65 to 75)
  - Decreasing during the middle years due to losses in mobility (age 75 to 85)
  - Increasing in later years (85+) due to health related costs
- 4 The PPI also reported that perception played a large part in how individuals view the adequacy of their retirement income, with the change from pre- to post-retirement income often revealing unsustainable pre-retirement spending habits.
- 5 There are two broad approaches the Commission might adopt to measuring adequate incomes in retirement, :
  - measures which attempt to set a minimum income level at which an individual is able to meet basic needs and achieve a minimum standard of living and:

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<sup>4</sup> *Retirement income and assets: do pensioners have sufficient income to meet their needs?* - Pensions Policy Institute, 2006.

measures which aim to set 'adequacy' in the context of the ability to maintain a similar standard of living to that which they enjoyed whilst in employment.

- 6 Examples of the former would include government measures such as the minimum income guarantee; income standards set as factor of average earnings; definitions of what constitutes 'poverty'; and the levels at which top-up benefits are triggered.
- 7 The latter measures would include income replacement rates, such as those referred to earlier in the response to Question 1.
- 8 Whilst the choice between measures which reflect either 'needs' or 'expectations' is largely a subjective one, research by Lord Turner's Pensions Commission (replayed in both the PPI report referred to above and the Commission's interim report) would suggest that a benchmark replacement rate measure comes closest to encompassing the two key influences in adequacy set out previously.
- 9 We would conclude therefore that the Commission should continue to use the Turner Commission Replacement Rates as their benchmark for assessing the adequacy of future pensions arrangements for the public sector.

**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?**

- 1 The implications of the decline in pensions participation as occupational pensions have declined in the private sector (as evidenced at Table 3 and supported extensively by the findings of Lord Turner's Pensions Commission and various statistical indicators since the final 2006 report) strongly suggests that, in the absence of occupational pension schemes, an increasing proportion of the UK workforce is failing to make adequate provision for retirement.
- 2 This would suggest that to minimize the risk of underprovision amongst public sector workers, the combination of basic state pension and public service pension should be designed to provide an adequate income in retirement. The alternative of allowing any shortfall to be made up by individuals making their own arrangements runs the risk of this not materializing (as has been the case in the private sector), resulting in increased reliance on state benefits.
- 3 The consequence of this is that many may have to fall back on state benefits to produce an adequate income with resultant strain on the public finances.

**Q13) How should this change where people work part careers in public service?**

- 1 It is clearly difficult to allow for those whose careers take them into and out of public service. The best that can be achieved is to ensure that there is access to a pension scheme that will allow them the opportunity to work towards making provision for their retirement whilst in public sector employment, and that those benefits accrued during this time are portable into other pension arrangements (should the individual wish to do so).

## **EMPLOYEE UNDERSTANDING AND CHOICE**

The second call for evidence states that 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.

### **Q14) How much do workers value and understand pensions? Is there any evidence this differs between groups (for example, by age, by income)?**

- 1 Based on evidence from various public sector schemes, there would appear to be a fairly high level of understanding of the value of pensions in the public sector workforce. Employers, administrators and employee representatives are all heavily involved in pensions awareness activities and positively promote scheme membership.
- 2 There is no strong evidence to suggest that understanding varies by age or income group but there are behavioural and decision-making differences:
- 3 In those schemes where participation rates are relatively low, the decision to opt-out (which is largely found in female, young and lower-paid workers) is not necessarily due to a lack of understanding of pensions but is more likely to be driven by more immediate financial pressures: the need for disposable income and the need to service debt (student loans etc).

### **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?**

- 1 As we have noted in responses to previous questions, whilst it is important to ensure that any future public sector pensions provision is affordable and sustainable in the context of the public finances, this should be balanced with providing a scheme that is also affordable and attractive to employees. If it is not then there is the risk that employees will fail to make adequate provision for their retirement through participation in their occupational pension scheme
- 2 In our previous comments, we have concluded that the moving to a CARE scheme with a normal pension age linked to state pension age and fixed ratio of employee and employer contributions would appear to provide the best fit in terms of:
  - meeting the Commission's over-arching design principles
  - striking the appropriate balance between employee and employer interests
  - retaining the current high level of public sector employee saving through pension scheme participation
  - retaining, and increasing, the significant contribution that public sector employee pension contributions make to meeting the cost of existing pensions.
- 3 In relations to pension scheme reforms influencing participation rates in the private sector, we have noted previously that, based on the available evidence, reform has largely manifested itself in DB scheme closure (first to new entrants and then to future accrual) and this in turn has led to a significant withdrawal from pension savings by employees.
- 4 Elsewhere, such as in the universities scheme (USS) and the BBC pension scheme, it is too early to assess the impact of scheme changes on opt-out rates.

**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?**

- 1 Whilst we recognise that such options may appeal to some members of public sector pension schemes, we therefore believe that the take-up would be so small that it would not justify the undoubted additional administrative expenses that would be involved.

**Table 3: Added year and AVC participation in the public sector**

	Added years contributions as a %age of total scheme contributions	AVC's (£millions)
NHS Pension Scheme	3.06%	11.0
Teachers Pension Scheme	0.60%	181.0
Armed Forces Pension Scheme	0.03%	-
Civil Service Pension Scheme	1.32%	12.0
Judicial Pension Scheme	0.69%	0.4

*Source: Published accounts, 2009-10*

- 2 Members already have the option to top-up their pension benefits through purchasing added years of service or making additional voluntary contributions (AVCs) to a defined contribution pension (which should continue to be available under any future pension arrangement). In schemes were variable scheme types and accrual rates are offered at different contribution rates (such as the Social Housing Pension Scheme) the choice rests with the employer not the employee. However based on the current level of take-up of these options (which as Table 3 above demonstrates, is relatively low) it seems unlikely that many would exercise enhancement options.

## **PENSIONS AND PLURALITY OF PROVISION OF PUBLIC SERVICES**

The Commission's call for evidence for its final report notes that 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.

**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?**

- 1 Removing barriers to entry into the market for providing public services is a major challenge. The participation of the private sector, the third sector (through social enterprises, charities etc), employee-led mutuals, voluntary groups or individuals in the provision of public services (as envisaged under the Big Society agenda) will require a wide-ranging review of which facets of public service provision act as disincentives to participation. In this regard public services pensions are just one of many possible factors.
- 2 The government has already taken the first steps to providing a more level playing field through the withdrawal of the Code of Practice on Workforce Matters in Public Service Contracts (also known as the Two –Tier Workforce Code). Under this Code, outsourcing employers were required to give new employees a broadly comparable package to that received by the outsourced.
- 3 However in the recent Modernising Commissioning green paper, it is clear that the Cabinet Office are continuing to seek a better understanding of these barriers to entry and have already committed to a review of the guidance around TUPE in relation to public sector procurement.
- 4 As an integral part of the public sector reward package, it would seem sensible therefore for pensions be considered as part of this wider review, rather than being treated in isolation and out of the wider context of commissioning reform. This would avoid outsourcing decisions being unduly dominated by the pensions issue and would ensure that the all elements of the public sector reward package are considered.

## ADMINISTRATION COSTS

The Commission's call for evidence for its final report notes that 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. It states that 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?

- 1 The annual Capita Hartshead administration survey<sup>5</sup>. A good source of evidence of pension scheme administration costs in the private sector. The 2010 survey covered pension schemes valued at £297 billion, with 5.4 million members.
- 2 Table 4 below shows data from the 2010 survey alongside comparative figures for a selection of public sector schemes where the cost data is in the public domain. (Comparative data for other public sector schemes is not readily available as the costs of administration are subsumed within wider administrative costs.)

**Table 4: Comparative administrative costs – private sector, public sector and third party**

Scheme type	2004	2005	2006	2007	2008	2009	2010
<b>Cost in £'s per scheme member</b>							
<b>Up to 1,999 members</b>							
In-house	72	76	80	87	94	97	105
Third-party	71	76	80	89	97	101	107
<b>2,000 to 4,999 members</b>							
In-house	61	64	67	71	77	77	82
Third-party	51	53	56	62	67	74	79
<b>5,000 to 9,999 members</b>							
In-house	47	49	52	56	59	60	64
Third-party	39	41	44	48	51	55	59
DFID Overseas superannuation scheme	n/a	n/a	35	37	38	36	n/a
<b>10,000+ members</b>							
In-house	39	41	43	46	47	43	47
Third-party	30	31	33	36	37	39	41
Local Government Pension Scheme (England) (excluding fund management costs)	25	27	26	26	28	29	28
Local Government Pension Scheme (Wales) (excluding fund management costs)	29	28	31	29	32	27	30

Source: Capita Hartshead Annual Pension Scheme Administration survey 2010; CIPFA Research, 2010

<sup>5</sup> Capita Hartshead 17<sup>th</sup> Annual Pensions Administration survey 2010 - <http://www.pensionsadminsury.co.uk/index.html>

- 3 The table shows that the costs of administration in the public sector (based on a measure of annual cost per scheme member) compare favourably with the private sector at similar levels of scheme membership, with the indicative costs of the large centrally-administered schemes such as the Teachers scheme considerably less than £10 per member per annum (based on data from DCSF and the Teachers Pension Scheme for 2008-09, the annual cost per member was around £7 per annum).

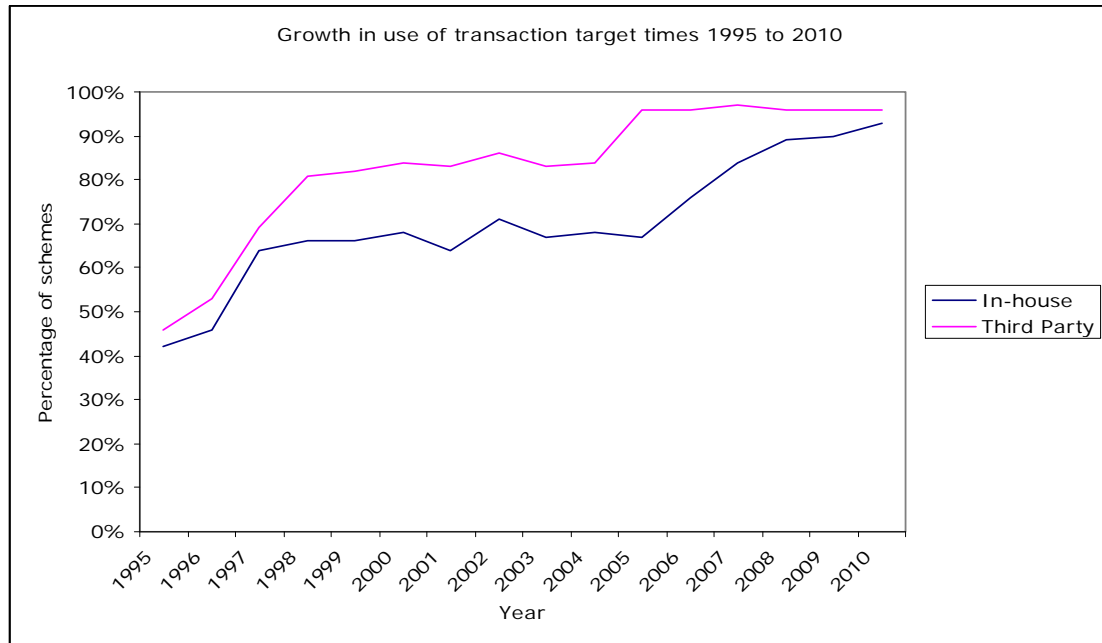
**Q21) How do private sector schemes ensure that there is good quality and efficient scheme administration? Which measures can be applied to public service schemes?**

- 1 There are various means by which efficient and effective scheme administration is sought in the private sector.
- 2 Internally, efficiency and effectiveness can be driven by the use of service level agreements (SLAs) between administrator and pension scheme trustees/managers. These largely define the expected timescales for the completion of transactions and have become increasingly common in the last 15 years.
- 3 There are also external drivers such as the Raising Standards in Pensions Administration (RSPA) project. This initiative exists to advance knowledge and learning in respect of pensions administration, in particular through the creation and maintenance of a collection of guidance notes, case studies, tools and checklists, with the aim of improving the standard of service delivered to members of pension arrangements in the UK. The RSPA website offers guidance in areas such as scheme administration and communications, risk and data management.
- 4 In the public sector, SLAs are also commonplace and for many years have been widely used as a means of communicating performance both externally to service users and internally, having been developed out of initiatives such as ministerial target-setting for Executive Agencies, the Citizens Charter, Chartermark (now Customer Service Excellence), etc. Some organizations publish this performance data in their pension scheme annual reports, although this is not consistent practice.
- 5 Financial benchmarking is also well-established in the public sector. CIPFA's benchmarking service for pensions administration currently covers 68 of 100 local government pension schemes across the UK.
- 6 Members of the benchmarking club receive a detailed analysis of their own administration costs compared with similar public sector member bodies<sup>6</sup>. In addition, pensions administration is the one financial service where an essentially similar function is provided in the private sector, and where surveys of private sector costs are publicly available. Therefore, the benchmarking club is also able to supplement comparisons between members with reliable private sector comparisons.
- 7 Each of these approaches to improving efficiency and effectiveness in pension scheme administration are capable of being applied across the public sector.

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<sup>6</sup> A sample report for members of the CIPFA Pensions Administration Benchmarking Club can be found at [http://www.ipfbenchmarking.net/pdf/CIPFA\\_Pensions\\_Example.pdf](http://www.ipfbenchmarking.net/pdf/CIPFA_Pensions_Example.pdf)

**Figure 6: Growth in the use of transaction time targets 1995 to 2010**



Source: CIPFA research, 2010

**Q22) Is there scope for rationalising the number of local government pension funds? If so, how could this be achieved?**

- 1 The wide variety of pension arrangements in the public sector reflect various geographical and sectoral boundaries within the public sector (see Figure 7) and each of which has its own particular approach to administration (see Annex A for a snapshot of the current administration landscape).
- 2 Leaving aside the routine organisational HR and payroll actions necessary register and maintain an employee in a public service pension scheme (a responsibility that falls upon every employer whose employees are members of these schemes), over 300 separate organisations are involved in some way in the more detailed administration of public sector pensions (maintaining records, calculating benefits, making payments etc), including every government department, 100 local authorities and every police and fire authority in the UK.

**Figure 7: Public sector pension schemes in the UK**

The following represent the major public sector pension schemes in the UK:

- Principal Civil Service Pension Scheme (PCSPS)
- Armed Forces Pension Scheme (AFPS)
- NHS Superannuation Scheme (England and Wales)
- Teachers' Superannuation Scheme (England and Wales)
- Local Government Pension Scheme (LGPS)
- Firefighters Pension Scheme (England, Scotland and Wales)
- Police Pension Scheme
- United Kingdom Atomic Energy Authorities Superannuation Schemes
- Judicial Pension Scheme
- Department for International Development – Overseas Superannuation Scheme
- Research Councils' Pension Scheme
- DFP Northern Ireland Superannuation and Other Allowances
- DFP Northern Ireland North/South Pension Scheme

HPSS Northern Ireland Superannuation Scheme  
Police Service of Northern Ireland Pension Scheme  
Northern Ireland Teachers' Superannuation Scheme  
Northern Ireland Firefighters' Pension Scheme  
Scottish NHS Superannuation Scheme  
Scottish Teachers' Superannuation Scheme  
Parliamentary Contributory Pension Fund (UK parliament)  
Scottish Parliamentary Contributory Pension Fund  
National Assembly for Wales Members' Pension Scheme  
Northern Ireland Assembly Members' Pension Scheme

In addition to the above, there exists a wide range of other pension arrangements in the public sector. One common form in a large number of non-departmental public bodies (NDPBs) and other bodies operating at arm's-length from the government are 'by analogy' schemes. The schemes are so called because they base themselves on the Principal Civil Service Pension Scheme (PCSPS) but are separate from the main civil service scheme.

While these types of schemes share similar characteristics, they are employer-specific (such as the House of Commons Staff Pension Scheme). Although catering for relatively small numbers of employees (compared with the larger public sector schemes), these schemes together represent another significant element of public sector pensions (the House of Commons scheme referred to above for example covers around 2000 members and has liabilities of £471 million as at 31 March 2010).

- 3 Leaving aside the routine organisational HR and payroll actions necessary register and maintain an employee in a public service pension scheme (a responsibility that falls upon every employer whose employees are members of these schemes), over 300 separate organisations are involved in some way in the more detailed administration of public sector pensions (maintaining records, calculating benefits, making payments etc), including every government department, 100 local authorities and every police and fire authority in the UK.
- 4 One of the clear implications that can be drawn from Figure 7 above unit cost data is that smaller scale units are less cost-effective from an administrative cost standpoint, although this does not necessarily mean they are less effective at generating investment returns. This would therefore suggest greater aggregation of administration into fewer larger units would yield significant economies of scale. This is particularly relevant where the same set of scheme rules is being administered by a number of different organisations such as in the local government, police and fire-fighters schemes.
- 5 The potential benefits of consolidation into fewer units are already being actively progressed in some areas. A prime example of this is the Pathfinder project in Scotland (for a précis of the origins, progress and current status of this initiative please see Annex B).
- 6 Under the Pathfinder project, all eleven of the Local Government Pension Scheme administering authorities in Scotland are working together, actively investigating, as one option, reducing the number of funds down to one or two. A separate workstream is also under way which is looking at the structure of pension scheme administration which will also consider police and fire-fighters pension scheme administration.
- 7 If successful, this collaborative approach to seeking greater efficiency could provide the 'proof of concept' for further application in the UK public sector schemes.

## **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?**

- 1 The major public sector pension schemes in the UK have recently been through a period of change during which it has been necessary to migrate to new scheme arrangements. A good example of how this has been managed is the 'Your NHS Pension Choice' programme.
- 2 Following the last round of public sector pension reform, all new NHS employees from 1 April 2008 were enrolled in the new 2008 pension scheme. However existing NHS employees were faced with the choice of remaining in the old scheme or moving into the new scheme. Therefore as part of three year transition programme, the NHS Business Services Authority (NHSBSA) Pension Division devised a number of tools to communicate with members and their employers to inform their decision-making. These include:
  - A web-hosted pensions choice calculator
  - Payslip information leaflets
  - A NHS Pensions Choice Pack, which includes a Pensions Choice benefits statement, detailed guide and explanatory DVD (mailed individually to members and hosted on the NHS BSA website)
  - A guide for employers
  - A series of factsheets
- 3 The key to the exercise is clear communication of the issues to scheme members and using various media types to convey the message.
- 4 The Commission should look to public sector pension scheme administrators to draw upon their past experience (such as that outlined above) and encourage organizations to share best practice in order to manage any transition to new scheme arrangements.
- 5 It should also recognise that given the large numbers of employees that would be affected by any change to pension arrangements, scheme administrators would need adequate lead time to effect the changes successfully. As noted above, the NHS programme is being carried out over three years. Equally in other public sector examples not involving options exercises like that in the NHS, the timescale from first consultation on new scheme arrangements to their practical implementation may take up to 2 years.

### **Q24) What can the Commission learn about moving to a new scheme from best practice in the private sector and internationally?**

- 1 As noted above, the public sector has a great deal of experience in managing scheme change, and whilst private sector examples might be informative, the much larger scale of the public sector schemes is a major consideration when looking to draw lessons from such comparators (the NHS Pensions Choice exercise for example covers some 1.4 million members across over 9,000 different employers).

**Q25) How have accrued rights been protected or transferred during changes in schemes in the private sector?**

- 1 A common approach to preserving accrued rights during scheme changes is to close the scheme, thus preserving any rights accrued to that point to be paid upon the pension age for that scheme. Employees then begin to accrue service in the new scheme from a forward date.
- 2 This represents the simplest solution where whole-scale scheme changes are being introduced and avoids the need for complex service conversion from one scheme to another (where accrual rates change) or the maintenance of reserved rights or sections within a new scheme.

## Public Sector Pensions Scheme Overview

Scheme	Administrator	Regulator
Principal Civil Service Pension Scheme (PCSPS)	<p>The administration of the scheme is split between pre-and post retirement.</p> <p>Pre- retirement, the Cabinet Office has delegated responsibility for administration to employers (government departments). Departments are responsible for maintaining service records, scheme communications and deduction and paying over contributions. There are also required to appoint an APAC (Authorised Pensions Administration Centre) to undertake pension scheme calculations (benefits estimates, transfer of benefits/service between pension schemes, pension entitlement at retirement etc).</p> <p>(Note: we understand these arrangements to be under review)</p> <p>Post retirement, the payment of pensions and administration of pensioner records is centralized. This was previously undertaken by the Office of the Paymaster General until privatization in 1997. The contract for pensioner payroll currently rests with Capita. Other services such as actuarial services are also outsourced.</p>	Cabinet Office
Armed Forces Pension Scheme (AFPS)	<p>The scheme is administered centrally on behalf of all of the armed forces by Service Personnel and Veterans Agency (SPVA), which is an executive agency of the Ministry of Defence.</p> <p>Pensioner payroll and administration is currently outsourced to Xafinity Paymaster. Other services such as actuarial services are also outsourced.</p>	Ministry of Defence (MoD)
NHS Superannuation Scheme (England and Wales)	<p>The scheme is administered centrally by the NHS Pensions Division of the NHS Business Services Authority, a Special Health Authority of the NHS.</p> <p>Pensioner payroll and administration is currently outsourced to Xafinity Paymaster. Other services such as actuarial services are also outsourced.</p>	Department of Health (DH)
Teachers' Superannuation Scheme (England and Wales)	<p>All elements of the administration of the scheme have been fully outsourced under one contractual arrangement by DfE. The current contractor is Capita. Other services such as actuarial services are also outsourced.</p>	Department for Education (DfE)
Local Government Pension Scheme (LGPS)	<p>The scheme is administered by 100 administering authorities across England Scotland Wales and Northern Ireland<sup>7</sup>.</p>	England and Wales - Department for

<sup>7</sup> Administration of the LGPS in Northern Ireland is centralised for the 26 local councils, Education & Library Boards and the Voluntary Grammar Schools, Housing Executive and Translink and other associated employers that are party to it. Administration of the scheme is undertaken by the Northern Ireland Local Government Officers' Superannuation Committee (NILGOSC).

<b>Scheme</b>	<b>Administrator</b>	<b>Regulator</b>
	Administration consists of pre- and post-retirement events and financial administration of the pension funds themselves. Different degrees of outsourcing take place across all of the functions.	Communities and Local Government (CLG) Scotland – Scottish Public Pensions Agency (SPPA) Northern Ireland – Department of the Environment (DENI)
Firefighters Pension Scheme (England, Scotland and Wales)	The Firefighters Pension Scheme is administered by each of the 51 fire authorities in England (47), Scotland (8) and Wales (3). This includes maintenance of service records, calculation and payment of benefits. As in local government, some elements of outsourcing take place.	England and Wales - Department for Communities and Local Government (CLG) Scotland – Scottish Public Pensions Agency (SPPA)
Police Pension Scheme (England, Scotland and Wales)	The Police Pension Scheme is administered by each of the 58 police authorities in England (39), Scotland (8) and Wales (4). This includes maintenance of service records, calculation and payment of benefits. As in local government, some elements of outsourcing take place.	England and Wales – Home Office Scotland - SPPA
United Kingdom Atomic Energy Authorities Superannuation Schemes	The schemes are administered by the UK Atomic Energy Authority (UKAEA). Some services such as actuarial services are outsourced.	UKAEA, with ministerial oversight from the Department for Business Innovation and Skills
Judicial Pension Scheme	The scheme is administered by the Judicial Appointments and Human Resources Division (JAHRD) within the Ministry of Justice. Pensioner payroll and administration is currently outsourced to Xafinity Paymaster. Other services such as actuarial services are also outsourced.	Ministry of Justice (MoJ).
Department for International Development – Overseas Superannuation Scheme	The scheme is administered by the Overseas Pensions Department of the Department for International Development.  There are no longer any active members of the scheme so the primary responsibility of the department is the payment of pensions as and when they fall due. Some services such as actuarial services are also outsourced.	Department for International Development (DFID)
Research Councils' Pension Scheme	The schemes are administered by the Research Councils' Joint Superannuation Service (JSS) – a unit within the Biotechnology and Biological Sciences Research Council. Pensioner payroll is provided by the Research	Research Council pensions Scheme Management Board with

<b>Scheme</b>	<b>Administrator</b>	<b>Regulator</b>
	Council Shared Service Centre. Actuarial services are provided by the Government Actuary's Department (GAD).	oversight from the Department for Business Innovation and Skills
DFP Northern Ireland Superannuation and Other Allowances	The scheme is administered by the Civil Service Pensions Branch of the Department of Finance and Personnel (Northern Ireland). Actuarial services are provided by the Government Actuary's Department (GAD).	Department of Finance and Personnel (Northern Ireland)
DFP Northern Ireland North/South Pension Scheme	The scheme is administered by PricewaterhouseCoopers on behalf of the members bodies. Actuarial services are provided by the Government Actuary's Department (GAD).	Department of Finance and Personnel (Northern Ireland)
HPSS Northern Ireland Superannuation Scheme	The scheme is administered by the HSC Pension Branch of the Department of Health, Social Services and Public Safety (Northern Ireland). Actuarial services are provided by the Government Actuary's Department (GAD).	Department of Health, Social Services and Public Safety (Northern Ireland)
Police Service of Northern Ireland Pension Scheme	The scheme is administered by the PSNI on behalf of the Northern Ireland Policing Board. Actuarial services are provided by the Government Actuary's Department (GAD).	Northern Ireland Office
Northern Ireland Teachers' Superannuation Scheme	The scheme is administered by the Department for Education (Northern Ireland). Actuarial services are provided by the Government Actuary's Department (GAD).	Department for Education (Northern Ireland)
Northern Ireland Firefighters' Pension Scheme	The scheme is administered by the Northern Ireland Fire and Rescue Service.	Department of Health, Social Services and Public Safety (Northern Ireland)
Scottish NHS Superannuation Scheme	All elements of the scheme are administered centrally by the Scottish Public Pensions Agency (SPPA). The SPPA uses the Government Actuary's Department for actuarial services.	SPPA
Scottish Teachers' Superannuation Scheme	All elements of the scheme are administered centrally by the Scottish Public Pensions Agency (SPPA).	SPPA
Parliamentary Contributory Pension Fund (UK parliament)	The scheme is administered RPMI Ltd on behalf of by the House of Commons Pensions Unit. As in local government, some other elements of outsourcing take place, including fund management, actuarial services etc.	Leader of the House of Commons
Scottish Parliamentary Contributory Pension Fund	The scheme is administered by the Scottish Public Pensions Agency (SPPA). Actuarial services are provided by the Government Actuary's Department (GAD). Investment management is also outsourced.	Scottish Parliament

<b>Scheme</b>	<b>Administrator</b>	<b>Regulator</b>
National Assembly for Wales Members' Pension Scheme	The day to day running of the Scheme is carried out by the Financial Services department of the National Assembly for Wales. Several functions are outsourced, including investment management, actuarial services etc.	National Assembly for Wales Remuneration Board
Northern Ireland Assembly Members' Pension Scheme	The Scheme is administered by the Pensions Team of the Human Resources Office of the Northern Ireland Assembly's Resources Directorate. Pensions administration is outsourced to the SPPA, whilst investment management and actuarial services are also outsourced.	Northern Ireland Assembly Commission

**Source: CIPFA, 2010**

## The Scottish Pensions Pathfinder Project

### Background

In 2007, following work carried out under the auspices of the Pathfinder Programme by the City of Edinburgh Council in partnership with Scottish Borders and Fife Councils, the potential for a shared services pathfinder for the Local Government Pension Scheme (LGPS) was identified.

Subsequent discussions in 2008 between the three councils, Scottish Government's Shared Services team, Improvement Service and the Scottish Public Pensions Agency (SPPA) confirmed potential advantages for the Pathfinder organisations could be replicated throughout Scotland. This led to the establishment of a project aimed at identifying opportunities to improve the current arrangements for managing the LGPS in Scotland. Because of the existing relationship between authorities managing the LGPS and administration of the Police and Fire Fighters pension schemes consideration was also given to how their management might be improved. Phase One of the project focused on gathering information on current scheme administration and investment management arrangements, identifying best practice and considering options for improvement.

During the initial stages of the project it was recognised that the extreme challenges presented by the current financial climate has led to a far bleaker financial picture than when the Pathfinder was commenced. Current analysis suggests real reduction in public spending of between 6.7% and 11.4% over the next few years and low growth beyond that for the foreseeable future. Under these circumstances, it was evident that it would be increasingly necessary to fully explore options for efficiency savings achieved through internal improvement or shared services.

In April 2009 Hymans Robertson were commissioned to gather and analyse data on cost and performance for the investment management and administration services *'To establish if there are any opportunities to rationalise and improve with the pathfinder organisations the management of the Local Government Pension Scheme in Scotland including identifying potential broader benefits for the LGPS in Scotland.'* A final report on their findings and conclusions was produced in October 2009.

The Pathfinder Project Board met to review the final Hymans Robertson report, at which time the Board drew conclusions on the analysis and recommendations made by the consultants, and reached a consensus on how best to proceed with the project by outlining a proposed work plan and strategy for Phase Two. This plan encompasses further work to identify the most cost-effective, beneficial administration management and investment management models.

**Table 2: Summary of the Hymans Robertson findings**

	Title	Description
1	<b>Pooling of Investment funds management</b>	<p>There are strong arguments for creating larger pools of assets. The most optimal arrangement would be for this to be a one or two funds structure. This could be achieved by</p> <ul style="list-style-type: none"> <li>– A merger of funds (where all the responsibilities transfer to a new administering authority) or</li> <li>– Create a common investment fund structure (where responsibilities other than investment rest with the current administering authority).</li> </ul>

	Title	Description
2	<b>Single Host for Investment Management</b>	Hymans would recommend a single host structure for investment. But subject to <ul style="list-style-type: none"> <li>– Due account had been taken of the actuarial considerations;</li> <li>– Positive agreement on a suitable structure</li> <li>– Commitment to appropriate resourcing of the host service provider and</li> <li>– Agreement to this was 'hard-coded' into any agreement to implement this solution.</li> </ul>
3	<b>Maintain current non – investment LGPS arrangements</b>	Responsibility for management of other aspects of the LGPS e.g. administration should, on balance, remain with the current administering authorities. Authorities may wish to retain local decisions in respect of <ul style="list-style-type: none"> <li>– Exercising discretions available within the scheme,</li> <li>– Employing their own actuary to determine the pace of funding and</li> <li>– Communication and negotiation with employers.</li> </ul>
4	<b>Investigate administration service levels and costs</b>	Undertake detailed investigation of cost and service levels to inform a decision on the cost/service level balance appropriate to the Scottish LGPS funds. This will enable the most effective service delivery model to be identified.
5	<b>Agree and implement standard administration benchmarks</b>	Implementation of standardised benchmarking of quality and cost of administration to allow like for like comparison going forward.
6	<b>Rationalisation of administration – Police and Fire-fighter Schemes</b>	Further work should be conducted on how to implement merged administration for Police and Fire Fighter schemes.
7	<b>Merger of four smaller funds</b>	Hyman's consider that the four smallest funds are particularly vulnerable and recommend that these funds should be merged with larger funds and the responsibility for the administration and investment of these funds should be transferred to larger entities.

The Pathfinder Project Board concluded that pensions investment management and administration are not the core business of councils and that from a cost perspective the only issue is the rate of employer's contribution which forms a direct cost on the council, and other organisations in the scheme. The opportunity to rationalise administration and investment would help reduce costs and improve long term financial sustainability.

### **Investment Management**

The Board was well aware that the pensions investment market is becoming more complex, with an increasing trend towards diversification. There are also growing pressures to deliver improved governance and strengthen the capacity of trustees to exercise their fiduciary responsibilities. Though these were not thought to be incompatible with current arrangements, simplifying and rationalising those arrangements would allow those pressures to be addressed.

The Pathfinder Project Board was pleased to note Hymans Robertson's view that Scottish LGPS Funds are starting from a relatively good base. However, the Board noted that there were significant risks to the maintenance of that record due to future challenges of

an increasingly complex market, including the growing number of investment solutions available.

The Pathfinder Project Board concluded that changes to investment management are required if these challenges are to be met successfully. Grouping assets into a one or two investment fund structure would present the best opportunity to:

Make savings in external investment management fees (these could be reduced by £8 to £10 million)

Sustain the performance of funds through improving capacity for investment risk management - an improvement in the performance of the Scottish funds by just 0.1% per annum would be worth £20 million

Increase influence in terms of corporate governance, negotiating fees and obtaining tailored approaches from investment managers

Strengthen the capacity for managing pensions in a complex investment environment by creating:

An appropriately resourced Supervisory Board drawing on senior personnel drawn from the investment industry

A pool of full-time professional investment staff, capable of fulfilling all of the functions required in relation to investment decision-making, manager monitoring activity, legal, accounting and compliance functions, etc.

A Scottish 'Centre of Excellence' in pension fund management

Modelling by Hymans Robertson found that a larger fund could produce savings in investment management fees. For example, it would cost approximately £3.7 million in fees for four individual funds of £250 million, but £3.16 million for a single fund four times as large (£1 billion). Similarly, the investment management fees for three funds of £1 billion would amount to £9.47 million compared with fees of £7.10 million for a single fund three times as large (£3 billion).

The grouping of assets into two rather than one investment fund structure could, in the view of Hymans Robertson, prove to be sub-optimal in relation to cost savings due to lower critical mass. Though a two-host model would reduce risk when compared to the status quo, it would be unlikely to be as risk resilient as a single host.

The Pathfinder Project Board believed in principle that a single fund and that full merger rather than merely pooling assets could offer significant benefits over time. This would allow the single host to establish a simplified, professional and clearly defined and strengthened governance structure. The opportunity that this model could offer pensions management would build upon the concept of a Scottish Centre of Excellence, where highly skilled investment management personnel and an appointed Executive could manage a single, fully merged fund centrally.

Whilst the Pathfinder Project Board recognised that while Hymans Robertson presented a strong argument and logic for merger, the consultants recommended the pooling of assets as their preferred option. The Board consider that a modelling exercise was required to fully explore both the merging and pooling options. The Board believe that a detailed comparison of the two models should cover the likely costs involved, the potential for short and long-term savings and improvements to performance management.

Governance of any future arrangement was identified as being key to the projects success. The pooling or merging of funds would have significant implications for the nature and level of local governance through the current administering authorities. The next stage of the projects would therefore need to deal with the necessary technical aspects and also fully address what future governance and oversight will look like in practice.

### **Administration Management**

The Board accepted that the competencies required to administer pensions (member record management, quotations, transfers of service, etc.) are not the same as those associated with managing an investment fund. Consequently, it was content to continue to consider this as a separate workstream.

Hymans Robertson identified key man risk in the current eleven funds, which lead to concerns about the risk of delivering accurate, timely and quality administration services. The Board therefore believed there would be opportunities to rationalise administration management services in order to reduce this risk and make efficiency savings. However, further work was required in this area.

The initial report further highlighted that there needed to be more clarity around responsibilities and roles of scheme administrators, managers and employers. Again, the Board agreed with this position and recognise the need for further work in this area.

In order to fully assess opportunities, there needed to be detailed consideration of service standards, levels of service and costs for administration. Findings could then be considered alongside the investment management modelling exercise by identifying the most appropriate administration solution that takes into account what levels of service are valued and at what cost by employees, pensioners and employers. This would also extend to the administration of the Police and Fire Fighter schemes.

### **Next Steps**

As discussed above, the next stage of the project was the modelling of two potential design solutions for investment management:

#### *Model 1 – Merged Funds*

The model sees the merging of eleven funds into one or two newly created administering authorities<sup>8</sup> focussed on managing all aspects of fund management.

#### *Model 2 – Shared Service – Pooled Investment Funds*

This model proposes a shared service between existing administering authorities where investments are pooled into one or two common investment funds.

It was recommended that both models be assessed together against the status quo (as a baseline for comparative purposes only) to arrive at the most satisfactory solution.

A separate workstream to consider administration management was also required. A key principle regardless of which model is selected is that the administering authority has the responsibility to choose the most cost effective services - from choosing actuaries to

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<sup>8</sup> 'Administering authority' is the term currently used to describe a body required to maintain a pension fund under The Local Government Pension Scheme (Administration) (Scotland) Regulations 2008. It should not be confused with the pensions administration function, which is being considered as part of this project.

providing payroll services. There are no presumptions that direct provision is more desirable than 'outsourced' or 'independent' provision. This issue would remain at the forefront of any recommendations made in terms of investment or administration management solutions.

While it was recognised that it was necessary to include Police and Fire Fighter schemes explicitly in any work carried out, it was considered that the best approach was to first carry out the modelling exercise that can identify the potential impact of any changes and then engage with the appropriate stakeholders to consider their position.

In order to carry out the modelling exercise and activities of both workstreams, further resource was required. It was necessary and desirable to acquire a range of external support to offer expert input, as well as drawing on the investment management and administration expertise within current administering authorities. This allowed for a robust and detailed design of the highest quality. Initial activity in the next stage therefore included a procurement exercise to obtain these skills.

A dedicated project manager was also required with knowledge and experience of providing a thorough and detailed approach to co-ordinating activity and delivering against agreed milestones.

### **Revised Governance and Timeline**

Following the first phase of the project, a reshaped Project Board was established to provide the requisite challenge, direction, leadership and a mechanism for decision-making, including CFOs, investment managers, pensions administrators and HR.

Engagement with trustees through a reference group of the chairs of the 11 'trustee' bodies was also established.

### **Communications**

At various stages in the project, members of the Pathfinder Project Board have engaged directly with stakeholders - SOLACE, Directors of Finance, Pension and Investment and Administration Managers to discuss their conclusions and the way forward.

The purpose of these communications was to inform stakeholders of the conclusions of the Board and to secure their support for undertaking further analysis before coming back with recommendations for the future.

### **Conclusions and next steps**

The Pathfinder Project Board has concluded that the initial Hymans Robertson report makes a strong case for the grouping of pensions investment assets and that this would deliver reduced costs, and improved risk management and investment performance.

Pensions investment management and administration are not the core business of councils and under the current financial climate it is necessary to fully explore opportunities for efficiency savings.

Further modelling in phase two of the project would allow assessment between the merging and pooling options and the viability of a single-host model as opposed to a two-council dual host model. A separate administration management work-stream has been established to investigate service levels, standards and costs.

The Board believed that larger funds would manage risk, reduce cost and strengthen the capacity to manage pensions in a more complex and challenging market environment.

The project is progressing well with full engagement of all eleven funds within both the Investment and Administration Management workstreams.

The research for the Investment Management Workstream will be carried out by consultants who will begin work in November 2010.

The research for the Administration Management Workstream is already underway with analysis planned for September to December 2010 by a senior pensions officer.

Summary reports of the first two workstreams will be produced in March 2011, with progression to workstream three (Governance and Implementation Planning) being dependent on the direction of travel set out in the summary reports.