Self-sufficiency is the key

Addressing the public sector pensions challenge

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CONTENTS

Foreword
The vision
Guiding principles
Summary
The proposals

Introduction 1

Part I: The evidence
1. Unaffordable public sector pensions 2
2. Unfair public sector pensions 13
3. The political context 23

Part II: Alternative Frameworks
4. Risk sharing 32
5. Funded or unfunded pensions? 48

Part III: The Reforms
6. Prepare the ground 55
7. Compulsory participation in NEST (for the public sector) 60
8. Pensions reform; two alternative frameworks 63
9. Modelling the "cautious" framework 69
10. The Local Government Pension Scheme (LGPS) 74

Part IV: Implementation
11. The communication challenge 81
12. Lessons from the Isle of Man 87

Conclusion 91

Acknowledgements 93
Appendices 94
Glossary 104

FOREWORD

In this outstanding contribution to the debate on public pensions, Michael Johnson sets out a powerful analysis of the cost and challenges of funding current public pension schemes and provides a rigorous review of the alternative policy options. Following on from his previous analysis of the private pensions funding crisis *Simplification is the key: stimulating and unlocking long term saving*, he has provided an invaluable overview of the critical policy choices that any UK government must address in ensuring that future generations have an adequate, yet affordable, source of retirement income.

As an essential starting point, he makes a powerful case for ensuring that all citizens – whether employed in the private or public sectors – have the bedrock assurance of an adequate basic (and non means-tested) State Pension. They would then be better positioned to build additional retirement income through a combination of NEST, other pension plans and private savings. However, he points out clearly the funding and social equity issues that arise if we seek to maintain the existing 'defined benefit' scheme with guaranteed retirement benefits linked to final salaries for public sector workers. To many, this appears inequitable, given that an increasing proportion of private sector employees are being moved into 'defined contribution' schemes without a guaranteed benefit level in retirement, and with the individuals bearing the risk of both investment returns and reducing annuity rates, as longevity rises. The options he explores set out alternative ways of addressing these challenges and seek to bring greater equity across the public and private sectors, while avoiding a 'race to the bottom', and recognising the different roles that government could play in taking on risks and providing assurance for all citizens.

While different readers may reach different conclusions about which of these options is to be preferred, the clarity of Michael Johnson's analysis can only help in ensuring the debate is well-informed and properly understood across the political spectrum.

Lord Blackwell　　　　Baroness Hollis of Heigham

THE VISION

Comparable pensions, irrespective of employment sector

The long term vision is that people with similar skills and responsibilities (whilst working) should have broadly equivalent incomes in retirement, irrespective of where they worked. Given that there is little prospect of private sector occupational pension schemes returning to any form of defined benefit (DB)-based provision, public sector pensions should be, ultimately, defined contribution (DC)-based, perhaps on a collective basis (to share risk amongst scheme members). Not to express such a vision is to conclude that the quality of pension provision in the (wealth-creating) private sector will, from hereon, be second class.

The principal objective is to ensure that pensioners will not be living in poverty. For this reason, a broader perspective, of pensioners' *total* retirement income, is required, i.e. taking into account the State Pension. And whilst the cost of public sector pensions has to be reduced, this should not be achieved by participating in a "race to the bottom" vis-à-vis the quality of private sector provision.

Political consistency

This vision is consistent with the prevailing political ethos, that of a responsibility revolution which is intended to encourage people to assume more personal responsibility; this includes responsibility for the financial consequences of their own longevity. It is unfair to expect subsequent generations, or co-generational taxpayers, to assume the longevity risk of others, whilst also having to provide for their own retirement.

But……patience is required

It is, however, recognised that transitioning, in a single episode of reform, public sector workers who are currently on final salary-based pensions to a pure DC framework is a risky proposition. At a time when the public sector is concurrently facing a pay freeze, the risk of job losses and rising taxes, there is a considerable risk that reform implementation would be disrupted by union action.

Nonetheless, whilst the vision of a pure DC framework may not be immediately realisable, that does not render it unreasonable.

GUIDING PRINCIPLES

The following guiding principles have helped shape this paper.

i. Whilst reforming public sector pensions, we have a golden opportunity to catalyse a broad-reaching savings culture amongst 20% of our workforce. This is in their and the UK's, long-term interests.

ii. The generational inequality associated with mature pension schemes has to be arrested and then, ideally, reversed.

iii. Whatever reforms are introduced, they should not defer today's labour costs by, for example, improving short-term cashflow at the expense of increasing future liabilities, however politically attractive that may be.

iv. Funded pension schemes are more transparent than unfunded ones, which readily accommodate opacity. Unfunded schemes also harbour greater behavioural risk, notably the temptation to defer some of today's employment costs (fuelling generational inequality).

v. The state's capacity to absorb pensions-derived longevity risk is limited; such capacity should be utilised solely within the State Pension, rather than allocated in favour of any particular employment sector.

vi. Reforming public sector pensions is foremost an exercise in effective communication to influence behaviour, not least to ease the subsequent implementation process. Widespread industrial unrest would only hinder the UK's competitiveness, and economic recovery.

vii. Ideological differences (be they in respect of social or economic policy) should not distract us from the pursuit of a sustainable framework for public sector pensions. Indeed, de-politicisation is a crucial ingredient for successful reform.

viii. The proposals within this paper should be consistent with the guiding principles of a previous paper, *Simplification is the Key.*[1] Indeed, they should be considered sister papers.

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[1] Michael Johnson, CPS, June 2010.

SUMMARY

Mature pension schemes are pyramidal

- Today's public sector pensions framework is unaffordable and unfair; i.e. unsustainable. It is akin to a Madoff-style pyramid, now collapsing under the weight of insufficient contributions, rising longevity[2] and demographic change.[3] The forthcoming workforce contraction will exacerbate the problem; without reform, we are embarked upon a slippery slope to fiscal calamity.

- The rapidly growing unfunded liability is alarming, but not the central issue. Annual cashflow is the primary concern, notably the Treasury's obligation to make good the rapidly increasing annual shortfall between contributions and pensions in payment. In 2005-06 this was an immaterial £200 million; by 2015-16, it is expected to be more than £10 billion, and rising. When added to employer contributions, the taxpayers' share of public sector pension contributions is nearly 80%; this is unreasonably high.

Pensions inequality could lead to societal division

- Pensions inequality is manifesting itself in four different respects: the growing gulf between the quality of public and private sector pensions provision; the disproportionately high pensions paid to high earners; the emergence, within the private sector, of two-tier workforces as a consequence of TUPE and Fair Deal pension protection; and looming generational inequality. The latter manifests itself as a rising tax burden on today's workers, who then have less to save for their own retirement.

Prepare the ground; raise the basic State Pension

- As a pre-requisite to reforming public sector pensions, the basic State Pension (BSP) should be raised to a flat rate above the Guarantee Credit threshold to, say, £140 per week.[4] This would boost the income replacement ratio[5] of low earners, to allay pensioner poverty concerns, and it would then pay to save. In addition, such a move would help in union negotiations over public sector pensions.

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2 Some 10 million people in the UK today can expect to live to see their 100th birthday, 17% of the population; *DWP; Number of Future Centenarians,* December 2010.

3 The population of retired public sector workers is expanding relative to the workforce, and living longer, i.e. the pensioner support ratio is deteriorating.

4 Rumoured to be under discussion within government (December 2010). In parallel, S2P and Pension Credit should be terminated (preserving accruals), a dramatic simplification of the pensions landscape.

5 Retirement income as a percentage of salary at retirement.

"Quick wins" needed… but the choice is limited

- There are two quite different approaches to closing the cashflow gap, thereby eliminating the Treasury's exposure to pension costs. The Treasury's preference is likely to be for "quick wins", i.e. immediate cashflow savings. The alternative is to reverse the growth of the total liability, by reining in future benefit promises, but this would only produce cashflow savings very slowly. In practice, both should be pursued.

- The most simple quick win is to raise employee contributions (widely signalled as inevitable), but pensions in payment could also be cut (albeit very challenging, politically), the LGPS could be moved onto an unfunded basis (a Machiavellian move that would reduce transparency), and the option to contract out of the Second State Pension (S2P) could be removed. The latter would produce an immediate cashflow benefit of some £1.5 billion per year;[6] it should be pursued, with full preservation of S2P rights accrued to date.

Funded is fairer….and cheaper

- The unfunded status of (most) public sector pensions is exacerbating schemes' lack of sustainability. Unfunded schemes harbour behavioural risk, notably the temptation to defer some of today's employment costs, fuelling generational inequality. They are also, in the long term, more expensive, as the Audit Commission has pointed out.[7]

- This paper proposes a two-pronged approach for starting to tip-toe towards at least a *partially* funded framework;[8] compulsory NEST participation for public sector employees, and limited seeding with indexed-linked gilts. This would reduce the cost of pensions provision, substantially improve transparency[9] and, crucially, help stimulate a savings culture, subsequently boosting investment.

Compulsory NEST participation

- All public sector employees with annual earnings of more than £10,000 should be compelled to participate in NEST. Given the expected widespread private sector NEST participation, this would help make real the Chancellor's "we're all in this together."

- By a quirk of coincidence, the rumoured rise in contributions (3% of salary) is, for the average earner, close to the proposed employee contribution rate into NEST; 4% of NEST band earnings (not salary). The Treasury would rather have the additional 3% for itself, but foregoing this cashflow would be consistent with its own "spend to save" thinking.[10] The

6 This figure excludes private sector schemes still contracted out. Note that the LGPS accounts for some £500 million of this, and contracting the LGPS back into S2P would leave a legacy S2P liability.

7 Audit Commission; *Local government pensions in England*, July 2010. Funded schemes should be able to achieve a better long-term return on investment than the cost of government borrowing (necessary to fund the growing cashflow shortfall between contributions and pensions in payment).

8 It is recognised that fully funding the public sector's pension liabilities should be, at best, a very distant objective (requiring the accumulation of c. £1,000 billion of assets, in today's money terms).

9 It would be easier to hold employers to account, directly compare the quality of public and private sector schemes and ensure that pension promises appear on the nation's balance sheet.

10 "Spend to save" thinking is encapsulated in both the Treasury's Green Book and the Office of Government Commerce's Common Minimum Standards (OGC is part of the Efficiency and Reform Group of the Cabinet Office).

long-term benefit of catalysing a savings culture amongst a significant proportion of the working population would outweigh the associated costs. The Treasury would, however, have to meet the associated cost of tax relief.

- Given compulsory NEST participation, the state should consider absorbing the 1.8% NEST subscription charge, at a cost of some £64 million per annum. This would be a small price to pay, if it succeeded in catalysing a savings culture amongst 20% of the working population (also consistent with the "spend to save" philosophy).

Limited seeding with index-linked gilts

- Unfunded schemes could be "seeded" with tradable securities, to move them towards a funded status; the Treasury could simply deliver new index-linked gilts to the schemes; there would be no exchange of cash. This would not create *additional* liabilities; the Treasury would have an obligation to service the gilts for interest and principal, *obligations it is already, ultimately, faced with,* albeit today characterised as unfunded pensions liabilities. Pensions contributions would continue to flow to the Treasury.

- Treasury concerns that seeded gilts may subsequently depress secondary market prices could be assuaged by limiting maturities to £5 billion per annum, say. After 2020, employers could be required to reimburse the Treasury its gilt repayments. This would pressurise them to exert more control on their pension promises, thereby setting in motion the process of employers transitioning, very slowly, to a funded pensions framework.

- It would be crucial to clearly, and repeatedly, communicate that gilts seeding would not change the UK's credit worthiness; the rating agencies should be specifically briefed. Indeed, such a move would enhance transparency (reducing risk); we would simply be crystallising part of the pensions liability and surfacing it in the national accounts.

One size does *not* fit all

- The public sector's unfunded schemes do not have standardised benefits. Consequently, ahead of any reforms, schemes are starting from quite different positions. Harmonising pension schemes across the public sector, by imposing a "one size fits all" universal scheme, would face significant, and unnecessary, implementation challenges.

A single objective for pension schemes; cashflow self-sufficiency

- Public sector pensions schemes should be required to become cashflow self-sufficient, thereby eliminating the Treasury's (i.e. taxpayers') open-ended exposure. Self-sufficiency is a mechanism by which innocuous accounting entries and nebulous measures (such as the liability) would increasingly be overshadowed by the reality of cashflow discipline. It should, for example, place a constraint on employers' largesse with regards to the ongoing accumulation of unfunded pension promises. Pension schemes that are cashflow self-sufficient, i.e. not reliant on Treasury pit-propping, are likely to be sustainable.

- Pension schemes management, appropriately empowered and accountable, and working with employers, should be given discretion as to *how* they achieve cashflow self-sufficiency.

Two alternative frameworks; one brave, one cautious

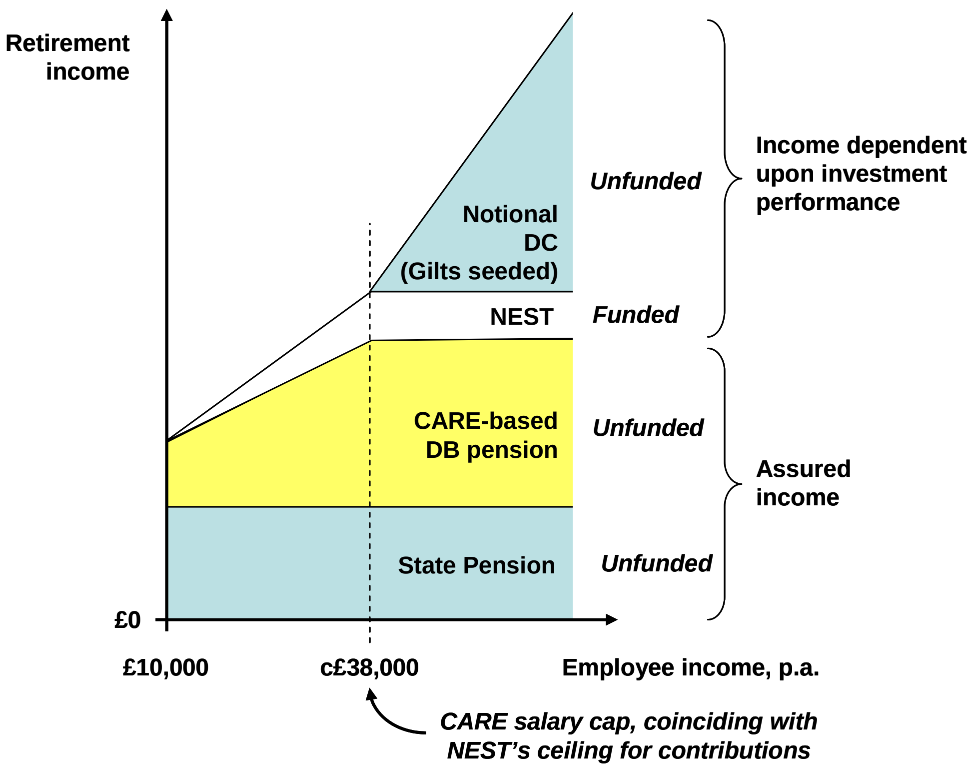
- The implementation risk that would accompany pensions reform outweighs the risks traditionally associated with pensions (investment, inflation and longevity). Furthermore, it is comingled with political risk, which could materialise as industrial unrest. With this in mind, this paper proposes two alternative frameworks for reform, labelled, from an implementation perspective, "brave" and "cautious". It is for the Government to choose between them.

- The Government's "brave" approach should be to timetable the closure of the public sector's DB schemes, and then move to a notional DC framework, with implementation by 2020, say. Employees' accounts should be seeded with index-linked gilts, in an amount that reflects the annual increase in the state's liability. Employees should be allowed to exchange gilts for other, higher risk/higher return assets, *at their own risk*. At retirement, the account balance could be used to purchase an annuity.

- One by-product of the "brave" approach would be to concentrate all the state's pensions-derived longevity risk into the State Pension. This would be an equitable use of a limited resource.

- The Government's "cautious" framework should comprise a CARE[11]-based DB scheme up to a salary cap, with a gilts-seeded, notional (i.e. unfunded) DC scheme above it, leading to an annuity at retirement.

The "cautious" framework



[11] Career Average Revalued Earnings.

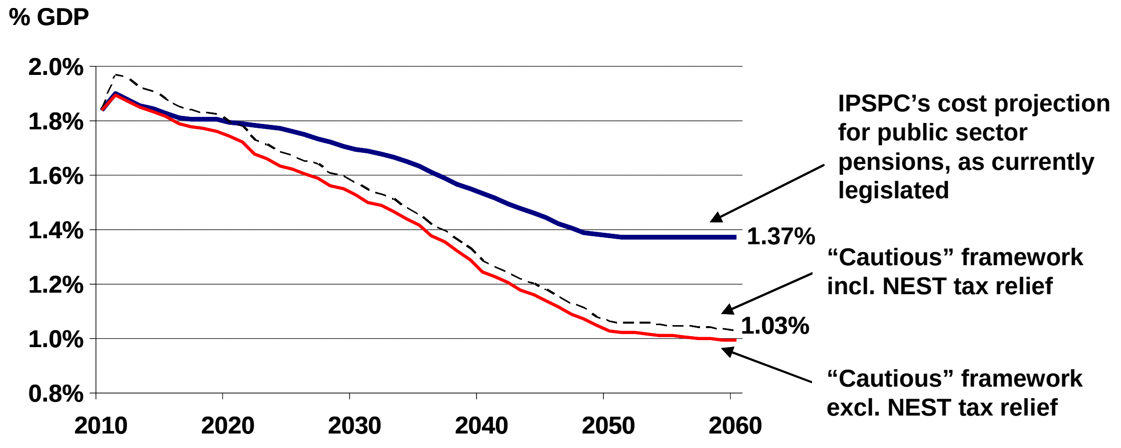
The "cautious" framework; Treasury guidance

- In addition to requiring cashflow self-sufficiency, if the Treasury were to adopt the "cautious" framework it should provide "recommended" parameters *for guidance purposes only.* These should include a salary cap to coincide with NEST's contributions ceiling (expected to be around £38,000), with an unfunded[12] notional DC scheme above the cap. The CARE DB accrual rate should be 1/60th, the notional DC scheme should be equivalent to roughly 19% contributions, revalued (pre-retirement) at 5% per annum. At retirement, the annuity conversion should be based on expected long term yields, with a Normal Pension Age (NRA) of 65 for new entrants (subsequently retreating with the State Pension Age).

"Cautious" framework; cost as a percentage of GDP

- The "cautious" framework's recommended parameters emerged from comparing alternative scheme designs with the IPSPC[13]'s central projection for the cost of public sector pensions (based upon public sector pensions *as currently legislated*).[14] The objective is to produce a meaningful cost reduction, expressed as a percentage of GDP, relative to the IPSPC's projection.

- By 2060, the "cautious" framework, with the recommended parameters, would save approximately 0.34% of GDP, i.e. a 25% reduction on the IPSPC's cost projection of 1.37% of GDP.



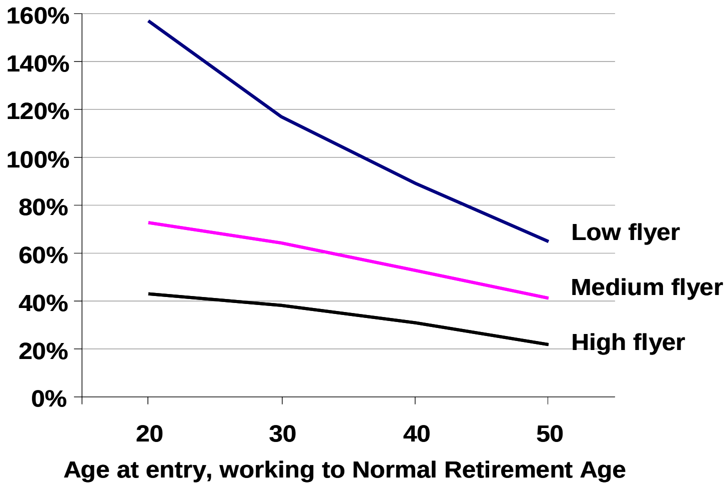
[12] Unfunded in respect of schemes that are currently unfunded.

[13] The Independent Public Service Pensions Commission, chaired by Lord Hutton.

[14] *IPSPC; Interim Report; Appendix C, Chart C2,* 7 October 2010.

“Cautious” framework; adequacy and the replacement ratio

- The replacement ratio of employees on low, medium and high income trajectories has been considered to assess the adequacy of the CARE DB’s recommended parameters.



- The low flyers’ very high replacement ratios are explained by their starting salaries not growing in real terms during their careers, so they would be, effectively, on a final salary scheme (but at a low level in Sterling terms). The (fixed) State Pension would also disproportionately enhance the replacement ratio of the lower paid; the recommended parameters clearly protect the low paid in retirement.

“Cautious” framework; distribution of longevity risk

- The notional DC and NEST components of the “cautious” framework would transfer longevity risk from the state to the individual, increasingly so as salary rises.

	Age at entry / Years accrual				
	20/48	30/38	40/27	50/16	
Low flyer	2%	5%	5%	4%	Proportion of longevity risk assumed by the individual
Medium flyer	9%	9%	8%	6%	
High flyer	21%	27%	38%	45%	

- Low flyers’ retirement income would be largely immunised from longevity risk, i.e. the risk resides with the state. Conversely, high flyers starting late in the public sector would be assuming almost half of their own longevity risk in retirement, having relatively few years of CARE DB accruals. The value of this risk transfer from the state to the individual is hard to quantify, but it is likely to be significant.

Contributions

- The only proposed increase in employee contributions should be in respect of compulsory participation in NEST; equivalent to roughly 3% of salary for someone on average earnings. The IPSPC’s cost projection includes employee contributions equivalent to roughly 0.33% of GDP. Assuming the division of contributions between employer and employee is unchanged, and given that the total cost is expected to fall from 1.37% to 1.03% of GDP, the employees' share of the cost would rise from 24% to 32% of GDP[15] by 2060 (for the "cautious" framework).

Implementation

- Pension scheme management, working with employers, should not be compelled to precisely adopt the Treasury's recommended parameters; they may change them, either unilaterally or in negotiation with the unions. In extremis, to minimise change (people do not like change), the CARE-based "chassis" could, for example, be adopted without a salary cap (there would then be no notional DC scheme). The accrual rate would have to be slowed to roughly 1/62[ths] to stay within the same cost envelope (i.e. reaching 1.03% of GDP by 2059-60).

- Scheme management should be free to incorporate in their pension schemes whatever "safety valves" they deem necessary, for the purpose of sharing risk to control pension costs. These could include conditional indexation of benefit accruals, lump sum payments and, contentiously, pensions in payment. Other countries already include pensioners in the risk sharing arena; we should serious consider doing likewise, not least to reverse the emerging generational inequality.

Communicate….or risk failure

- Successful implementation requires clear communication amongst stakeholders. Consequently, whilst structural complexity can be intellectually rewarding, it should be eschewed. The sophisticated balancing mechanism within Sweden's Notional DC scheme, for example, should not be adopted. The Netherland's Collective DC does have its merits, including the socialisation of risk amongst members, and its assertive control levers (notably conditional indexation) to protect taxpayers. But all this comes at the price of complexity, making communication with members that much more challenging. Both these structures are discussed in this paper.

Local Government Pension Scheme (LGPS)

- The LGPS is significantly underfunded; the asset cover ratio is only some 75%, leaving a shortfall of £54 billion (£95 billion if liabilities are discounted using the gilts yield curve). Consequently, if the "cautious" framework were to be pursued, the Treasury's guidance package should be "strongly recommended" to the LGPS, albeit with the CARE-based, DB provision and any cash balance scheme both on a funded basis. Individual funds should be able to opt out, *provided* they have a funding ratio in excess of 90%, say, and can demonstrate a robust recovery plan, lasting no more than ten years.

- The LGPS governance framework is complex and ineffective. Each of the three key drivers of pension cost (asset performance, benefits and wages) are managed by different bodies (local government, via the administering authorities, central government and employers, respectively); it is perhaps no surprise that the LGPS is in such trouble. A single, trust-based, Board should be appointed to be responsible for all decisions

[15] 24% is 0.33%/1.37%, to 32% is 0.33%/1.03%.

concerning the sustainability of the LGPS, adhering to the same principle of cashflow self-sufficiency as the unfunded schemes.

The Isle of Man's experience

- The Isle of Man's (ongoing) reform of its public sector pensions is providing some valuable insights, not least because it represents a microcosm of the UK's public sector. The unions' ability to lead their members' views has enhanced the resistance to change, and communication is exacerbated by conflicted employers and a poor appreciation of the value of a final salary pension. It has become clear that offering choice is important, as it gives employees a sense of being in control; they would prefer, for example, to contribute more to keep existing benefits, rather than freeze contributions and lose benefits. But such flexibility comes at a price; structural complexity, adding to the challenge of communicating effectively with employees.

- Multiple rounds of stakeholder consultation have taken far longer than initially envisaged; the risk sharing negotiations have been particularly difficult. Implementation is not expected to start until more than five years after project inception, and transition is expected to last up to a further seven years. This is a potentially depressing harbinger for the forthcoming, nationwide, reform process.

The Independent Public Service Pensions Commission (IPSPC)

- The purpose of this paper is to contribute some actionable ideas to the IPSPC which, under Lord Hutton's chairmanship, is expected to report in Q1 of 2011. Consequently, this paper considers the four guiding principles identified in the IPSPC's interim report, namely: affordability and sustainability; adequacy and fairness (vis-à-vis the private sector, and within the public sector itself); transparency and simplicity; and supporting productivity (in respect of outsourcing to the private sector).

- This paper includes thirty five actionable proposals, developing some of the ideas outlined in an earlier paper,[16] but since its publication, the political context has changed, fundamentally.

- This paper was partly inspired by the 2010 Reith Lectures, delivered by Lord Rees,[17] his central theme being "scientific horizons". Many of the points that Lord Rees touched upon resonate strongly with the challenges facing pensions policy makers, notably the payoff for decisions taken today often being decades later (which is at odds with the electoral cycle); people's "irrational approach to risk assessment"; and the importance of transparency and good governance.

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[16] Michael Johnson, *Don't let this crisis go to waste: a simple and affordable way of increasing retirement income,* CPS, September 2009.

[17] Martin Rees, President of the Royal Society and Master of Trinity College, Cambridge.

THE PROPOSALS

Proposal 1: The size of unfunded public sector pension schemes' liabilities should be determined using the index-linked gilts yield curve for discounting, not the AA-rated corporate bond yield curve.

Proposal 2: The discount rate used to calculate employer contributions in the SCAPE model should be amended along the lines adopted by the Bank of England in 2005; the index-linked gilts yield curve should be used.

Proposal 3: Public sector pension schemes should utilise accruals-based accounting, so that the future cashflow implications of pension promises are more transparent.

Proposal 4: All public sector outsourcing contracts should:

- automatically grant "participating employer" status to bidding contractors;
- exclude pensions from the bidding process;
- require awarding bodies to pay the employer contributions;
- include an indemnity ("pass-through" arrangement) from the awarding authority that ensures that the contractor has no exposure to pre-contract accrued pension costs; and
- in respect of the LGPS, apply a consistent valuation methodology, at the start and at the end of an outsourcing contract.

Proposal 5: All contracting out should cease (public *and* private sector DB schemes), with full preservation of S2P rights accrued to date.

Proposal 6: Public sector pensions reform should be accompanied by initiatives to resuscitate private sector pensions provision. These could include:

- unwinding the regulations which converted discretionary benefits into onerous, legally hard-wired, pension guarantees;
- amending employment and pension scheme legislation to remove ancillary benefits that are not directly related to pension provision; and
- lobbying the Accounting Standards Board (ASB) to soften the accounting treatment of pensions, notably FRS17.

Proposal 7: The cap and share framework should be replaced by other, more assertive, cost control levers. It lacks ambition as it is expected to only save £1 billion a year from 2012-13, whereas the gap between contributions and pensions in payment is likely to exceed £10 billion by 2015.

Proposal 8: There should be a new chapter in the Budget Report which includes cashflow forecasts of public sector pensions in payment, and a description of how they will be financed.

Proposal 9: The Government should seed unfunded pensions schemes with £5 billion (say) of index-linked gilts maturing every year. After 2020, employers should be required to reimburse the Treasury its gilts repayments.

Proposal 10: All accrued pension rights should be protected.

Proposal 11: Pension scheme reforms should apply to *all* members, irrespective of their age or length of service; there should be no "grandfathering".

Proposal 12: As a pre-requisite to reforming public sector pensions, the basic State Pension should be raised to a flat rate above the Guarantee Credit threshold to, say, £140 per week per person (as is currently being discussed).

Proposal 13: Each public sector pension scheme should be required to become cashflow self-sufficient within a specific timeframe, to be individually negotiated with the Treasury.

Proposal 14: Employers and pension scheme management should be formally linked to establish total remuneration packages alongside a strategy for achieving pension scheme cashflow self-sufficiency.

Proposal 15: Pension schemes management, working with employers, should be given discretion as to *how* they will make their schemes cashflow self-sufficient. Their plans should be made public.

Proposal 16: Pension schemes should be free to incorporate whatever safety valves they consider necessary for the purpose of controlling their pension costs. These could include conditional revaluation of benefit accruals and conditional indexation of lump sum payments and pensions in payment.

Proposal 17: All public sector employees with annual earnings of more than £10,000 should be compelled to participate in NEST, contributing a minimum of 4% of NEST "range earnings", with attendant tax relief.

Proposal 18: Employers should be free (but not compelled) to contribute to NEST, accepting that they may be overruled by the Treasury out of consideration for its own cashflow requirement.

Proposal 19: The state should consider absorbing the 1.8% NEST subscription charge, consistent with the Treasury's philosophy of "spend to save".

Proposal 20: The Treasury should issue a guidance package to pension scheme managers, detailing its preferred reforms. Scheme management would not be obliged to adopt the package, provided they can convince the Treasury that their own plans would achieve cashflow self-sufficiency, within the agreed timeframe.

Proposal 21: The Government should consider two alternative frameworks for pensions reform, one brave, one cautious, before deciding which one to include within the Treasury's guidance package.

Proposal 22: The Government's "brave" approach should be to timetable the closure of the public sector's DB schemes, and then move to a notional DC framework, with implementation by 2020, say. Employees' accounts should be seeded with index-linked gilts, in an amount that reflects the annual increase in the state's liability. The gilts should be exchangeable for higher risk/higher return assets, at the employees' own risk. At retirement, the account balance could be used to purchase an annuity.

Proposal 23: The Government's "cautious" framework should comprise a CARE-based DB scheme up to a salary cap, with a gilts-seeded, notional (i.e. unfunded) DC scheme in respect of earnings above the salary cap. At retirement, the account balance could be used to purchase an annuity.

Proposal 24: Ancillary benefits should be stripped out of core pension provision. They should be made available separately, at the employees' expense.

Proposal 25: If the "cautious" framework were to be selected, the Treasury should recommend a CARE-based DB scheme (1/60th accrual rate) to a salary cap coinciding with NEST's contribution ceiling (expected to be c. £38,000). Above the cap there should be a notional DC scheme equivalent to roughly 19% contributions, revalued (pre-retirement) at 5% per annum.

Proposal 26: Aggregate contributions across the public sector should remain broadly unchanged, *excluding* employees' compulsory participation in NEST. The division of contributions between employer and employee would be for negotiation.

Proposal 27: The LGPS should adopt a funded version of whichever of the "brave" and "cautious" approaches is proposed by the Government. If the "brave" route were selected, there would be no need for employees to participate in NEST.

Proposal 28: The convoluted LGPS governance framework should be replaced by a single, trust-based Board, responsible for all decisions concerned with the sustainability of the LGPS.

Proposal 29: The LGPS Board should be empowered to:

- set fund-specific accrual and contribution rates;
- superimpose indexation-driven safety valves on an individual fund;

- set solvency parameters and then place wayward funds into "special measures" (i.e. the Board would assume direct control);
- permit individual funds to opt out of the new framework (be it "brave" or "cautious"), *provided* that they have a funding ratio in excess of 90%, say, and can demonstrate a robust recovery plan;
- encourage smaller funds to merge; and
- encourage fund administration activities to merge (irrespective of whether funds themselves merge).

The Board should *not* have any say in respect of investment policy (administering authorities should continue to do this), nor wages, which should be left to employers.

Proposal 30: The principles of cashflow self-sufficiency should be extended to the new LGPS Board, with no prospect of any financial support from the Treasury.

Proposal 31: Each LGPS fund should be required to adhere to the same standards of information disclosure as private sector occupational schemes. Furthermore, they should adopt the same disciplines, for example in respect of any deficit recovery plan, which should be concluded within ten years.

Proposal 32: A cap should be placed on the proportion of council tax income that could be allocated to LGPS pension funds, thereby protecting the delivery of services.

Proposal 33: All public sector employees should be given a monthly Total Reward Statement (TRS), rather than the conventional pay slip, to include the value of that month's pension accruals, expressed in terms of present day money.

Proposal 34: It should be an objective of public sector employers to emulate the private sector by providing access to workplace-based savings platforms (to include NEST assets).

Proposal 35: The behavioural "learnings" garnered from the Isle of Man's pensions reform experience should be included in the guidance package for scheme management and employers. It would be advantageous, from a negotiation perspective, if schemes were flexible enough to accommodate *individual* needs; for example, a non-specific retirement age (i.e. the later that people retire, the larger their pension).

INTRODUCTION

Few would dispute that public sector pensions are unsustainable, unaffordable and unfair.[18]

To date, public sector pensions have not been on the political agenda. In the run up to the last general election, all the major parties were silent on the issue, not least because change implies that many people would lose out financially. Post-election, the Independent Public Service Pensions Commission (IPSPC) has extended the period of tranquillity, but Lord Hutton will report in early 2011, at which point the responsibility will pass back to the Government. And it will have to confront economic and societal reality, and negotiate with the unions.

Not only are public sector pensions politically challenging, but there are few, if any, themes more loaded with technical detail and jargon; perfect material for obfuscation and bamboozlement. Reforming public sector pensions will be primarily a communications, rather than technical, exercise, and success will require transparency, today seriously lacking.

The opacity of our predominately unfunded public sector pensions framework masks the largest risk, rising longevity, which is outside of our control. Historically, this has been countered by economic growth, but this is a risky strategy because it exposes taxpayers to the mismatch between the fixed cost of final salary-based pensions and economic performance, a variable, which drives the country's ability to pay for pensions. The issue is compounded by other demographic risks, notably the deteriorating dependency ratio[19] (workers per pensioner).

Today's lack of risk sharing between employees and taxpayers (public sector employers are merely acting as agents on behalf of taxpayers) unfairly places all of the risks with the taxpayer. Resentment is on the rise, the quality of private sector pension provision having been in retreat for decades, revealing the relative generosity of public sector pension provision. Without reform, taxation will have to rise, reducing individuals' capacity to save and companies' ability to invest, thereby eroding our economic competitiveness. This is not in the national interest.

[18] The fairness issue is three dimensional; it is generational, sectoral (between the private and public sectors) and internal to the public sector.

[19] The unfunded basic State Pension is beset by the same problem.

PART ONE: THE EVIDENCE

1. UNAFFORDABLE PUBLIC SECTOR PENSIONS

There are two broad themes concerning the sustainability of public sector pensions; affordability and fairness. Chapter 1 considers affordability and Chapter 2 looks at fairness, comparing the quality of pension provision between public and private sectors and between generations, and also equality issues within the public sector itself. Chapter 3 considers the political context.

1.1 Background

(a) Different perspectives

"Unaffordable" is a subjective term; from whose perspective are public sector pensions unaffordable? On this issue, current and future recipients of public sector pensions are unlikely to agree with private sector businesses and employees. What is clear is that, unless there is reform, the burden on taxpayers, including private sector business, will continue to rise. This is simply because the population at large is, indisputably, ageing and therefore living longer in retirement, and the growth rate of our (developed) economy is lagging behind rising pension costs.

Consequently, doing nothing is only an option if we, as a society, accept that public sector pensions should absorb an increasing proportion of state resources; that consensus is not in evidence.

(b) Great scope for confusion

What does "cost" really mean?

Shortly after the last election, Nick Clegg, the Deputy Prime Minister, sowed confusion by saying that "the cost of paying for the pensions of millions of public sector workers will more than double within four years".[20] He was referring to the Office for Budget Responsibility's (OBR) figures that suggest that the Treasury's obligation to plug the shortfall between contributions and public sector pensions in payment will jump from £4 billion a year in 2010-11 to £9 billion a year by 2014-15.

But is this cashflow gap the right measure of "cost"? If Nick Clegg was focussing on the state's contribution, then employer contributions should also be included, some £12.4 billion in 2008-09 (in respect of the four largest unfunded schemes, albeit partially offset by the surplus cashflow from the funded LGPS). Furthermore, the "cost" should not just focus on this

[20] At the Institute for Government, Monday 14 June 2010.

year's cashflow, but also take into account the cashflow consequences of this year's *promises*, i.e. accrued pension rights. This would certainly encourage employers to plan for how to meet future cashflow requirements.

The core problem

Alternatively, Nick Clegg could have described the core problem; the persistent under-estimate of the value of the pension promise, leading to insufficient contribution rates. Increasing longevity and inappropriate methodology (notably concerning discount rates, discussed later) are to blame.

The cashflow gap, to which Clegg was referring to, is a more readily apparent issue, but it is a *consequence* of the core problem. The gap is now growing because most pension schemes have matured; the population of retired public sector workers is expanding relative to the workforce (and living longer).

Communicating the underlying issues is difficult, not least because there is a generational disconnection between today's cashflow requirement and the promises being made. Contribution rates are intended to reflect the size of the pension promise, *not* today's cashflow requirement. Cashflow and accruing promises have to be kept distinct. The former is obvious and immediate, whereas the latter is intangible and harder to quantify (the "liability" being the present value of the accumulating promises). But cashflow and pension promises are connected because the latter subsequently manifests themselves as demands for hard cash (i.e. pensions in payment).

Furthermore, the lack of transparency derived from the unfunded nature of most public sector pension schemes only adds to the communications challenge.

1.2 Measuring the cost

There are two alternative approaches in common use when assessing pension costs. Economists working in finance ministries and international organisations (such as the OECD), express spending as a share of future GDP. Actuaries and accountants, however, tend to focus on the present value of the liabilities (if an unfunded scheme) or any valuation gap between assets and liabilities (funded schemes).

(a) Cost as a share of GDP

Before the June 2010 budget

Table 1 shows the projected annual expenditure (i.e. pensions in payment) on unfunded public service pension schemes *before* the June 2010 Budget. The cost of State Pensions is shown for comparison.

Table 1: The cost of unfunded pensions (as a percentage of GDP)[21]

	2009-10	2019-20	2029-30	2039-40	2049-50	2059-60
Public service pensions	1.7%	1.8%	1.9%	1.8%	1.7%	1.7%
State pensions	5.5%	5.3%	5.9%	6.5%	6.5%	6.5%

It should be noted that projecting GDP out 50 years is risky, so relying on these forecasts of pension costs should be done cautiously. Some of the underlying assumptions (particularly for productivity growth) will, almost certainly, prove to be wrong, and the compounding of any misassumptions leaves significant scope for error.

The National Audit Office's (NAO) recent report specifically identifies the danger of expressing public service pensions costs as a proportion of GDP, the risk being that *"GDP growth is permanently lower than expected*."[22]

The June 2010 budget and CPI indexation

The June 2010 Budget changed the basis of indexation for future public sector pensions growth from the Retail Price Index (RPI) to the Consumer Price Index (CPI).[23] Whether the CPI is the "right" index to use for the indexation of pensions is a moot point, when the driver for the change is to save money.[24] CPI is usually a smaller number than RPI; over the last 15 years, it has averaged some 0.8% less than RPI, and over the next five years that gap is expected to widen to 1.2% a year.[25]

Consequently, pensions will grow more slowly in future, reducing the value of benefits by some 15% and therefore saving money.[26] The total reduction is nearer to 25% once the other reforms (such as cap and share) are included. The gross cost of paying unfunded public service pensions is expected to fall from 1.9% of GDP in 2010-11 to 1.4% of GDP by 2060,[27] which invites the question, is there really a problem?

Too little, too slowly

The main issue is that the recent reforms deliver savings too slowly; the Treasury expects to save only some £13 billion over four years from linking *all* benefits, including public sector

21 NAO, *The Cost of Public Service Pensions, Figure 11,* March 2010. State pension data from the OBR, *Pre-Budget forecast, Table 5.1: Projections for age-related expenditure*, June 2010.

22 NAO, *The impact of the 2007-08 changes to public service pensions*, 6 December 2010.

23 The Government has also recently removed the *statutory* requirement for private sector occupational pensions to be up-rated in line with the RPI, allowing the CPI to be used instead.

24 CPI excludes some elements of most Britons' cost of living (e.g. council tax and housing-related costs such as mortgage interest, but many pensioners do own their homes) and includes items that are not part of any Briton's cost of living (such as foreign students' university tuition fees). Pensioner inflation hit 6.8% in 2009 (for singles), when the RPI was below zero (Help the Aged). This raises the question of which age groups are the intended audience for the purpose of pensions indexation?

25 OBR.

26 This assumes that there are no successful legal challenges to the move to CPI, on the basis that the legislation expropriates part of the pension and therefore breaches human rights (the pension being a "right to possession").

27 *IPSPC Interim Report*, Ex 12, page 9. October 2010.

pensions, to CPI.[28] Faced with an annual deficit in excess of £150 billion, the Chancellor needs larger, annuity (i.e. annually repeating), “quick wins”.

(b) The unfunded liability

A very big number

Many in the media, as well as many analysts, are drawn to the newsworthy size of the unfunded liability (or “actuarial deficit”), but its precise size is open to question. It is certainly colossal, the latest official estimate from the Government Actuary’s Department (GAD) being £770 billion,[29] but this figure is now nearly three years out of date. Applying the same methodology, a more recent, non-government, estimate is £993 billion,[30] but most of the increase on the GAD figure is accounted for by the discount rate being 0.7% lower.

The unfunded liability is the present value of what taxpayers owe to public sector workers in the form of future pensions; calculating this number therefore involves the discounting of future cashflows. Here the debate starts: what is the most appropriate interest rate with which to discount these cashflows?

The discount rate debate

Private sector pension schemes discount their liabilities using the AA-rated corporate bond yield curve, to reflect the actual return they could expect to earn on scheme assets. The Government uses the same discount rate for accounting purposes, the preparation of annual reports and also calculating the pension liability. The justification offered is that this rate is used “to keep the public sector schemes in line with internationally accepted practice for private pension schemes”.[31] This is completely misleading because most public schemes have no invested assets; the relevant calculation is to determine the value of gilts needed to be put aside now for that value to roll up over time, to cover the future liability.

The consequence is to understate the liability, the corporate bond yield curve being higher than that for gilts. Using gilts rates, others have determined the figure to be £1,176 billion, just over 80% of GDP[32] and equivalent to almost £47,000 for every household in Great Britain. In addition, the Government has been inclined to underestimate life expectancy; consequently, past estimates of the liability have been too low.

Proposal 1: The size of unfunded public sector pension schemes’ liabilities should be determined using the index-linked gilts yield curve for discounting, not the AA-rated corporate bond yield curve.

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[28] HM Treasury; switching the index would save the Exchequer £1.17 billion in 2011-2012, £2.24 billion in 2012-13, £3.9 billion in 2013-14 and £5.84 billion in 2014-15.

[29] As at 31 March 2008, published in December 2009. The discount rate used was 2.5% over RPI.

[30] Towers Watson, as at March 2010. The discount rate used was 1.8% over RPI.

[31] As required by the Treasury’s Financial Reporting Manual.

[32] Towers Watson, March 2010.

The unfunded liability; largely a red herring

But we should be careful not to attribute too much meaning to the absolute value of the unfunded liability. It is not on the nation's balance sheet, and it is not being financed through gilts issuance or taxation. Indeed, in some respects it is really a distraction, likely to lead to unconstructive debates concerning discount rates. Furthermore, given its nebulous nature, exactly how it manifests itself in day-to-day life is hard to explain. There is only a tenuous link between the liability and the annual cashflow requirement to meet pensions in payment. Consequently, focussing on the liability is not much help to a Chancellor who is interested in "quick wins", i.e. immediate cashflow savings.

Understand why the liability changes

That said, keeping track of *changes* in the liability does have some value, provided that the underlying causes are individually identified. At first sight, the recent rapid acceleration in the rate of growth of the liability is alarming. According to the Government's estimates, it increased by 45% in the last three years of available data[33] and in 2005-06 alone it increased by £120 billion. There is, however, a simple explanation; nearly £100 billion[34] of this increase was due to falling discount rates. One day, interest rates will rise again (they cannot go much lower), and the liability will reduce (to some degree). Increasing life expectancy added another £9 billion that year.

In addition, changes in the liability are one way of assessing the impact of an individual reform. For example, the move from RPI to CPI for pensions up-rating is estimated to have cut the unfunded liability by some £55 billion, and if accrued rights for active members were also linked to CPI, this increases to c. £120 billion.[35] But this is a second order consideration. What really matters is annual cashflow, and the ability to accurately anticipate future annual cashflows, not the size of the unfunded liability.

1.3 Cashflow

(a) Total contributions

Table 2 shows the recent cashflows of the four largest unfunded schemes, together over 90% of unfunded liabilities.[36]

Table 2: Annual cashflow of the four largest unfunded pension schemes[37]

£ billion	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
Pensions in payment and lump sums	£15.0	£15.8	£16.2	£17.2	£18.2	£19.3
met by **employee contributions**	£3.6	£3.7	£3.9	£4.0	£4.0	£4.4
plus **employer contributions (a)**	£10.5	£10.8	£12.1	£12.2	£12.2	£12.4
plus **shortfall met by Treasury (b)**	£0.9	£1.3	£0.2	£1.0	£2.0	£2.5
Total cost to taxpayers (a+b)	£11.4	£12.1	£12.3	£13.2	£14.2	£14.9
Taxpayers' cost as % of total cost	76%	77%	76%	77%	78%	77%
Employees' cost as % of total cost	24%	23%	24%	23%	22%	23%

33 Up from £530 billion (31 March 2005) to £770 billion (31 March 2008); Government Actuaries Department (GAD).

34 HM Treasury, *Long-term Public Finance Report; An Analysis Of Fiscal Sustainability*, March 2008.

35 Hymans Roberson, October 2010.

36 The pension schemes of the Armed Forces (AFPS), Civil Service (PCSPS), NHS (NHSPS) and Teachers (TPS).

37 NAO, *The cost of public service pensions*, March 2010.

The taxpayers' share of meeting pensions in payment (and lump sums), the combination of employer and Treasury contributions, has been remarkably consistent (whether by accident or design is unclear), with employees contributing just under a quarter of the annual cashflow. But it is also clear (Table 3, covering *all* the unfunded schemes) that since 2005-06, employee and employer contributions to unfunded schemes have been rapidly falling behind the same year's pensions in payment. This gap, or shortfall, has to be plugged by the Treasury.

Table 3: The growing cashflow shortfall (all unfunded schemes)[38]

£ billion	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10***	**2010-11****
Total contributions	£17.4	£17.9	£19.1	£19.4	£21.1	£21.1
***less* pensions in payment**	£17.6	£19.1	£21.4	£22.5	£24.3	£25.2
Shortfall	**£0.2**	**£1.2**	**£2.3**	**£3.1**	**£3.2**	**£4.1**

**Estimated outturn* ***Planned*

Some would say that 2009-10's £3.2 billion shortfall is relatively palatable when compared with total public spending that year of £669.8 billion.[39] But this perspective is challenged when one considers the OBR's Pre-Budget report (14 June 2010), and then, eight days later, the Emergency Budget documentation (also using OBR data)..

Table 4: OBR's net public service pensions cashflow shortfall forecasts

£ billion	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**
14 June 2010*	£4.0	£5.5	£6.2	£8.0	£9.4	-
22 June 2010**	£4.0	£5.1	£5.8	£7.3	£8.9	£10.3

**OBR Pre-Budget Report*, Table 4.8, Total Managed Expenditure
***HM Treasury Budget 2010*, Table C13, Total Managed Expenditure

The reasons for the difference between the two OBR forecasts are unclear, but the key message is unambiguous; the cashflow shortfall is expected to rise rapidly, not least because the 16% increase in the number of public sector employees since 1997, from 5.17 million to 6.02 million,[40] is expected to produce a surge in pension payments in the future.

(b) The SCAPE[41] model, and another discount rate debate

Insufficient contributions

Section 1.2 (b) downplayed the significance of looking at a pension scheme's liability *in isolation*, but it is significant in respect of setting contribution rates for unfunded schemes.

[38] HM Treasury, *Public Expenditure Statistical Analyses 2010*, Table D1, July 2010. This covers central government pension schemes; it excludes unfunded local government schemes.

[39] *PESA 2010 National Statistics release:* Table 1, Total Managed Expenditure,14 October 2010.

[40] ONS Statistical Bulletin, *Public sector employment, Q1 2009*, 2009. The inclusion of Royal Bank of Scotland Group and Lloyds Banking Group in the public sector (in Q4 of 2008) increased public sector employment by 230,000.

[41] Superannuation Contributions Adjusted For Past Experience.

The Treasury oversees a model called SCAPE, which estimates the level of contributions which will *theoretically* be sufficient to cover each scheme's liabilities, over time.

For SCAPE purposes, the discount rate is fixed at RPI plus 3.5%,[42] which happens to be the same as the social time preference rate (or Social Discount Rate, SDR), used within government for assessing potential investment in projects. The justification for the SDR being higher than index-linked gilts is that it reflects "soft attributes"; the projects concerned are intended to deliver a "social good", i.e. benefits to society as a whole. The SDR also accommodates a degree of (project) uncertainty, which is inappropriate in a pensions context; a discount rate of RPI + 3.5% is much too high for the purpose of determining pension contributions.[43]

The knock-on effect has been that the SCAPE model, loaded with understated liabilities, has produced employer contribution rates that are far too low, and this has been the case for a very long time. The employer contribution rate towards teachers' pensions, for example, was last raised in 1996, by 1% to 14% of salary, to reflect increased longevity. It has not changed since then, primarily because the discount rate was fixed *in 2001,* at RPI + 3.5%. There have not been any subsequent reductions to reflect lower real interest rates.

The official bill to taxpayers for employer contributions to unfunded schemes is put at some £15 billion a year, but the actual cost (reflecting the value of pension promises being made) is nearer £30 billion (the OBR puts the figure at £26 billion). Consequently, since 1997 the total understatement of annual public sector pension costs (i.e. employer contributions) is estimated to be between £120 billion and £150 billion, which goes unrecognised in government accounts.[44]

Who should pay?

If the SCAPE model were to use a realistic discount rate, total contributions would have to be much higher; estimates go as high as 35% of salary, depending upon the scheme. Given that taxpayers already contribute more than 75% of the total cost of many public sector schemes (see Table 2), they cannot reasonable be asked to contribute any more.

Consequently, employee contributions have to go up, but clearly not to the extent that the SCAPE model may suggest. One approach could be to freeze the employer contribution rate and raise employee contributions so that the split is 65% employer, 35% employee, say, close to a typical private sector arrangement.

But the contributions debate cannot be conducted in isolation; there are other facets to consider, including offering employees a choice between preserving existing benefits and paying more in future, or paying the same contributions in return for smaller retirement benefits. This is more fully discussed in Chapter 12.

[42] Confusingly, this is different to the discount rate used to determine scheme liabilities for accounting purposes (see Section 1.2(b)).

[43] This is more fully discussed by the Public Sector Pensions Commission's report *Reforming Public Sector Pensions*, July 2010, (*not* Lord Hutton's Independent Public Service Pension Commission).

[44] Figures from John Ralfe, independent consultant.

The Bank of England's example

In 2005 the Bank of England changed the discount rate it uses to calculate contributions to its non-contributory funded final salary scheme, adopting the return on index-linked gilts as its benchmark. This immediately lifted the current service cost to 41.3% of salaries, a far more realistic figure; a pointer for the rest of the public sector?

Proposal 2: The discount rate used to calculate employer contributions in the SCAPE model should be amended along the lines adopted by the Bank of England in 2005; the index-linked gilts yield curve should be used.

(c) The accounting; the future demand for cash

An analysis of the accounting of unfunded schemes provides robust evidence that they are unsustainability, particularly when the future demand for cash is considered. In any given year, there are three significant non-cash accounting entries concerning unfunded schemes that have implications for future cashflow. They are:

i. **the increase in the public sector pensions liability in that year** (note that this is not a present value calculation). This includes items such as employees' pension accruals for that year, and employees adding to their years of service. This is quoted gross: it excludes pensions in payment in the same year;

ii. **the reduction in the provisions put aside in prior years.** This (roughly) mirrors the cash payments made to pensioners during the year (some relatively small payments are typically not provided for in earlier years); and

iii. **the unwinding of the discount rate**. Each year, as future pension payments come a year closer, the diminishing effect of discounting them reduces, so the present value of the liability actually grows. This figure[45] is loosely equivalent to the amount of interest that the Government would have had to pay if the unfunded public sector pensions schemes had been funded. In 2007-08 the figure was £32.8 billion; using the (lower) gilts yield curve for discounting produces a figure of £45.2 billion.[46]

Note that changing the discount rate only affects the theoretical actuarial liability (a present value calculation); it has no impact on the actual cashflow expected in the future, and is therefore not a consideration (unlike assumptions concerning longevity, for example).

Table 5 shows a rough estimate of the annual change in the present value (PV) of the future cash requirement, derived from the three (non-cash) accounting entries that signal a cash requirement in the future. In the six years shown here, the PV of accounting items with cashflow implications increases by £212 billion.

[45] This is sometimes referred to as "interest on scheme liabilities"; not automatically a gilt rate.

[46] Neil Record, *Public Sector Pensions; the UK's Second National Debt*, Policy Exchange, June 2009.

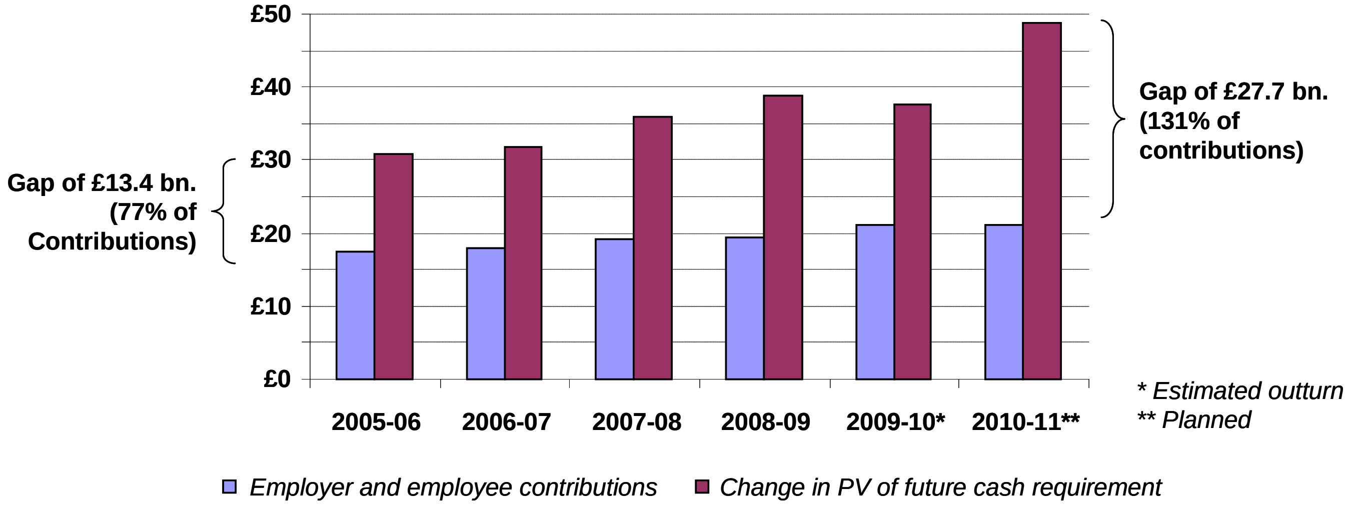
Table 5: Increase in the PV of the future cash requirement[47]

£ billion	2005-06	2006-07	2007-08	2008-09	2009-10*	2010-11**
Change in gross liability	£20.9	£21.1	£24.4	£24.8	£23.9	£32.8
***less* pension provision**	-£17.5	-£18.9	-£21.3	-£22.4	-£24.1	-£25.1
***plus* unwinding of discount rate**	£27.4	£29.5	£32.8	£36.5	£37.8	£41.1
Total	**£30.8**	**£31.7**	**£35.9**	**£38.9**	**£37.6**	**£48.8**

**Estimated outturn* ***Planned*

Figure 1 compares actual cash contributions with our measure of the annual increases in the PV of the future cash requirement (Table 5); contributions are falling further and further behind, but this evidence is subtly buried within non-cash-related accounting entries, such as the unwinding of the discount rate. Over the six years period, cash contributions are expected to increase by 21% (from £17.4 billion to £21.1 billion, Table 3), but the PV of future demands for cash is expected to have increased by 58% (from £30.8 billion to £48.8 billion). This is clearly unsustainable.

Figure 1: Cash contributions falling behind the PV of the future cash requirement (£ billions)



The growing cashflow shortfall, bridged by the Treasury (i.e. a direct subsidy from the taxpayer) is symptomatic of today's contributions being unable to cope with the onslaught of the advancing unfunded liability. This is a proxy for generational inequality; the bigger the gap is, the greater the burden being placed on taxpayers, and the younger generations.

This begs a key question; who should be responsible for meeting pensions in payment? This question has to be addressed, particularly if transparency around public sector pensions is to be materially improved, a prerequisite to achieving *meaningful* employer-employee negotiations (that are sure to come). It is perhaps ironic that improved transparency is likely to help employees realise just how valuable their pensions are, perhaps making forthcoming negotiations that much more challenging.

[47] HM Treasury, *Public Expenditure Statistical Analyses 2010*, Table D1, July 2010.

(d) Workforce size and the cost of pensions

A sensitive subject

In March 2010 the NAO published a report[48] assessing the cost of public sector pensions. Modelling for the report was conducted by GAD on behalf of the Treasury, and the latter established four key assumptions for projecting the cost of unfunded pensions (see Appendix I). Notable amongst these was the assumption that the workforce size would remain constant.

The NAO was scathing about this, pointing out that "the size of the public service workforce is a critical driver of pension costs" and that "analysis of the impact of different workforce growth (or contraction) is needed". The Treasury's riposte to the NAO was that "a constant policy approach (concerning workforce numbers) is in line with international best practice for long term projections". This was an extraordinary position to adopt when conducting *scenario* modelling, when a contraction in public sector headcount over the next few years was quite likely (albeit not confirmed at that time). But the NAO was ignored, seriously prejudicing the validity of the GAD/Treasury-produced forecasts. One wonders whether political sensitivities got in the way of common sense.

To its credit, the NAO declared that it would include a sensitivity analysis in respect of a changing workforce in its next report, consistent with its laudable aim to "bring greater transparency to, and understanding of, the costs of public service pensions". This report was published in December 2010;[49] in the event, the NAO was unable to shed any more light on this vexing issue, other than to recommend (again) that the Treasury *"should improve its understanding of the financial impact of changes to public service pensions by undertaking sensitivity analyses of different workforce size projections".*

OBR forecasts for public sector workforce size

Following the March 2010 NAO report, the OBR produced a forecast for workforce size (Table 6) which was used in the modelling for both the June 2010 Budget and the IPSPC's Interim Report (October 2010).

Table 6: OBR forecasts for public service workforce

millions	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**
Headcount	5.53	5.47	5.39	5.23	5.04

Subsequently, the OBR revised this forecast, after the Government decided to replace some planned cuts in public services spending with further cuts in welfare.[50] The current expectation is that general government employment will fall by 330,000 over the next four years, with a further 80,000 fall in 2015-16 (due to total public spending being frozen in real terms that year).[51]

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48 NAO, *The cost of public service pensions*, March 2010.

49 NAO, *The impact of the 2007-08 changes to public service pensions*, 6 December 2010.

50 Comprehensive Spending Review, October 2010.

51 OBR; *Economic and fiscal outlook*, November 2010.

Do not cut the workforce?

The size of the headcount reduction may be uncertain, but what is clear is that workforce contraction widens the cashflow shortfall because there are fewer contributors, and some departees will take early retirement. This is at odds with the Chancellor's need for "quick wins".

Furthermore, ironically, the planned pay freeze will exacerbate the problem because contributions will not grow, whereas pensions in payment will continue to be up-rated by CPI. Perhaps bizarrely, this suggests that cutting the workforce, from a cashflow perspective, is not as attractive as it may first appear (although wage cost savings would arise, and there would be longer term pension-related savings). This problem would not arise if pensions were fully funded.

(e) The 2007-08 initiatives; flawed

During 2007-08, a few changes to public sector pensions were introduced, including:

- increased employee contributions (for *some* staff);
- an increase in the Normal Pension Age, from 60 to 65 years, (for new staff only, and not for all schemes); and
- a cost sharing and capping mechanism to transfer *some* longevity risk from employers to employees (further discussed in Section 4.1).

In aggregate, these changes are expected to save some £5 billion over the current spending review period.[52] But changes to tax rules are now allowing employees to take more of their pensions as lump sums on retirement; this is expected to increase costs by £4 billion over the same period, i.e. almost eliminating the expected savings.[53] Subsequently, pensions will be lower than otherwise, but that is no help to a Chancellor who requires "quick wins".

The NAO's December 2010 report includes some recommendations *"so that omissions in the way the 2007-08 changes were introduced are not replicated in any future changes".* These include:

- the need for a long-term public sector pensions strategy;
- sensitivity analysis around projections for workforce size as well as the interactions with the tax and benefits systems; and
- ensuring that there is a mechanism in place to measure the financial impact of any future pensions reform.

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52 2010-11 to 2014-15.

53 NAO, *The impact of the 2007-08 changes to public service pensions*, 6 December 2010.

2. UNFAIR PUBLIC SECTOR PENSIONS

The public sector's pension arrangements are spawning four aspects of division:

- a growing gulf between the quality of public and private sector provision;
- looming generational inequality, accommodated by a predominately unfunded framework;
- disproportionately high pensions paid to high earners; and
- the emergence, within the private sector, of a two-tier workforce, as a consequence of TUPE and Fair Deal pension protection within outsourcing contracts. This adversely impacts productivity, and therefore our nation's competitiveness, a theme that Lord Hutton refers to as "supporting productivity".

2.1 Division vis-à-vis the private sector

(a) The quality of pension provision

One of the main criticisms of public sector pensions is their superior quality, compared to that of the private sector. A Niagara of data show a growing sectoral schism, including:

- 81% of private sector schemes are now closed to new members of staff, whereas almost all the public sector's final salary schemes are still open to new joiners;[54]
- 17% of private sector employees are in DB pension schemes, compared with 76% in the public sector;[55] and
- public sector employees receiving their pension benefits at an earlier age; 56% of public sector scheme members can retire at 60, compared to 25% in private sector schemes.[56]

It is therefore no surprise that public sector employees receive more pension benefits than similarly skilled private sector employees, and in recent years this differential has been growing. A lifetime civil servant, employed from the age of 21, could expect to receive a

54 Institute for Fiscal Studies, *Reforming Private Pension Enrolment*, June 2009.

55 Lane, Clark and Peacock, *16th Annual Accounting for Pensions 2009 survey*, 2009.

56 Public Sector Pensions Commission; *Reforming public sector pensions,* July 2010.

pension of £28,900, thanks to his (unfunded) final salary-based (DB) pension scheme. Conversely, a lifetime private sector worker could expect a pension of just £11,600.[57]

(b) Private sector in retreat

The quality gap has emerged because the quality of private sector provision has deteriorated over the last 30 years, for a variety of reasons, including:

- the decade of contributions holidays that followed the introduction (by Nigel Lawson) of the 105% funded requirement for DB schemes. When payments were resumed, the shock of the "new" additional cost provoked severe cost-cutting measures;
- actuaries acknowledging decades of under-estimating longevity improvements, and then "catching up";
- periodic collapses in equities markets;
- the rising regulatory burden on DB-based pensions, partly as an over-reaction to Maxwell; and
- employers reining back costs in response to increasing global competition.

The principal reaction of private sector employers has been to close their final salary schemes, first to new members and now, increasingly, to existing staff. Indeed, private sector DB schemes are almost extinct; for example, only four FTSE 100 companies now offer new staff a pension scheme that has *any* DB element to it;[58] the rest have moved to DC-based provision. Appendix II provides some more detail.

Today, companies are having to divert substantial free cashflow to make good their schemes' accumulated deficits, sacrificing investment and risking future business growth… and employment prospects. Business investment has fallen from a past peak of 15% of GDP (1999) to just 9% of GDP, the lowest on record. In 2009, a third of FTSE 100 companies spent more on deficits than funding pensions for current staff; nearly £2 out of every £3 spent on DB plans went on deficit reduction.[59] It is no surprise that the private sector is retreating from DB to DC pension provision, and often taking the opportunity to significantly reduce employer contributions when it does so.

(c) The cost of contributions relative to the wage bill

Employer contributions to public sector pensions schemes vary (see Appendix III for detail), but in the three largest schemes (LGPS, Teachers and NHS) they are roughly 13%-14% of pay (and much higher in other, smaller, schemes). This is more than double the average private sector DC scheme sponsor's contribution of 5.8% of basic salary.[60] But once the true value of final salary-

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[57] These illustrations are detailed in the PricewaterhouseCoopers (PwC) paper, *The Tortoise and the Hare 2 – a post mortem on their pensions race*, 2009.

[58] Royal Dutch Shell (the only remaining final salary scheme), Amec, Diageo, and Tesco (all based on career average earnings).

[59] KPMG Pensions Repayment Monitor; "*2009 – Tipping point reached in pension financing*", August 2010.

[60] Businesslink.gov.UK (Running a Pension Scheme). Contributions average 14.2% into the relatively few private sector DB schemes that remain open.

based pensions is taken into account, the *implied* public sector employers' contribution rates are as high as 35% of salary, a theme that has been examined in detail in other papers.[61]

There is no reason why private sector employers should be expected to fund (via taxation) the costs of public sector DB schemes (a minority in society), when they cannot afford to do the same for their own employees. Indeed, for those interested in pensions comparability between public and private sectors, perhaps the acid test is whether, *post-reform,* the private sector would be prepared to afford for its own employees the same standard of pension provision as in the public sector. If the answer to this question were "no", then the voices of business may claim that that particular reform package was too generous.

(d) The pay myth

Historically, the more generous public sector pensions have been justified by pay being lower than in the private sector. Table 7 contains data that debunks this argument.

Table 7: Gross pay and total reward: summary statistics[62]

	*£ weekly**	**Mean**	**1st quartile**	**Median**	**3rd quartile**
Gross pay					
	Private sector	£581	£330	£465	£677
	Public sector	£605	£393	£539	£722
Total reward**					
	Private sector	£614	£335	£479	£719
	Public sector	£692	£444	£615	£830

** Full-time employees on adult rates of pay whose earnings were not affected by absence.*
*** Total reward is defined as gross pay plus employer pension contributions.*

It should be noted that:

- mean (i.e. average) gross pay and total reward are higher in the public sector, by 4% and 13% respectively. The latter is not so surprising given that it includes employer pension contributions;

- the gap between "mean" and "median" pay and total reward is wider in the private sector than the public sector, indicating a larger disparity of remuneration in the private sector; and

- the public sector clearly protects low earners (1st quartile), their gross pay and total reward being particularly high relative to private sector 1st quartile remuneration. (It is higher for 3rd quartile earners too, but less so.)

Furthermore, the differential in pay and total return is widening. In Q2 of 2010, total private sector pay rose by 0.8% compared with Q2 of 2009; the corresponding pubic sector figure is 2.9%.[63] This trend is also mirrored in graduate starter salaries.

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[61] Notably the Public Sector Pension Commission's report of July 2010.

[62] ONS; *Economic & Labour Market Review Table 1*, September 2010. Underlying data from *The 2009 Annual Survey of Hours and Earnings (ASHE),* 12 November 2009.

The NAO has made it clear that real-terms increases in earnings, rather than increasing longevity, *is the principal driver of the escalating cost of public sector pensions*, expected to account for 84% of the total rise between now and 2060. The NAO expects the cost of unfunded pensions to more than treble by 2060, from £25.4 billion (2009-10) to over £79 billion (at 2008-09 prices).[64] It should be noted, however that the NAO's projection uses the Treasury's assumption of 2.0% real-terms annual earnings growth, an assumption that dominates the calculation. Evidence suggests that this is too high; nationwide, pay rises over the past ten years, for example, have only been 9.5% in real terms, and over the next four years, median pay rises are expected to remain below inflation.[65]

To decide whether recent years' earnings increases have been justified, we need to consider public sector productivity.

(e) Public sector productivity[66]

In the eleven years to December 2008, the public sector productivity index *fell* by 3.3%, an annual average decline of 0.3%, in stark contrast to a 28% increase in private sector productivity over the same period.[67] In the meantime, public sector earnings, in real terms, rose by 17.1% (against RPI) and 34.4% (CPI),[68] driving up the cost of final salary-based pension schemes.

Given this, it would appear that many pay rises have been unjustified because they have been disconnected from performance (and the nation's ability to pay for them). There has been a degree of management failure that would not be tolerated in the private sector. Lack of accountability and personal responsibility are partly to blame, as is the practice of collectively determining salaries and pay grades at a national level. Pay and productivity need to become connected, ideally at an individual level (or at least locally), and disconnected from aspects such as length of service. And, of course, a more effective public sector could function with fewer people, leading to a smaller pensions bill.

What this really hints at is the need for cultural change within the public sector, but that is the provenance of a very different paper. In the meantime, a labour market unfairly skewed in favour of the public sector, with a pension promise against which the private sector cannot compete, is not in the national interest. It is also unfair on the majority of citizens who are not employed in the public sector. It is forcing private sector employers to offer wages that could render them uncompetitive, and increasingly risks driving the more mobile industries offshore. Furthermore, it restricts job mobility, the pension being a huge disincentive to leaving the public sector.

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63 ONS; *Labour Market Survey, Table 15*, 18 August 2010.

64 NAO, *The Cost of Public Service Pensions, Clauses 3.4 and 3.5,* March 2010.

65 Hay Group.

66 One can dispute how to measure public sector productivity, but using it to make comparisons with the private sector does has *some* validity. The ONS defines productivity as "the quantity of output that is produced divided by the quantity of input used"; see ONS; *Total Public Service Output and Productivity*, June 2009, for detail.

67 ONS UK Centre for the Measurement of Government Activity; *Total Public Service Output, Inputs and Productivity*, 27 July 2010.

68 ONS data series; Average Earnings Indices (LNNJ and LNKY) and inflation (CHAW and D7BT). The corresponding private sector real earnings increases were 21.4% (RPI) and 38.7% (CPI).

It should be noted that the Treasury has traditionally assumed long term, *whole economy,* productivity growth (i.e. including both public and private sectors) to be 2% per annum.[69] This is a key ingredient when forecasting GDP, which is usually accepted as a fair proxy for the ability to pay for the public sector. But public sector pay should be correlated to *public sector* performance, not that of the whole economy. With public sector productivity growth lagging so far behind, expressing the future cost of public sector pensions as a percentage of GDP (Table 1) is unreasonably forgiving, and blatantly unfair on the private sector.

2.2 Generational inequality

The unfunded, pay-as-you-go (PAYG) approach is generationally unfair because it conveniently shifts employment costs into the future, leaving the younger generations to assume the financial risks (including longevity) and field the cashflow consequences. Thus, for example, employers are not required to consider the post-retirement (cashflow) costs when agreeing to pay rises. Deferring costs is financially convenient but ultimately irresponsible, and totally unfair on the following generations. Pension promises are part of today's employment cost, and should be recognised as such, but individual schemes have yet to move away from cash to accruals-based accounting.[70] Instead, they report the cost of pensions as the cash amount paid each year towards their schemes; the future cashflow implications of pension promises are unreported.

Proposal 3: Public sector pension schemes should utilise accruals-based accounting, so that the future cashflow implications of pension promises are more transparent.

2.3 High earners

There is a huge discrepancy between the pensions of most public sector workers and a minority of highly paid senior managers, a theme that transcends the public-private sector divide. A final salary framework disproportionately rewards the higher paid relative to their lower paid colleagues, because their pensions will be a much higher percentage of their career *average* earnings.[71]

Whilst accepting that fairness is entirely subjective, this does not *feel* right, and it provides a very strong case for a pensions framework based upon career average revalued earnings (CARE).[72] CARE-based schemes provide a defined benefit pension, in the sense of income certainty, but pensions are lower than with a final salary arrangement. They are therefore

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69 Notwithstanding the risk that our ageing workforce is unable to meet the Treasury's long term view of productivity growth. Furthermore, labour productivity has only averaged 1.75% since 1994 (which corresponds to the start of the current, consistent, ONS data series; *LZVD UK Whole Economy: output per hour worked % change per annum, 1994-2009).*

70 Recognising a cost when the cost is incurred, not when it is paid.

71 Consider employees A and B starting work on the same salary. By retirement, A's salary has not increased whereas B's salary has quadrupled. Assuming linear salary growth, B's pension (four times that of A's) will be 80% of B's career average salary. A's pension, however, will only be 50% of A's career average salary. Furthermore, higher earners tend to live longer, so they will receive a pension over a longer period.

72 See the Glossary for detail.

cheaper to provide, *provided* that the accrual rate is not increased. Union opposition may be muted because moving from a final salary-basis to a CARE-basis mainly affects high earners.

There are other ways of achieving more pensions fairness *within* the public sector, whilst retaining income certainty in retirement *and* cutting the cost of pension provision. Employee contributions could, for example, be tiered rather than flat rate, rising with salary. This would provide for more equality between the costs and benefits of scheme membership,[73] but if a final salary (rather than CARE-based) scheme were to be retained, employee contributions would have to rise to an unacceptably high level.

Quite separately, but with top earners in mind, we could allow the over 50's to commute their pension assets, provided they have first secured a lifetime income, perhaps set at the Minimum Income Retirement (MIR).[74] Thus, those with very large pension pots could immediately convert them into free assets that they could spend, but they would then also start paying income tax, which the Treasury would appreciate.

2.4 Supporting productivity

(a) The public sector is different... but less so than in the past

Is there something special about working for the state that justifies a privileged (final salary) pension? The historic rationale centred around security (soldiers were the first to receive a state pension), with civil servants and other public sector workers subsequently being included, to:

- secure the independence of public servants;
- make a career in public service attractive;
- shift the cost of remunerating public servants into the future; and
- provide a mechanism to retire older workers, in a politically and socially acceptable manner.[75]

Today, this rationale is looking distinctly frayed. Career paths, for example, are no longer mutually exclusive, because the state's role in delivering services is coalescing with private sector delivery. With contract outsourcing, public sector employees are being compulsorily transferred to the private (and voluntary) sectors, the hope being that "better" working practices will catch on, leading to more efficient[76] service delivery, and improved productivity.

73 The Scottish LGPS has a five tier contribution system; 5.5% on earnings under £18,000, progressively stepping up to 12% on earnings above £40,000.

74 The MIR is the income level below which retirees would still have to annuitise at age 75. This has been set at £20,000 per annum (effective April 2011), as part of the Treasury's proposal to remove the requirement to annuitise by age 75. Given the expected increase in State Pension (£140 per week?), and that less than 2,000 people per year buy an annuity of more than £20,000 p.a. (ABI), this figure feels too high.

75 *Civil service pension schemes around the world*, Robert Palacios and Edward Whitehouse, 2006.

76 The meaning of "efficient" is open to interpretation; some treat it as a euphemism for cost cutting, others as a genuine desire to improve effectiveness (better outcomes for the same spend or the same outcomes for a smaller spend).

Attracting and retaining staff is also a lower priority than previously (particularly in the current environment). Consequently, the justification for the quality of pension provision to be better in the public sector than in the private sector is disappearing.

(b) TUPE and the Fair Deal

How it works

A framework of legislation and guidance has emerged to ensure that transferred employees' accrued benefits are protected, and that their future service benefits are "broadly comparable" to what they had prior to being transferred. The initial TUPE regulation[77] protected workers' pay and conditions, but it contained a pensions exemption clause (Regulation 7). The later Fair Deal Guidance Note[78] largely addressed this, by setting out the *preferred* treatment of pensions in public sector outsourcing contracts. Whilst this is not legislation, some local authority outsourcing contracts have a statutory underpin[79] (Best Value contracts) that require the contracting authority to *oblige* the service provider to provide broadly comparable pensions.

Best Value contracts effectively ensure that all outsourcing contractors offer transferees the choice of either staying in a public sector pension scheme or having access to broadly comparable, alternative, pensions through a bulk transfer arrangement ("first generation transfer") into the contractor's scheme. Should a transferee subsequently move on to another private sector employer, his pension rights would then move with him ("second generation transfer").[80]

Low take-up

In practice, there is a low take-up rate of first generation transfers; perhaps less than 20%. This is usually because transferees place a high value on the security of the public sector scheme relative to the private sector scheme (and the older the transferee, the more so). The short-term nature of some outsourcing contracts is also a deterrent to transferring a pension into a contractor's scheme.

"Broadly comparable" eroded

The subsequent TEPP regulations[81] (part of TUPE) watered down the meaning of "broadly comparable" because it allows service providers to meet their TUPE obligations by providing a DC pension scheme with a matching contribution of up to 6% of pensionable pay; a cheaper option than previously. But TEPP only applies to employees who were members of (or eligible for) an occupational scheme prior to being TUPE transferred. New recruits, working alongside TUPE employees, are excluded, but they do benefit from other government guidance.

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77 Transfer of Undertakings (Protection of Employment) Regulations (TUPE), 1981, replaced by TUPE 2006 to take account of the amended Acquired Rights Directive (No 2001/23).

78 HM Treasury Guidance Note; *Fair Deal for Staff Pensions: Procurement of Bulk Transfer Agreements and Related Issues,* June 2004.

79 Notably the *Code of Practice on Workforce Matters in Local Authority Service Contracts, Annex D of the ODPM Circular,* March 2003.

80 Transferred past service benefits retain the link to the employees' salary, so they increase each year in line with salary growth. Employees who do not transfer their benefits become deferred members of the public sector scheme; their deferred benefits then increase annually in line with deferred revaluations.

81 Transfer of Employment (Pension Protection) Regulations 2005 (TEPP).

(c) Different arrangements for local government

Bidders for local government outsourcing contracts can seek "admitted body" status to the LGPS, which allows their transferred staff to continue as active LGPS members. The underlying "admission agreement" sets out the terms on which the private contractor (the "participating employer") may participate in the LGPS and which employees may become LGPS members. Contactors without admitted body status must provide a pension scheme that is "broadly comparable" to the LGPS.

(d) Deterrents to outsourcing

The TUPE and Fair Deal arrangements are accompanied by some significant additional risks to contractors, including:

- **a "two-tier" workforce.** Over time, a contractor's former public sector employees are likely to be joined by new recruits who are unlikely to join on similar (public sector standard) pension benefits. In addition, they may become co-mingled with the contractor's existing workforce, who will be almost certainly accruing lower quality pension rights;

- **exposure to additional redundancy costs.** Consider, for example, a TUPE-transferred worker participating in the contractor's in-house DC pension scheme who is subsequently made redundant. He may then be eligible, thereon, for an early retirement lump sum and a DB-based pension, accrued *as if he had never left the public sector*. Unsuspecting private sector contractors have been caught out by this, believing that such benefits were excluded from TUPE. There have been two notably legal cases,[82] after the companies concerned refused to pay up. Both companies lost; the pension costs then had to be borne by the company schemes, not the awarding authority;

- **protracted disputes over risk sharing.** Risk Sharing Agreements (RSA) between contractors and awarding authorities are used to detail the pension arrangement, such as the contributions rates. But some RSAs have proved to be vague documents; unclear and cumbersome, they can lack standardised definitions and are now catalysing time-consuming, and expensive, disputes between the concerned parties;

- **technical exposures (funded schemes).** At the start of a contract with a contractor who is a participating employer (in the LGPS), the LGPS assets are valued on an on-going basis. When the contract ends, the liability to the departing employees (including deferred members and those who became LGPS pensioners during the life of the contract) is crystallised. This "Cessation Value" is usually determined on a basis consistent with the initial valuation, although a gilts-based assessment is used when the employer does not have a fund guarantor, i.e. using a lower discount rate than the initial valuation.[83] Consequently, unless the LGPS's assets have performed well during the contract, the contractor may have to pay compensation to the LGPS. The mismatch between the long-

[82] Beckmann vs. DWM Ltd at the European Court of Justice (June 2002) and a similar case of Martin and others vs. South Bank University. Beckmann and Martin had both been TUPE-transferred out of the NHS.

[83] All else being equal, i.e. assuming interest rates have not moved.

term investment strategies[84] used for LGPS assets and the relatively short-term outsourcing contracts only heightens the risk. And even if a surplus were to develop during a contract, the LGPS keeps it.

In addition, if the costs associated with an employee's pre-contract accrued pension rights were to rise during a contract (through weak investment performance, for example), the contractor may have to compensate the LGPS for the asset shortfall. This risk is compounded by short-term contracts, particularly during a period of high market volatility, or if an employee has many years of public sector service before being TUPE-transferred.

It goes without saying that the relatively high cost of public sector, final salary, pensions is a deterrent to many private sector firms (particular smaller ones) pitching for outsourcing contracts.[85] Indeed, firms would have to pay even more to match the quality of public sector provision because their schemes are subject to arduous (i.e. expensive) regulation.

Ideally, outsourcing contractors should be free to price contracts purely on the basis of the services being provided, i.e. without having to factor in a pensions risk premium, care of their exposure to pre-contract accrued pension costs. This would create a level playing field for awarding authorities, when comparing contract bids.

(e) Confront reality

The continued existence of TUPE regulations and the Fair Deal represents a failure to address a key issue; the growing disparity between the quality of public and private sector pension provision. They provide a cost barrier to the outsourcing of public services which inhibits the deployment of private sector-honed management skills and business practices, thereby diminishing the prospect of improving the efficiency of the delivery to public services.

Given that local government funding is to be cut by 7.1% each year for the next four years,[86] there is likely to be a surge in outsourcing demand. This is likely to be frustrated if TUPE legislation and the Fair Deal are not reformed, perpetuating the inefficient delivery of some of our public services, to the frustration of many talented individuals working within the public sector.

Amending, or ending, the Fair Deal should be legally straight forward because, as a Guidance Note, it has no legal status. But if it were removed, the statutory-based TUPE would return to the fore, accompanied by some very expensive ancillary benefit risks, notably concerning redundancy. Annulling the TUPE legislation could, of course, prompt some serious industrial relations issues.

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[84] Long term investing usually entails a higher exposure to equity markets, whereas a shorter term focus tends to involve more exposure to fixed income.

[85] For example, employer contributions to the Teachers Pensions Scheme are 14%, and average around 19% to the PCSPS.

[86] *Comprehensive Spending Review, October 2010*. Local government "departmental expenditure limits" (DEL) are to be reduced by 28% over the CSR period – going from £28.5bn in 2010-11 to £22.9bn in 2014-15. Factoring in all grants from central government to local government, that means a 26% overall decrease. If current Council Tax revenue assumptions are included, total real-terms reductions to all local government expenditure is expected to be around 14% over the period.

(f) A way forward

Away from the LGPS, it is very rare for an outsourcing contractor to be allowed to become a participating employer in the contracting authority's pension scheme. The NHS pension scheme does allow participation, provided the contractor can obtain Direction status;[87] few achieve this, so this serves as a barrier to contractors bidding for outsourcing contracts.

But even if "participating employer" status were to be automatically granted, few contractors could afford the contributions, in spite of the hidden subsidy (the true value of the benefit exceeds contributions). One approach could be to require the awarding body to continue to pay the employer contributions (it would be paying them anyway, if there were no contracting out). Contracting out would then exclude pensions, so the bidding process could focus on the merits of the services being delivered (i.e. where contractors can best add value).

Proposal 4: All public sector outsourcing contracts should:

- automatically grant "participating employer" status to bidding contractors;
- exclude pensions from the bidding process;
- require awarding bodies to pay the employer contributions;
- include an indemnity ("pass-through" arrangement) from the awarding authority that ensures that the contractor has no exposure to pre-contract accrued pension costs; and
- in respect of the LGPS, apply a consistent valuation methodology, at the start and at the end of an outsourcing contract.

87 Under either Section 7(1) or Section 7(2) of the Superannuation (Miscellaneous Provisions) Act 1967.

3. THE POLITICAL CONTEXT

3.1 Prevailing ethos

The current Government's political ethos is defined in two publications,[88] published early in the Cameron era, in which David Cameron sums up his political philosophy in the phrase "social responsibility". He also commented that "there is a renewed need for greater local fiscal autonomy". This emphasis on "localism" was reinforced by the Sustainable Communities Act Amendment Bill, which passed into law in April 2010, with strong cross-party support. This is intended to provide communities with a greater say about how public resources are allocated locally.

The subsequent Coalition Agreement's central theme was of "fairness, freedom and responsibility".[89] Some would say that this is consistent with an ongoing change in British society, with risk increasingly being transferred from the state to the individual. The State Pension Age (SPA) is in retreat, healthcare rationing is emerging, albeit covertly, and welfare cuts are now a reality. And private sector occupational pension schemes have almost completed the move from DB to DC.

It is reasonable to expect that the Government's approach to reforming public sector pensions will resonate with this ethos. In the interests of good governance and financial disciple, pension scheme management and employers should be held jointly responsible for the cost of the employees' pensions. Furthermore, they should be held accountable for any subsequent budgetary pain that results from having made excessive pension promises in the past. In this sense, public sector employers should be treated no differently to private sector employers, but they currently have insufficient control over pension costs.

3.2 What does "progressive" mean?

(a) The progressivity index

Over the last year, the word "progressive" has become more evident in the political lexicon. In the pensions context, progressivity is a measure of the strength of the link between pre-retirement earnings and post-retirement pension income; confusingly, the *higher* the progressivity index, the *weaker* the link.

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88 *Built to Last*, a short paper setting out the aims and values of the Conservative Party, and *The Permissive State; How to Achieve Local Social Responsibility*, by David Cameron and Caroline Spelman, August 2006.

89 When it comes to personal responsibility and providing for one's retirement income, some view this as a euphemism for "you're on your own, folks".

Consequently, a pension system with an index of 100% (maximum progressivity) pays the same flat rate to pensioners regardless of their pre-retirement income; thus, an individual's replacement rate[90] declines with earnings. The state pension schemes of Ireland and New Zealand are 100% progressive, and Australia, Canada, the Czech Republic and the UK all have an index above 65%, indicating a weak link between earnings and the state pension.[91]

Conversely, a "pure insurance" scheme (0% index) aims to pay the same replacement rate to all workers when they retire. DC pension schemes conform to this model if the contribution rate is a constant proportion of earnings for all workers, as do DB schemes that offer the same accrual rate regardless of earnings, years of service or age. Finland, Hungary, Italy, the Netherlands, Poland, Slovak Republic and Turkey have indices of less than 10%. The OECD average index is 36.9% (with the USA at 40.9%).

There is no "correct" answer for which size of index is most appropriate, but countries with high or low indices are culturally very different. Anglophone countries have an index that averages 82.7% (the UK's is 81.1%), indicating that the state pension plays a substantial role in wealth redistribution. Conversely, Southern Europe's index averages 10.2%, indicating a very strong link between an individual's earnings and his state pension.

(b) Comingled objectives

British politicians regularly couple the terms "progressive society" and "fairness", and our state pension's relatively high progressivity index is consistent with this. Equally so is the repeatedly stated objective of ensuring that the low paid do not fall into poverty in retirement. But why commingle this laudable objective within the (DB, final salary) structure of public sector pensions? It adds to complexity, and is inconsistent with DC-based private sector pension provision. Our concerns about pensioner poverty (both public and private sector) should be addressed in a simpler, more efficient manner, through a much higher basic State Pension, set at a level above Guarantee Credit,[92] thereby lifting people above the means testing threshold (and making it worthwhile to save).

Until this is agreed, it is premature to debate an appropriate income replacement rate to be derived from public sector pensions. Furthermore, this would only be relevant if pensions are to retain some certainty-giving, DB-like features; otherwise it is merely aspirational.

3.3 Dilemmas

With six million public sector employees, reforming their pensions is politically challenging; change is unlikely to produce any "winners". Today's politicians face several dilemmas:

- policies that lead to short-term cashflow savings ("quick wins") are of high economic value but mixed political value (business would support them but the unions are unlikely to);

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[90] The replacement rate is the ratio of post-retirement income to pre-retirement income.

[91] OECD; *Pensions at a glance: public policies across OECD countries, 2007*, p44.

[92] Guarantee Credit provides a guarantee of a minimum level of weekly income for single people (£132.60) and couples (£202.40).

- medium- and long-term reductions in the liability are of minimal politically value today. They are, however, of considerable economic value to the next generation of taxpayers… who currently do not vote;
- with deficit reduction being today's top priority, Departmental budget cuts are likely to lead to a smaller workforce; pensions contributions will therefore reduce. Furthermore, some (albeit a minority) of the involuntary leavers may immediately become pensioners, adding to pensions in payment (and others would become unemployed and then claim benefits). Consequently, headcount reduction could, in the short-term, backfire on the Treasury because it will only widen the cashflow gap that the Treasury has to plug (although, in the broader context, savings on salaries will more than compensate for the wider gap);
- the widespread perception that we are trapped in the PAYG web, typically characterised by the "pay twice" problem (further discussed in Section 5.4);
- implementation of public sector pensions reform may well coincide with the next round of deterioration of private sector pension provision, care of the roll out of auto-enrolment and NEST from 2012 onwards. NEST requires employers to contribute a wholly inadequate minimum of 3% of NEST band earnings (i.e. less than 3% of salary). This is an open invitation for employers to reduce their contributions from a current average of around 7% of salary for DC schemes. If this were to happen, public sector pensions are likely to continue to be generous relative to private sector provision, and an on-going source of ire; and
- the risk of ideological inconsistency. David Cameron's localism agenda, replacing top-down control with "local accountability", is at odds with some approaches to improving efficiency. Harnessing the government's buying power, for example, is typically achieved by moving activities to the centre, activity mergers being used to realise economies of scale.

3.4 "Quick wins"; limited choice

Whilst there is a pressing economic need to quickly reduce the cost of pensions in cash terms, the Chancellor's options are very limited.

(a) Higher contributions

Increasing employee contributions is the most obvious cashflow "quick win", but any increase in employer contributions will inevitably feed through to cuts in services, increased council taxes or a combination thereof. Furthermore, this would only exacerbate the inequality concerns vis-à-vis private sector employer contributions.

(b) Ending contracting out

S2P is paid implicitly to public sector employees

Occupational pension schemes can contract out of the Second State Pension (S2P) in return for a partial rebate on both employer and employee National Insurance contributions

(NICs).[93] After retirement, to compensate for the lack of S2P, the employee receives replacement income from their employer's scheme, the idea being that NICs rebates would have been used to purchase additional assets for the scheme. Consequently, scheme sponsors are taking a gamble as to whether the rebate (and subsequent asset performance) is sufficient to make up for the lack of S2P.[94]

When a scheme contracts out of S2P, it has to commit to provide "equivalent" replacement income. Assuming that unfunded public sector schemes are no different (why should they be?), the replacement income can only come from taxpayers (there being no underlying assets).

Consequently, the burden on the state has not been reduced; S2P (more specifically, its equivalent replacement) is *implicitly* incorporated within public sector pensions.[95] The public sector's contracted out status is therefore a non-sequitur; it should be reversed and public sector workers and employers should be paying full-rate NICs.[96] Furthermore, the public sector's replacement for S2P is more generous than that from private sector schemes because pensions are paid from scheme pension age, not the later SPA.

Ending contracting out; the cashflow benefit

Ending contracting out for all public sector schemes would provide the Treasury[97] with an immediate cashflow benefit of some £1.5 billion per year, calculated as follows:

- GAD expects contracting out rebates of £7.486 billion to be paid in 2010-11;[98]
- there are 2.4 million contracted-out private sector workers;[99] and
- c. 5.2 million public sector workers contacted-out of DB schemes.

Assuming the average wage in the two sectors to be the same, the portion of the rebate attributable to the public sector is then £7.486 x 5.2/7.6 = £5.1 billion. 30% of this is derived from employee rebates, i.e. £1.54 billion.

This figure *excludes* the employer component of the NICs rebate, which is circular (it simply returns to the Treasury) but a third of it relates to the LGPS, which is funded. Contracting the LGPS back into S2P would introduce an additional deferred cost (S2P payable in the future),

93 Contracted out employers and employees pay reduced rates of NICs, receiving discounts of 3.7% and 1.6% from the full rates of 12.8% and 11%, respectively. The Pensions Act 2007 provided for the abolition (in 2012) of contracting out of S2P for DC schemes, personal and stakeholder pensions, but DB schemes (which includes most of the public sector) are excluded.

94 On 23rd August 2010, GAD launched a consultation in respect of contracting-out rebates for 2012 to 2017.

95 As pointed out by Dr. Ros Altmann, in her submission to Lord Hutton's Independent Public Service Pensions Commission, 29 July 2010.

96 As proposed by Michael Johnson, in *Don't Let This Crisis go to Waste*, CPS, September 2009.

97 More specifically the National Insurance Fund, albeit effectively co-mingled with the Treasury.

98 GAD; *Report by the Government Actuary on the draft Social Security Benefits Up-rating Order 2010, Appendix 6,* January 2010.

99 ONS, *Pension Trends, Chapter 8, Table 8.4,* April 2010.

but in the meantime the Chancellor would hugely benefit from the time value of money, spanning a generation. If we exclude the LGPS, the cashflow benefit is just over £1 billion per year, with no additional deferred cost. As an aside, from April 2012 all MP schemes will be contracted-in.

Lord Hutton's perspective

Lord Hutton's interim report[100] refers to the ending of contracting out, but appears to discount it on the basis that it "does not look attractive from a value for money perspective in the long-term". Given that, in recent years, many corporate schemes have contracted back *into* S2P, having concluded that the rebate is insufficient relative to the value of S2P, Lord Hutton's "value for money" comment is probably from the Government's perspective, rather than the schemes', a tacit acceptance that the rebate is indeed too low.

But this should not deflect attention away from the earlier point that the public sector *should* be paying the full rate of NICs anyway. Even if this argument is not accepted, the temptation is for the Chancellor to go for a cashflow quick win, accepting the subsequent growth in the S2P liability as a price worth paying.

Contracting out; a moot point?

There are two other considerations. Employee contributions are widely expected to rise as a result of pensions reform, and benefits will also be curtailed, so compounding employees' woe with higher NIC's contributions would probably exacerbate what are already likely to be difficult negotiations. And simplification of the State Pension may well herald the end of S2P anyway (subsumed within a higher State Pension), and with it, all contracting out, there being nothing to contract out of.

Other ancillary benefits to be derived from ending contracting out include:

- fairer competition for contract bidding. Private sector contractors are currently at a competitive disadvantage compared to the public sector when bidding for contracts because they have to pay full rate NICs. Consequently, less work is outsourced than otherwise; and

- greater transparency in respect of the cost of public sector employment; employers would have to pay full rate NICs.

Proposal 5: All contracting out should cease (public *and* private sector DB schemes), with full preservation of S2P rights accrued to date.

[100] Independent Public Service Pensions Commission: Interim Report, 7 October 2010. See clauses 8.19-8.21.

3.5 Where does the power lie?

(a) The unions

The TUC's influence has been in decline for decades. Trade union membership peaked in 1979 at 13.2 million, but the TUC now represents 6.2 million workers,[101] some 25% of the UK workforce. Union membership is, however, much higher in the public sector, some 57% of employees, as opposed to 16% in the private sector (an all time low). UNISON, the principal public sector union, has 1.3 million members, although this includes a substantial membership in private companies (following privatisation). PCSU, which organises civil servants, has 300,000 members.

Some public sector union leaders may see pensions as their (personal and professional) Alamo, as well as an opportunity to arrest the decline in their membership. We have already seen a predictable response to Lord Hutton's interim report from union leaders ("change will be fiercely resisted"), but given that union membership is concentrated amongst low earners, much may depend upon what first happens to the basic State Pension.

(b) Business

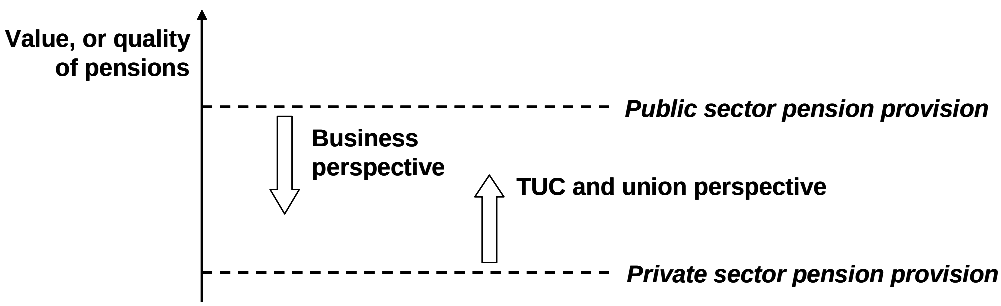
Vocal, but impotent?

Public sector pensions impose a burden on tax-paying private sector businesses, so the latter's representative bodies (including the IoD, CBI and FSB) have been increasingly vocal on the subject of pensions reform. And whilst the voices of business may not be at the negotiating table, they are a relevant stakeholder and, ideally, would buy into whatever reforms are proposed. If, however, they do not feel that reform has gone far enough, it is unclear what they can actually do about it, other than to continue to lobby.

Diametrically opposed views

The position of the TUC and the public sector unions is that private sector employers should do more for their workers and improve the quality of pension provision.[102] The business perspective is the reverse, namely that the relative generosity (i.e. cost) of public sector pensions should be curtailed, as Figure 2 illustrates.

Figure 2: Different perspectives on pensions reform



[101] Labour Force Survey. The TUC has 58 affiliated unions. Another 700,000 workers are unionised but unaffiliated to the TUC.

[102] Two out of three private sector workers receive no employer support towards a pension; Brendan Barber, TUC General Secretary.

Business voices may suggest that the unions' perspective is compromised by stark economic reality, notably the weak economy and increasing international competition. More specifically, they point to the private sector pension schemes' huge deficits, as well as the accounting and regulatory environment that imposes risks on business which are outside of their control, and unrelated to their core activities (see Appendix II).

Perhaps the ideal outcome is that the quality of the two sectors' pension provision should converge.[103] Public sector pensions should be made more affordable (i.e. less generous) at the same time that steps are taken to improve private sector pensions; a strategic, consensus-building move to make real the buzz-phrase that "we're all in this together".[104]

Resuscitating private sector occupational pension provision

As part of a strategy to appease the private sector, Parliament could also, whilst debating public sector pensions reform, explore how to help resuscitate private sector schemes. Initiatives could include loosening some of the regulatory strictures that have sent private sector schemes into retreat, i.e. reopening some of the "safety valves" that existed twenty years ago, but which were welded shut by subsequent legislation. More specifically, Parliament could:

- unwind the regulations which converted discretionary benefits into onerous, legally hard-wired, pension guarantees. Ideally, we should return to a good faith, "best efforts" basis, contingent on investment performance i.e. redress the over-reaction to the Maxwell scandal. In particular, employers should be given more discretion when up-rating pensions in payment and deferred rights;[105]

- amend the Companies Act to allow companies, when measuring their pension scheme liabilities, to use a discount rate which more appropriately reflects the individual circumstances (notably, the asset composition) of their pension funds;

- amend employment and pension scheme legislation to remove ancillary benefits that are not directly related to pension provision, such as the need for group life and long-term disability cover; and

- lobby the Accounting Standards Board (ASB) to soften the accounting treatment of pensions, notably FRS17 (which requires a scheme's surplus or deficit to be reported, potentially introducing considerable balance sheet volatility[106]). IAS19 is also part of the

[103] That said, public and private sector provision will never be directly comparable; the latter cannot match the quality of the state's AAA-rated employer covenant, for example, and the regulatory frameworks are very different.

[104] Along the lines described in this paper's Vision (for Britain's occupational pensions).

[105] The 1995 Pensions Act introduced Limited Price Indexing (LPI), which requires pensions to be up-rated by a measure of inflation, up to a limit of 2.5%. Historically RPI has been used as the index; in future this will be CPI. This was the first sensible initiative, in many years, to help resuscitate occupational schemes because it acts to counter the main force that has been driving employer-sponsored schemes into retreat; the cost to the employer.

[106] The volatility arises because the reported surplus or deficit is the difference between two very large numbers; assets and liabilities, which are themselves volatile.

problem, but as an international accounting standard it is harder to tackle. That said, there has been much debate concerning the appropriateness of mark-to-market accounting for pension liabilities, but change is unlikely until a more suitable alternative is proposed…and that has not been forthcoming.

Proposal 6: Public sector pensions reform should be accompanied by initiatives to resuscitate private sector pensions provision. These could include:

- unwinding the regulations which converted discretionary benefits into onerous, legally hard-wired, pension guarantees;
- amending employment and pension scheme legislation to remove ancillary benefits that are not directly related to pension provision; and
- lobbying the Accounting Standards Board (ASB) to soften the accounting treatment of pensions, notably FRS17.

In addition, the Government should at least be aware of the potentially damaging consequences of a recent EU Green Paper[107] that proposes to apply insurance-style funding solvency rules to DB pension schemes, modelled on Solvency II. The Commission is seeking to treat pensions in the same way that it deals with insurance schemes. Whilst the latter could suddenly face large, unexpected demands on their capital, pensions pay out over time in a fairly predictable manner. The CBI claims that a typical pension fund liability would be about 10% higher under Solvency II than IAS19, leading to British companies having to inject many £ billions of additional cash into their DB pension schemes.

(c) The Independent Public Service Pension Commission (IPSPC)[108]

Temporary shelter for the Government

The Chancellor established the IPSPC, under Lord Hutton's chairmanship, to help the Government side-step the political landmine that is public sector pensions. It was no surprise that the political parties' pre-election manifestos were pretty silent on the theme. Furthermore, until the IPSPC reports in March 2011 (in time for the Budget), public sector pensions and the complexity of coalition politics can be kept apart. The IPSPC has been charged with the responsibility to undertake a "fundamental structural review" of public service pension provision; Appendix IV contains the Terms of Reference.

The interim report

An interim report was released in October 2010, which provided a thorough appraisal of the current position. It concludes that "the status quo is not tenable", i.e. public service pensions are not on a "fair and sustainable footing that provides the best possible value for money to

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107 European Commission, Green Paper: *Towards adequate, sustainable and safe European pension systems,* 7 July 2010 (consultation finishes 15 November 2010).

108 Not to be confused with the Public Sector Pensions Commission, sponsored by the Institute of Directors. Its report *Reforming Public Sector Pensions* was published in July 2010.

the taxpayer as well as adequate retirement incomes for public service employees". More specifically, Lord Hutton:

- was quick to rule out any prospect of diluting existing pension rights, perhaps mindful of the retrospective aspect of the move from RPI to CPI indexation. Indeed, he is seeking legal clarity as to the meaning of accrued rights;
- flagged the growing disparity between the pension systems for public and private sector employees;
- more than hinted that higher contributions are required, along with a later retirement age; and
- acknowledged the unsustainability of final salary schemes. Here, his line of attack included unfairness *within* the public sector, i.e. the relatively few, highly-paid, public servants who are disproportionately well pensioned, compared to the vast majority of state sector workers.

Comprehensive Spending Review (CSR)
The CSR followed shortly after the publication of the interim report. The Chancellor used his CSR statement to the House of Commons as an opportunity to deliver, very publicly, some clear messages to Lord Hutton, no doubt with the IPSPC's final report in mind. After providing some warm words of encouragement ("*an excellent and independent piece of work*"), he commented that:

- Lord Hutton's proposal to consult on the discount rate was welcomed, the implication being that a reappraisal of contributions rates is due (i.e. they should go up);
- the Chancellor is looking for an additional cash saving of £1.8 billion per year, by 2014-15 (above the savings already legislated for in changes such as cap and share);[109]
- Lord Hutton's proposals should include a more progressive contributions structure (thereby protecting the low paid); and
- any new framework should retain a "*form*" of DB. This is a less than subtle hint that the days of final salary schemes are limited, perhaps to be replaced by CARE.

A litmus test for Lord Hutton?
If, post-reforms, there is a continuing need for Fair Deal-like guidance, this suggests that a material gulf remains between the quality of public and private sector retirement provision. Barriers to outsourcing could then remain, something that Lord Hutton is keen to address ("supporting productivity"), which could imply that either the Government had failed to fully implement his proposals, or that he was ignored. One hopes that this is not the case.

[109] The OBR's latest *Economic and Fiscal Outlook, Table A1,* November 2010, anticipates additional Exchequer income from public sector pension contributions of £160m, £1.27bn. £1.76bn. and £1.85bn over the 2012-13 to 2015-16 period.

PART TWO: ALTERNATIVE FRAMEWORKS

4. RISK SHARING

The prospect of any public sector pensions reform prompts us to ask fundamental questions about where the risks and responsibilities associated with retirement income should lie. Any risk sharing requires acceptance of collectivism and, more than likely, some inter-generational risk transfer (unless restricted by age cohort). The alternative is every man for himself, leading to a wider distribution of retirement income, with more retirees likely to be living in poverty.

4.1 British tinkering

The current framework for public sector pensions is devoid of cost control levers ("safety valves") that *automatically* respond to changing circumstances, notably our ability to pay for pensions.

(a) Accrual and contribution rates

Contributions and accrual rates of individual schemes and the Normal Pension Age have been amended over the years, but inconsistently across the different schemes and with mixed results. Inevitably, the more far-reaching reforms have only been applied to new entrants, and not to current members. Whilst politically expedient, such moves only deliver savings very slowly, if at all.

In mid-2007, for example, the Principal Civil Service Pension Scheme (PCSPS) ended final salary benefits for new joiners; thereafter, new employees have been entitled to a career average-based pension (i.e. a CARE-based scheme), but as part of the negotiations, accrual rates were *increased,* from 1/60^{ths} to 1/43^{rds}. At least one actuarial consultancy[110] reckons that the PCSPS is going to cost *more* in the future than before the 2007 changes. Given that the ballot of members in respect of the amendments to their pension scheme produced an overwhelming acceptance, by a 99% majority, it feels like the changes were indeed counter-productive from a taxpayer's perspective.

(b) Cap and share

A more serious attempt to introduce risk sharing was contained in December 2009's Long-Term Public Finance Report (LPFR) report. This announced the introduction of a cap and

[110] Which wishes to remain anonymous.

share mechanism for four of the largest public sector pensions schemes,[111] to limit the taxpayers' liability. The idea is that cost increases below a cap (set at 20% of salary) will be shared equally between employers and employees, with costs above the cap being met solely by employees. In addition, those earning the highest salaries will be required to pay higher contributions.

At first sight this approach appears to be sensible, but the policy rationale was described as "controlling cost pressures arising from improving life expectancy", i.e. the cap only applies in respect of longevity assumptions. Consequently, taxpayers are not protected from other factors that could increase the cost of public sector pensions provision, notably real-terms wage rises, poor economic performance, inflation and inherent unfunded scheme structural weaknesses, including a contraction in the size of the workforce relative to the number of pensioners.

Furthermore, the December 2009 Pre-Budget Report hinted at the previous government's lack of ambition, because cap and share is expected to save only a modest £1 billion a year from 2012-13 (and any subsequent increases in the benefit will be slow to materialise). That said, the cap and share approach does have merits, but how it will pan out in the future is unknown, and it will only bite slowly because the costs of getting longevity wrong will build up only gradually. We have no idea what the savings will be because we have yet to experience implementation, but seeking an annual saving of £1 billion appears to be inconsistent with addressing the OBR's cashflow shortfall forecast (Table 4), which is likely to exceed £10 billion by 2015. A much more assertive approach to risk sharing is required, and leaving the cap and share framework in place would only add to complexity.

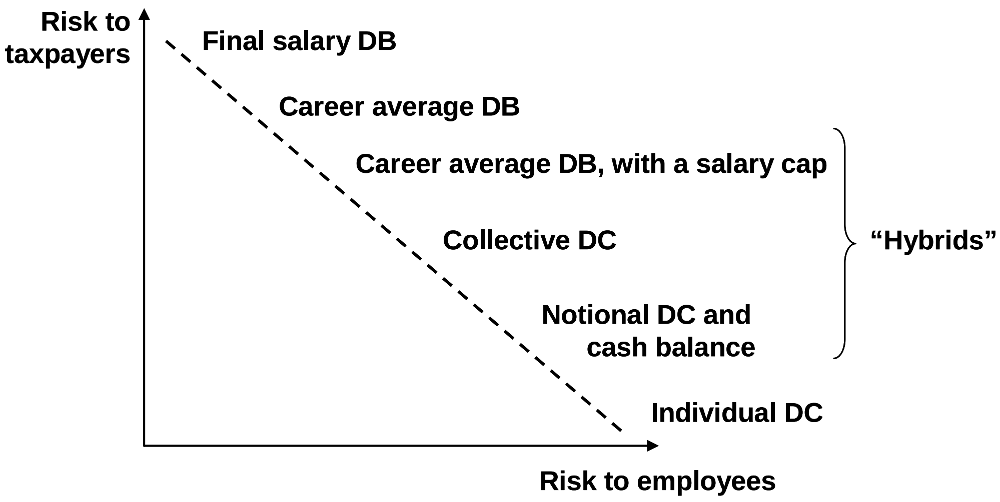
Proposal 7: The cap and share framework should be replaced by other, more assertive, cost control levers. It lacks ambition as it is expected to only save £1 billion a year from 2012-13, whereas the gap between contributions and pensions in payment is likely to exceed £10 billion by 2015.

4.2 The risk sharing spectrum

Figure 3 illustrates the risk distribution between taxpayers and employees for a range of alternative pensions frameworks.

[111] The Local Government Pension Scheme (funded) and the NHS, Principal Civil Service and Teachers Pensions Schemes (all unfunded). The Parliamentary Contributory Pension Fund (funded) has also introduced cap and share arrangements.

Figure 3: Distribution of risk for different pensions frameworks



Today's final salary regime is at one extreme of the distribution. It leaves public sector employees with minimal risk in respect of the financing of their pensions; the burden rests with the taxpayer (which of course includes public sector workers). Conversely, private sector pensions are predominately at the opposite end of the risk distribution, employees bearing all the risk themselves, in individual DC plans.

These alternative risk-sharing structures are discussed below, in descending order of risk, from the taxpayers' perspective.

4.3 A pure DC framework

4.3.1 Chile: personal DC accounts

Chile's experience with pension saving is interesting for two reasons; it has moved more comprehensively to *mandatory* pension saving than any other country, and in so doing, Chile is on the way to completing the difficult transition from an unfunded framework to a (mostly) funded one.

Like other countries, Chile has a three-tier pensions framework. Sandwiched between government-guaranteed pensions and voluntary saving are obligatory Social Security savings. 12.3% of the monthly payroll (up to an income threshold) is deducted, to be administered by one of seven private pension funds,[112] with access to assets only at retirement. Unsurprisingly, after this was introduced (in 1981), Chile initially experienced a marked increase in domestic saving which generated fresh long-term investment, a lower cost of capital, new jobs and economic growth. Subsequently, this virtuous circle has diminished, as the formerly unfunded system has transitioned to a more funded one.

It is hard to draw firm conclusions from Chile's experience, because when compulsory pension saving was introduced, Chile had an immature financial system and a very weak economy. The country was, at that time, also emerging from a time of political turmoil and

[112] The Administradoras de Fondos de Pensiones (AFP) system.

widespread distrust of government. Consequently, people liked the personal nature of the mandatory savings accounts because of the direct link between their contributions and the benefits they would subsequently derive from them. The system has, however, survived the test of time….with implications for NEST?

Within Chile itself, the debate has focused on people who have remained outside of the system for many years (mostly the self-employed or those with career-breaks). Many will not achieve the 20 years of payments required to gain access to a minimum pension; in response, the government has made pension saving mandatory for the self-employed, to be phased in over 2012-18.

4.3.2 Lessons from Australia (and thinking about NEST)

(a) The Cooper Review[113] and MySuper

Whilst the NEST structure is still evolving, it is useful to look at how the Australians are approaching funded occupational pensions. They have accumulated significant experience with compulsory saving via their state-sponsored Superannuation Guarantee ("Super G") programme, albeit that compulsion is only in respect of employer contributions (currently 9% of earnings, probably rising to 12%). Following the Cooper Review, the Australians are considering a new "universal fund", called MySuper, which would offer fewer features than existing funds. It will be available to every Australian worker as a basic option for their retirement planning.

(b) Default funds

The Australians have recognised that pension saving has to accommodate *all* workers, not just a minority with an "investor" mindset. Super G has demonstrated that most people leave investment decision-making entirely to their fund managers, or they take no interest in it at all. Government-sponsored retirement funds hold 87% of assets in the default option fund (for industry-sponsored funds the figure is 72%).[114] Consequently, MySuper will offer a list of eligible, low-frills, default funds from which employers can choose, on behalf of employees not wishing to select a fund themselves; the aim is to make it easier to save by removing barriers, including the need to make decisions.

NEST appears to be headed in a similar direction, creating a series of "target date funds", pre-set for all possible retirement years. Each fund will be made up of a blend of the five underlying funds[115] with the asset allocation determined by the NEST trustee board. The funds will use life-styling techniques to reduce risk in the run up to retirement, but this will not be a mechanistic process; the trustees will exercise their discretion while focusing on three distinct accumulation phases; "foundation", "growth" and "consolidation".

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113 *Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System,* 30 June 2010.

114 Australian Institute of Superannuation Trustees.

115 Global equity, diversified growth, gilts, index-linked gilts and cash.

(c) Post-retirement; a dearth of products

By their own admission, the Australians' key outstanding issue concerns the lack of post-retirement (i.e. decumulation) products that can cope with longevity risk, in particular.[116] They, and most other governments, want to stay out of the retirement risk market, not least because governments are already exposed to longevity through the state pension. Australians have few other options; there is a big bias against annuities (deferred annuities are illegal); for the average Australian, longevity is an uninsurable risk.

With regard to NEST, at retirement, a saver's assets could automatically be converted into a (market-priced) annuity, with the ability to opt-out. But we should expect annuity prices to become increasingly expensive because, there are very few natural counterparties with which to hedge longevity risk.[117]

(d) Charges

The Australian government has realised that Australians typically pay around A$85 a month in pension charges, more than the average person's monthly mobile phone bill. Consequently it is insisting that MySuper will have no unnecessary fees or charges, with:

- no entry fees, and exit fees limited to cost-recovery;
- a ban on commissions and conflicted remuneration structures in relation to retail distribution and advice (akin to the Retail Distribution Review's proposals); and
- a requirement for providers to deliver value for money, or be stripped of their licence by the regulator.

Every dollar Australians save in unnecessary fees directly boosts their retirement savings. The Federal Treasury predicts that the MySuper charging structure will result in a 40% reduction in costs for average investors, saving a total of A$1.7 billion a year across the industry, boosting the average individual nest-egg for a 30 year old by A$40,000 at a retirement age of 65. (The Australians are now overhauling the administration of their Super G with "SuperStream", to make the system more efficient and less costly to run.)

(e) Transparency

MySuper funds will be licensed by APRA,[118] which will also monitor and publish MySuper fund investment returns and costs to ensure members are getting value for money. There will be standardised reporting requirements, in plain English, and simple features that will make it easier to compare fund performance.

(f) Vested interests

Perhaps not surprisingly, the Australia's Investment and Financial Services Association has come out strongly against MySuper, describing it as *"overly paternalistic… it will entrench*

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116 ABC News, Inside Business, 18 July 2010; Alan Kohler's interview with Jeremy Cooper.

117 Care homes, pharmaceutical companies and funds looking to diversify away from traditional financial market risks. Ultimately, there is insufficient capital available to meet demand.

118 The Australian Prudential Regulation Authority, the regulator of banks, insurance companies and superannuation funds, credit unions, building societies and friendly societies.

disengagement and disinterest". The Association of Superannuation Funds in Australia was similarly disparaging, being unwilling to accept that lower costs would genuinely emerge.

4.3.3 Pure DC; fair, but not immediately achievable

This paper's Vision describes why public sector pensions should be, ultimately, DC-based.[119] It is, however, recognised that transitioning in a single step to a pure DC arrangement is not a pragmatic proposition, as it risks confrontation with the unions, and economic disruption.

4.4 Hybrid pension schemes

A hybrid scheme is one that provides a *degree* of income certainty to the retiree, but the extent of that certainty varies enormously between different hybrid structures.

Three structures are discussed here; cash balance, notional DC (NDC) and collective DC (CDC), but they share many features. Cash balance and notional DC schemes, in particular, are very similar, but the former is funded, the latter unfunded. All three structures may be accompanied by one or more safety valves, such as conditional revaluation of benefit accruals, transferring risk from the employer and taxpayer to the individual.

4.4.1 Cash balance schemes (funded)

Cash balance schemes were first developed in the US to replace conventional DB schemes. For legal purposes, they are still treated as DB schemes, but the promised benefit is the size of an account balance *at retirement*, not a specific, ongoing, income in retirement.

Employee and employer contributions are accumulated in participants' retirement accounts, the employer providing an assured rate of return on the account (such as CPI or the Treasury bill yield). The cash may be invested as it is with other occupational DB scheme funds, but the employer assumes the investment risk, up until retirement.

At retirement, the "cash balance" is passed to the retiree who then, typically, uses it to purchase an annuity at the prevailing market rate, thereby creating certainty of income in retirement; a "pension". His has therefore hedged his own longevity risk.

After a brief spell of popularity in the US, some cash balance schemes subsequently closed, for the same reason that final salary schemes in the UK have closed; the burden they place on employers, notably investment risk (until retirement) as well as, in some cases, high contributions.

4.4.2 Notional DC (NDC) schemes

Notional DC schemes have been tried and tested in a number of countries, notably Sweden,[120] where one forms a component of a broader mandatory savings framework that encompasses all workers (i.e. not just the public sector), as well as the self-employed.

[119] Given that a wholly DC framework provides no certainty of income in retirement, this is really a form of saving, not a pension.

[120] Although legislated for in 1994, implementation was not completed until 1999. Other countries using NDC schemes include Italy (1995), Kyrgyzstan (1997), Poland (1999), Mongolia (2000) and Latvia (2001).

(a) NDC mechanics: pre-retirement

Notional DC schemes provide individuals with a *notional* account which details their contributions; there are no underlying assets. Consequently, being unfunded schemes, contributions are paid contemporaneously to retirees. NDC schemes are therefore PAYG, which avoids the implementation challenge of transitioning an unfunded scheme onto a funded framework.

Given the lack of assets, a "deemed" rate of return on contributions has to be determined, ideally in an unambiguous manner. Sweden and Poland, for example, have indexed their NDC scheme contributions to the performance of the economy (not least to reflect the state's ability to pay); Italy and Latvia use price inflation.

(b) NDC mechanics: at retirement

At retirement, the notional account is converted into an annuity using a rate provided by the state. Note that if annuities were purchased from providers other than the state (i.e. an open market option), the state's own cashflow is disadvantaged as it would have to monetise the virtual accounts.

(c) NDC mechanics: administration

With transaction costs prior to retirement being limited to collecting contributions (there is no account access, nor any assets to manage), NDC scheme administration costs are low.

There is plenty of NDC operational experience to be gleaned from abroad, including the PAYG-based U.S. Social Security system, in which each worker has an account showing their accumulated contributions (but no underlying assets).

(d) Risk allocation and risk management

If an NDC scheme were to be used to replace a final salary-based pension, there would be a significant transfer of risk from the state to the individual. This is primarily because the size of NDC-derived pensions is linked to contributions rather than salary. This risk transfer is, however, mollified by the state providing an assured rate of return on contributions; the state assumes the (virtual) investment risk. Some countries also assume risks associated with the annuity pricing, which may be fixed and below market. Sweden currently guarantees to provide an annuity with 1.6% annual real growth, but reduces its exposure by including cohort life expectancy in the calculations. Consequently, "NDC" is a misnomer, the DC aspect not being wholly DC; NDC schemes are hybrids.

Notwithstanding these forms of risk mitigation, it became clear that the early NDC schemes could not accommodate the demographic risk, particularly a shrinking workforce relative to the number of pensioners. Consequently, they were financial unstable, contrary to the objective of providing a lasting, sustainable, framework. The Swedes responded by amending their original NDC scheme so that it achieves financial equilibrium, *automatically*.

(e) Sweden's balanced NDC scheme

The Swedes introduced a sophisticated balancing mechanism that monitors the asset/liability ratio,[121] the objective being to ensure long-term stability. If the ratio falls behind, short-term (reducing) adjustments are made to the indices governing both the returns credited to the notional accounts and pensions in payment, until the ratio is rebalanced. Thus, a wayward scheme is (theoretically) returned to financial equilibrium. Should any surpluses arise, the result of favourable demographic and economic conditions, they are added to a buffer fund which could, in the long term, be distributed.

(f) Sweden's balanced NDC; serious flaws

Some potentially serious flaws have now appeared in NDC schemes, notably concerning risk distribution.[122] The prospect of unpredictable reductions in pension payments shifts risk onto pensioners, when it is too late for them to develop other sources of retirement income. This problem is exacerbated by the lack of contributions flexibility (fixed at 18.5% in the Swedish model).

NDC schemes therefore require participants to plan their retirement income *as an individual*; to safeguard it, they either have to delay retirement or, whilst working, increase their savings elsewhere (i.e. in a separate scheme). Conversely, the risks inherent in our current public sector framework are borne by the whole of society. This raises the question of whether a balanced NDC scheme should ever be considered as an appropriate replacement for an underfunded DB pensions scheme.

Additional features could be added to the NDC balancing mechanism to address the pensions erosion, but at the price of further complexity. The contributions rate (paid by workers) could, for example, be periodically increased, *provided* that the annuity rate is not increased (i.e. no increase in the pension). Furthermore, only a part of the contribution would be allocated to the contributor's account; the remainder would have to be placed into a general (i.e. shared) buffer fund to help cope with the rising demographic burden. This approach would aim to fairly distribute the burden of an ageing population between active contributors and pensioners.

(g) Sweden's NDC; conclusion

Needless to say, Sweden's balanced NDC scheme is fiendishly complex. This raises significant challenges, notably in respect of the implementation of a NDC system, and communicating with stakeholders. Furthermore, it does not provide an innovative solution to the core problem; the lack of financial equilibrium in pension systems (worldwide), care of ageing populations. Other forms of NDC scheme have been introduced in some countries to reduce pension entitlement in line with declining mortality (i.e. increasing longevity), in a manner that is deemed politically palatable.

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[121] Assets are defined as the sum of the buffer fund plus the estimated value of assets in the form of contribution revenues. Liabilities are defined as the accrued notional pension capital plus the capital value of outgoing pensions.

[122] Michael Cichon, Director of the ILO's Social Security Department; *Balanced notional defined contribution schemes: A new "geist" in old bottles?* ILO, 2005.

Perhaps the "success" of Sweden's NDC scheme is a triumph of presentation over substance; it is certainly mis-labelled. The name suggests that the risks to which individuals are exposed to are the same as with a genuine DC scheme, with savers' contributions being directly correlated to their retirement income. But this is not the case, given that pensions in payment could be cut back. The misnomer is compounded by the inclusion of an assured rate of return on contributions, pre-retirement, which a wholly DC structure would not provide.

The original NDC schemes have been described as "new wine in old bottles, as similar financial effects could be obtained by an unfunded DB scheme with a career average pension formula and actuarial reductions and increments to compensate for early and late retirements, respectively".[123] This begs the question of why bother to change from an unfunded DB scheme to a NDC scheme? Perhaps it would be much simpler to persist with the existing architecture and increase contributions, raise the retirement age or reduce the benefits, or a combination thereof.

4.4.3 Collective DC (CDC) schemes (funded or unfunded)

Notional DC and cash balance schemes share risk between taxpayers and public sector employees. CDC schemes add another dimension; risk sharing amongst scheme members (hence "collective", i.e. the socialisation of risk).

(a) The Dutch CDC experience: two giant public sector funds

The Dutch pension system has three main pillars: a flat-rate state pension (AOW) related to minimum wages and financed via payroll taxes, individual saving schemes and funded occupational pension schemes that includes the public sector. The latter have a different legal status to Dutch private sector schemes, but in practice there is little difference between them.

Public sector pensions are dominated by two large funded CDC schemes; ABP, the National Civil Pension Fund, covering 2.8 million active and retired civil servants and teachers (assets of €231 billion, liabilities of €246 billion) and PfZW, serving two million workers and pensioners in the healthcare and welfare sectors (€97 billion of assets). Both have CARE-based accruals.

(b) The Dutch CDC experience: contributions

Dutch occupational pensions are structured to supplement the AOW state pension, so contributions (and benefit accruals) commence above a salary threshold[124] (€10,500 in 2010). ABP's contributions totalled 20.3% for 2010 (6.1% from employee, 14.2% from the employer), some 16.4% of the average salary (once the threshold has been taken into account). Employer contributions are negotiated periodically, typically every five years; all contributions are invested in private sector-managed funds.

[123] Michael Cichon; *Notional defined-contribution schemes: Old wine in new bottles?* International Social Security Review, Volume 52, Issue 4, pages 87–105, October-December 1999.

[124] This is automatically adjusted to the level of the state old-age pension for married couples.

(c) The Dutch CDC experience: indexation to control costs

The Dutch use conditional indexation to control the risk of under-funding (i.e. solvency risk), applying it to both benefit accruals and pensions in payment. Indexation is determined (objectively) by fund performance, i.e. the ability to pay, operating on a sliding scale. If the coverage (or funding) ratio[125] were to fall below 105%, indexation ceases, with full indexation kicking in above 130%. Consequently, almost all the risk within a Dutch-style CDC scheme rests with the active members and pensioners.

This is reflected in the accounting treatment for (private sector) CDC schemes, in which surpluses, deficits and expenses do not have to be shown in the employers' financial statements. A recent survey of 59 (private sector) CDC recovery plans, facilitated by changes in indexation, found that the employers' share in the recovery of fund deficits amounted, on average, to only 5% of the total plan deficit. Plan participants (active employees, former employees and retirees) were required to cover the remaining 95%.[126]

Scheme members do, however, benefit from investment collectivism, low costs and risk sharing between generations (i.e. current employees *and* pensioners). This is a fairer approach than that of the funded LGPS, for example, where deficits are only tackled through contributions (and not by reducing pensions).

(d) The Dutch CDC experience: governance

Dutch pension funds are typically overseen by an independent body with its own board of trustees,[127] supervised by the DNB, the central bank. The board's primary responsibility is to agree the pensions deal with employers and employees, including contributions, indexation and a target level for benefits. The boards of public sector funds have no political representation.

(e) The Dutch CDC experience: the communications challenge

The Dutch place considerable emphasis on stakeholder communication, not least in the interests of transparency. In a recent nationwide advertising campaign, the five biggest funds (including ABP) told members that they might have to accept lower, and less stable, pension payments than they had expected, identifying the causes to be adverse economic conditions and higher life expectancy rates. Yet many scheme members still think that their pensions are index-linked; part of the confusion arises from pensions being described as "defined" (through the CARE link to accruals) whereas the pensions are not guaranteed (being exposed to adverse changes in indexation).

(f) The Dutch CDC experience: evidence of Dutch CDC strain

- **Recovery plans and volatility.** In the first quarter of 2009, the majority of Dutch pension funds were required to file a five year recovery plan to the DNB, their coverage ratios

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125 Assets divided by liabilities. The liability is determined according to the financial commitments that have been made, taking into account benefits levels or any guaranteed investment performance.

126 OPF (The Dutch Association of Company Pension Funds).

127 Comprising employer and employee representatives, and an independent Chairman.

having dipped below the minimum 105%.[128] The primary cause was the very low interest rates used to value the long-term liabilities; lower rates translate into higher liabilities and lower coverage ratios.

ABP's ratio had fallen to 90% at the end of 2008, and PfZW's went down to 92%. Consequently temporary recovery surcharges were introduced, intending to raise contributions by 1% (July 2009) and then by a further 2% (January 2010). But the ratio recovered in the second half of 2009, care of rising markets, so the 1% surcharge was removed and the 2% surcharge never commenced. Yet by the end of September 2010 the ratios had fallen again; ABP's was 94% (PfZW's, 98%). Volatile markets feed through to volatile coverage ratios, which introduces uncertainty in respect of contribution rates. ABP and others have been lobbying their supervisor, the DNB, to change the current valuation rules so that the ratio is less sensitive to daily market swings.

- **Rising stakeholder tension.** Today there is increasing tension between the two key social partners, the trade unions and employers, over indexation and the prospect of cutting benefits and/or raising employee contributions. Both parties do, however, accept that the current arrangements are unsustainable, a message reinforced by two recent reports, commissioned by the Dutch government.[129] These concluded that many Dutch CDC schemes are wilting under growing life expectancy, an ageing population, volatile markets and low interest rates.

  In September 2010 ABP signalled that it may have to reduce pension payments (outside of the legislative framework, i.e. breaching past "guarantees"), citing historically low interest rates. It also warned that higher life expectancy will have a bigger negative impact than had been previously expected.

- **Automatic reassessment of life expectancy.** In the meantime, the social partners (unions and employers) are constantly looking over their shoulders, fearful that the Government will seize the initiative to address the funding concerns. The retirement age is already set to rise from 65 to 66 in 2020 (for occupational pensions as well as the state pension) and it has been agreed that average life expectancy will be reassessed every five years to see whether the pensionable age should be pushed up further.

(g) The Dutch CDC experience; negative outlook

Dutch pension schemes are struggling to meet pensions in payment. In a recent report, the OECD said that *"without a strong rally in equity markets, most Dutch pension funds won't be able to honour their internationally generous pension promises."* The OECD went on to say that in the longer term, promised pensions can only be secured through raising the retirement age, along with a mixture of higher contributions and lower real pensions and pension rights.

[128] 15 year plans are required if the ratio drops below about 120% to 125%, depending on the risk profile of the investment portfolio.

[129] The Frijins report (looking at investment strategies) and the Goudswaard report (long-term sustainability of pension schemes in the Netherlands).

(h) CDC; the UK perspective

- **The Retail Distribution Review** (RDR),[130] due for implementation in 2012, is likely to improve the quality of financial advice, but its availability will diminish. In ten years time there may be only a few thousand advice-giving IFAs left, and they will quite naturally focus on the wealthy, not least because these clients will be the most likely to pay for high quality advice.

  Consequently, the RDR will do little to help modest savers, and that includes most public sector workers, many of whom *need* financial advice, partly to mitigate risk. Hedging risk as an individual is more expensive than doing so collectively, so risk pooling makes sense within pension schemes that include at least an element of DC-based provision. It could be incorporated in both the accumulation and decumulation phases, perhaps as With Profits-like funds (which could be notional, i.e. unfunded) and the subsequent purchase of annuities, at retirement.

- **DWP; a dim view of CDC.** In the UK, CDC schemes (funded) are thought of as re-branded With Profits funds, albeit that the latter label now lacks public trust. Risk (including longevity) is spread[131] across all the scheme members, working and retired, so an individual's exposure is significantly less than with a personal pension, for example (unless the latter is invested in With Profits funds). This includes timing risk, the risk that retirement coincides with weak investment markets.

  The DWP has expressed a lack of enthusiasm for CDC schemes, citing concerns over generational risk transfer (i.e. pyramid schemes in the making), and in late-2009 it decided not to proceed with any UK legislative change to facilitate CDC schemes.[132] Such concerns could probably be mitigated by appropriate governance mechanisms (and many lessons have been learnt from the With Profits scandal), along with schemes having some capital backing, akin to how a bank supports risk.

(i) CDC; conclusion

It is unclear whether a CDC framework is the right one to achieve long term pensions sustainability. It may be, for example, that the problems currently being experienced by the Dutch stem from their pensions' excessive generosity, compared to contributions, rather than flaws in the CDC structure itself.

There is evidence[133] to suggest that CDC schemes' socialisation of risk does provide better *average* outcomes than standard DC schemes. Furthermore, assertive control levers (notably conditional indexation) could significantly protect the employer (or taxpayer, in the context of

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130 The RDR is a fundamental review by the FSA of the effectiveness of the retail distribution of pensions and savings products, and associated regulatory issues. It is intended to place a clear dividing line between sales and advice, and heralds major implications for the industry, particularly distributors (including IFAs).

131 "Smoothing". Consequently, the financial upside and downside of investing is dampened.

132 DWP Research Report No 623, *Employer attitudes to collective defined contribution pension schemes,* December 2009.

133 Ignis Asset Management; *2010; Sharing the Pensions Challenge. What role for risk-sharing arrangements in workplace pensions?*

the public sector). But this all comes at the price of complexity, making communication with members that much more challenging. In addition, it is hard to dispel concerns over whether even sophisticated risk management can really ensure generational equality.

The UK's unfunded public sector schemes could consider adopting elements of a notional CDC framework (some of the risk-sharing features, for example) but completely embracing a Dutch-style CDC framework would present a huge communications challenge.

4.4.4 UK corporate experience of hybrid schemes

A very limited number of UK companies offer hybrid schemes, almost all having skipped directly to pure DC provision from their previous final salary schemes. A couple of notable examples are the schemes offered by Diageo and Unilever.

(a) Diageo; a cash balance scheme

Diageo's Lifestyle Plan replaced a final salary pension scheme in 2006. It is similar to a US cash balance plan and, in a sense, is not a "pension" scheme at all since it does not pay a pension.

Members contribute 6% of salary (and Diageo provides a healthy 19%), which is invested, and at retirement, members are paid out a lump sum commensurate with their career average salary. They then typically purchase an annuity. Diageo therefore carries the investment risk while the fund is building up (with the attendant balance sheet volatility that comes with having to mark to market pension assets and liabilities), but on retirement this is passed to the members, along with the longevity risk.

(b) Unilever; core CARE DB, with a DC layer above

Unilever closed its final salary scheme to new employees in 2007, replacing it with a hybrid arrangement that has a CARE-based DB core. Employees make contributions of 5% of their pensionable earnings (between £5,032 and £39,737), earning 1/60 of pensionable earnings in each plan year of pensionable service. This yearly amount then increases by inflation (maximum 5%) until the age of 65. The pension is made up of all the "years worth" of pension added together (to a maximum of 40 years service). Unilever meets all other CARE plan costs not covered by employee contributions.

Employees also have the option to make additional contributions, above the threshold, into a DC plan, and Unilever will make a contribution of 12.5% of employees' pensionable earnings above £39,737. This can be received either as a contribution into the DC plan or as additional salary, or a combination thereof.

4.4.5 Hybrid schemes; conclusion

There is almost an infinite variety of ways of combining DB and DC features into a pension scheme, including the possibility of simultaneously accruing a part-DB pension and part-DC pension. Dividing risk between stakeholders comes at a price; structural complexity, and the risk of confusing employers and employees alike.

Replacing today's unfunded schemes with an innovative hybrid scheme would also raise a major question amongst employees; is this merely a politically palatable interim step en route to a wholly DC framework?

4.5 Pure DB

(a) "DB" is open to interpretation

At first sight, retaining a pure DB framework might suggest little change to the public sector's current pension arrangements. But "DB" is only a reference to the certainty of pension provision, not to its scale, nor *how* it is provided.

Consequently, smaller pensions and larger employee contributions would be consistent with a DB framework. Accruals could, for example, be slowed down by being moved to a CARE basis (and schemes would then be more progressive), and a salary cap could also be introduced, thereby limiting accruals (salary above the cap would not count for pension purposes). An upper limit could also be placed on pensions in payment.

(b) Guaranteed annuities?

Alternatively, pensions certainty could be provided by the state guaranteeing access to fixed price annuities, to be purchased with an uncertain "pot" at retirement. But if such a facility were to be made available (requiring the state to assume longevity risk), it should be open to the private sector too. The Treasury would appreciate the cashflow...

4.6 Risk distribution; summary

(a) No scope for alchemy

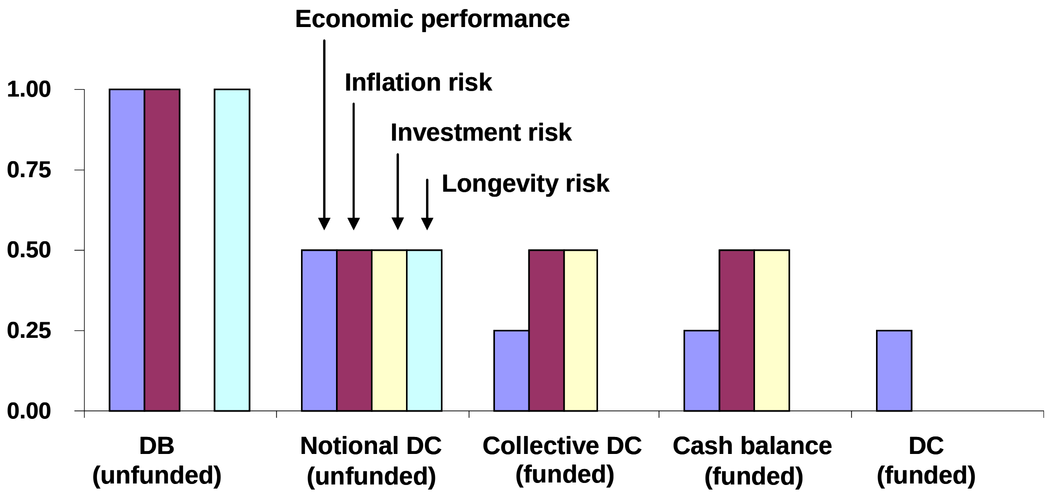
Risk cannot be structured away; individual components of risk have to be identified and allocated. Table 8 summarises the distribution of risks *from a taxpayer's perspective*; an employee's perspective is the reverse (for example, if the taxpayer is not exposed to a particular risk, then the employee is).

Table 8: Risk distribution; a taxpayer's perspective

Risk	DB (unfunded)	Dutch model of CDC (funded)	Notional DC (unfunded)	Cash balance (funded)	DC (funded)
Economic performance	Exposed	Exposure limited by indexation of accruals, pensions in payment	Exposed to high employer contributions	Exposed to high employer contributions	Exposed to high employer contributions
Inflation	Exposed to wage inflation and pensions indexation	Exposed to earnings inflation	Exposed to earnings inflation and annuity rates (if subsidised)	Exposed to earnings inflation and annuity rates (if subsidised)	Not exposed
Investment risk	Not exposed	Exposure limited by indexation of accruals, pensions in payment	Exposed through revaluation of notional accounts, pre-retirement	Exposed via assured asset growth, pre-retirement	Not exposed
Longevity risk	Exposed	Exposed, but limited by indexation of pensions in payment	Not exposed	Not exposed	Not exposed

Figure 4 replicates the information from Table 8 in a (crudely) quantitative manner.[134]

Figure 4: Risk distribution; a taxpayer's perspective



(b) Longevity risk; the biggest issue

The most difficult risk to manage is longevity, so it makes sense to place it where it can be best managed. But the state is already very exposed (through the State Pension, health and welfare costs), and whilst there are hedging tools available to the individual (such as annuities and some insurance products), they are becoming increasingly expensive, not least because, as previously noted, there are very few natural counterparties with which to hedge longevity risk.

Perhaps the best we can do is to raise awareness of longevity risk and encourage people to assume more personal responsibility for their retirement income. That means saving more, and to encourage this we need to introduce much more flexibility into pension schemes, such as being able to delay taking benefits, or taking smaller benefits, but earlier.[135]

Cash balance schemes are interesting because they clearly place longevity risk with the individual. Whilst working, however, employees get a helping hand to accumulate an asset pot (through employer contributions and assured pot growth) but, post-retirement, they are on their own, as per a DC scheme.

(c) Two non-traditional risks

Table 8 and Figure 4 exclude two risks not normally referred to in the context of pensions; behavioural risk and reform implementation risk. Behavioural risk refers to the temptation for employers to (continue to) defer today's employment costs into the future, essentially the perpetration of generational inequality on a colossal scale. It is the strongest reason to move away from wholly unfunded schemes.

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[134] With thanks to Peter Morris.

[135] This theme is more fully discussed in *Simplification is the Key*; Michael Johnson, CPS, June 2010.

Implementation risk will, perhaps, have more influence on the shape of reform than anything else, not least because it is comingled with political risk. It could materialise as industrial unrest, and is the justification for any reform package to strive to minimise change.

(d) Risk sharing and pensioners; in or out?

The issue of risk sharing raises a major question; should it be limited to current employees, or should pensioners also share some of the burden, such as in the Dutch CDC and Swedish NDC schemes? British public sector pensioners have no exposure to pensions curtailment, but if this were to continue, generational inequality is likely to be prolonged, and perhaps exacerbated.

5. FUNDED OR UNFUNDED PENSIONS?

5.1 Unfunded pensions; a cashflow catastrophe in the making

(a) Most schemes are unfunded

Unlike private sector pension schemes, the significant majority of public sector pensions are unfunded, representing some 70% of active members and including five of the six largest schemes; see Appendix V for details. The exception is the largest, the Local Government Pension Scheme (LGPS), with 1,656,000 active members. The financial dynamics of funded and unfunded schemes are quite different, although they are exposed to some common risks, notably increasing longevity.

Unfunded schemes have no underlying pool of ring-fenced assets generating a cashflow to meet pensions in payment. Instead, these are met on a pay-as-you-go (PAYG) basis, with complex implications for the future.

(b) What is the meaning of PAYG?

Most laymen probably expect "PAYG" to mean that contributions match pensions-in-payment in any given year, with occasional cashflow smoothing by the Treasury, i.e. cashflow neutrality. But this is not the case.

How PAYG got started

The original intention behind the PAYG framework was that contributions should be set to reflect pensions being accrued by employees. Thus, when they retired, their pensions would already have been provided for by their (and employers') *earlier* contributions. In practice, of course, contributions were spent immediately they were received, exposing subsequent generations to the demographic risks which, at that time, were not appreciated.

Initially, however, this approach worked well; in the early days of the NHS scheme, for example, there was a huge net cash inflow because there were so few pensioners relative to the number of employees, and the blithely held view was that cashflow "steady state" would eventually arise. Subsequent surges in lump sum payments (at retirement) and improvements in longevity were masked by a growing workforce and rising pay, which produced higher contributions to meet the increasing outflows. Thus, sustainability became reliant upon a combination of rising contributions and workforce growth *relative* to a combination of the size of the pensioner population being supported and rising pensions in payment due to increasing life expectancy.

Mature unfunded schemes are pyramidal

Our unfunded schemes have now “matured”; contributions are no longer adequate to meet pensions in payment. Consequently, the Treasury is no longer simply performing a cashflow smoothing role; it in increasingly *subsidising* contributions, a trend that is accelerating (Table 4). This is a “signal”, it is not statistical “noise”; there is no prospect of the Treasury returning to pure smoothing (unless contributions were to be hugely increased). Instead, once the Treasury’s top-ups and employer contributions are combined, the burden on taxpayers is increasing, to fund today’s public sector pensioners at the expense of many private sector workers’ own retirement provision.

Unfunded schemes now face a cashflow “triple whammy”. Not only is longevity continuing to rise but, as we have seen, Departmental cuts will reduce the headcount (i.e. fewer contributors), and some departees will take early retirement to become pensioners (leading to higher cash outflow).[136] Without reform, we are now embarked upon a slippery slope to fiscal calamity, which could be described as follows:

More pensioners and/or shrinking workforce	+	Generational cost shift, care of unfunded pension schemes	=	Unsustainable framework

With the benefit of hindsight, this is essentially a Madoff-style pyramid scheme. Bernie Madoff paid out artificially high investment gains by recycling new investors’ subscriptions, and when subscriptions fell behind previous investors’ withdrawals he liquidated assets to raise cash. Consequently, his fund management activity gravitated towards becoming an asset-free, unfunded, PAYG scheme (until the regulator stepped in).

In the pensions context, the past’s growing workforce has boosted the future liability. This is now manifesting itself as pensions in payment, which the workforce, as it shrinks, is increasingly unable to meet; clearly an unsustainable framework. Only the Treasury’s intervention (the cash plug) is preventing the pyramid from collapsing.

As an aside, the unfunded basic State Pension (BSP) is similarly afflicted; it too could be described in terms of Madoff economics. The BSP’s affordability and cashflow concerns have been largely assuaged by sending the State Pension Age (SPA) into retreat.[137]

[136] In 2009-10, of 57,000 retirees in the LGPS, redundancy accounted for 12,600 (22%), and ill-health another 3,000 (5.3%); *CLG Statistical Release, 13 October 2010, Local Government Pension Scheme Funds, England 2009-10*.

[137] The Pensions Act 2007 increased the SPA for both men and women from 65 to 68, between 2024 and 2046. This could cause more problems than it solves, becoming merely a re-labelling exercise as many of those in their 60’s become “benefit recipients” rather than “pensioners”.

(c) The TUC's interpretation of PAYG

Commingling the data

The TUC[138] justifies the ongoing affordability of unfunded pensions by pointing out that in 2007-08 the Treasury's contribution to unfunded schemes (plugging the £2.3 billion gap) was smaller than the net surplus from the LGPS ("£4-5 billion" according to the TUC), resulting in a "profit".

But such commingling of funded and unfunded schemes' data does not robustly evidence the viability of unfunded schemes. Furthermore, the Treasury did not receive the LGPS's surplus; it was retained within the LGPS's funds. The TUC's argument craters because in the following year (2008-09) the LGPS surplus contracted sharply, to £1.3 billion,[139] and unfunded schemes' cashflow gap grew to £3.1 billion (for a net "loss" of £1.8 billion?) Furthermore, the LGPS's cashflow is expected to become negative by 2016.[140]

Contributions; loans to the Treasury?

On a more philosophical level, the TUC's view of PAYG-based contributions is that they are loans from scheme members to the taxpayer (i.e. the Treasury), which are then put into the general public spending and taxation pot. To some extent, this is a credible interpretation of what is going on, pension payments representing loan repayment. But the TUC deems the Treasury's gap-plugging cashflow to be akin to loan interest; given the forecast size of the Treasury's contribution, this is a ludicrously expensive way of borrowing.

5.2 The behavioural downside of PAYG

The PAYG approach readily accommodates lax financial discipline within the public sector. It shields employers from economic reality (including rapidly increasing longevity) by, for example, placing few constraints on overly-generous pension promises being made to employees. Such commitments, reaching well into the future, are disconnected from the harsh reality of annual cashflow discipline.

For some employers, PAYG has become an irresponsible convenience, a soft option used to manage people out of the public sector with augmented benefits, such as bumping up their service or salary ahead of departure, all at the expense of the taxpayer. In the private sector, they would probably be made redundant.

Employers are not held directly responsible, let alone accountable, for the accumulation of pension promises; a serious governance failure. With most schemes being unfunded, employers never have to contemplate, let alone execute, a deficit recovery plan. Ideally, the alarm over the growing annual cashflow shortfall (between contributions and pensions in payment) will now prompt employers to quantify the annual incremental "cost" of *future* pension promises and plan for how to meet the future cashflow requirement.

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[138] Nigel Stanley's ToUChstone blog.

[139] Audit Commission; *Local Government Pensions in England*, July 2010.

[140] Meanwhile, the Unite union's website, in 10 key facts about the LGPS, tells us that "income from investments and contributions exceeding expenditure on benefits by £4-5 billion every year".

The Government could simply demand increased contributions, but this would only be a quick fix, not a lasting solution because it does not address the behavioural foibles that accompany any PAYG arrangement.

Proposal 8: There should be a new chapter in the Budget Report which includes cashflow forecasts of public sector pensions in payment, and a description of how they will be financed.

5.3 The ideal is a funded framework

(a) The benefits

Moving unfunded schemes onto a funded basis holds many attractions, notably that it would:

- **enhance transparency, making it easier to hold employers to account.** Unfunded schemes do not encourage prudent behaviour; the immediate funding requirement is disconnected from the cashflow consequences of the pension promises. Funded schemes require cashflow discipline and cost control, making it more difficult to defer current employment costs, and they would also appear on the nation's balance sheet. Today, only current pensions in payment are recognised in the fiscal accounts; new promises are unaccounted for.[141] In addition, public and private sector schemes would become directly comparable;

- **force us to address generational inequality.** Unfunded schemes have allowed us to foster on the younger generations a legacy of rising contributions (and taxation), to meet the older generation's pensions in payment. Funded pensions are backed by real assets, rather than a promise that taxation raised from the next generation will be sufficient to look after today's workers once they retire;

- **help stimulate a savings culture, subsequently boosting investment**. The importance of this should not be under-estimated; at some time within the next few decades we, as a nation, may well start the net decumulation of our savings assets, as our ageing population spends their savings. The cost of capital would then rise, perhaps at the same time that other developed nations are more aggressively competing (for the same reason) to source capital from abroad; and

- **reduce the cost of pensions provision.** As the Audit Commission has pointed out,[142] funded schemes should be able to achieve a better long-term return on investment than the cost of government borrowing (necessary to fund the cashflow shortfall being plugged by the Treasury).

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[141] In 1998 the Treasury, under Gordon Brown, introduced the idea of Whole of Government Accounts (WGA); full accruals based accounts covering the whole public sector and audited by the NAO. The objective was to reduce the opacity of public expenditure and increase government accountability. Implementation has, however, been repeatedly deferred.

[142] Audit Commission; *Local government pensions in England*, July 2010.

(b) Funded schemes; new challenges

Moving to a funded framework would provide some new challenges, notably concerning asset selection and associated risk management, and the need for collective funds to spread risk amongst employees. There would also be fund management charges to confront; these would have to be low to counter the asset erosion that results from years of cost compounding. And, to be clear, moving to a funded framework would not address longevity risk.

Robust governance would also be required, although not necessarily identical to that of private sector schemes. Public sector bodies, like the British Government, are effectively corporations without end, so they would not necessarily require mechanisms (such as a funding obligation) to protect employees in event of company liquidation.

5.4 Transition

(a) The "pay twice" problem...or is it?

The dominant issue is how do we wean ourselves off an unfunded framework, with its attendant generational inequality, and transition to a framework that may even be only partially funded? Whenever this question is raised, the "pay twice" problem surfaces, the suggestion that today's workers would have to contribute both to their own pension pots *and* contribute (directly or via taxation) towards paying for the previous generation's ongoing pensions in payment. This could be thought of as a hangover, following addiction to the convenience of an unfunded, PAYG, framework.

But moving to a partially or wholly funded framework does not create additional liabilities and has no impact on the Treasury's future cashflow. Inflation-proofed unfunded pension promises are state obligations in the same way that index-linked gilts in issuance are. The latter, however, are much more transparent.

(b) Seeding with index-linked gilts

Seeding the total liability

The idea of "seeding" unfunded schemes with tradable securities, to move them towards a funded status, is not a new one.[143] The Treasury could simply issue new index-linked gilts and pass them to the schemes; there would be no exchange of cash. Thereafter the Treasury would have an obligation to service the gilts for interest and principal,[144] *obligations it is already, ultimately, faced with,* albeit today characterised as unfunded pensions liabilities. In the meantime it would continue to collect employee and employer contributions.

Today's £1,000 billion (say) of unfunded pension liabilities would require the issuance of a commensurate volume of additional gilts, roughly doubling the UK Government's net financial debt from 62% to 125% of GDP. This may be cosmetically alarming, but, to reiterate, no additional cashflow pressure would have been placed on the Treasury, and contributions would continue to flow to the Treasury.

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[143] Toby Nangle, Baring Asset Management; *Solving the UK's Pension Problem*, May 2007.

[144] Note the commingling of interest and principal cashflows; pensioners would be indifferent as to the source of their pensions' cashflow.

Gilts; secondary market considerations
If the managers of the newly funded schemes were to subsequently diversify their asset holdings, by selling gilts and buying other asset classes, then the supply of index-linked gilts would increase, putting downward pressure on secondary market prices. Consequently, primary market (i.e. new issuance) real yields would rise, and that would not go down well at the Treasury.

This concern could be addressed by restricting the ability of pension funds to sell gilts into the secondary market, or the seeding programme could be introduced very slowly, spread over decades. Alternatively, we could pursue limited seeding.

Limited seeding
Let us revisit the forecast cashflow gap (Table 4) and, for purposes of illustration, assume that, post-Hutton, contributions will be increased from 2012-13 along the lines expected by the OBR, climbing towards the Chancellor's £1.8 billion CSR hint in 2015-16. As Table 9 shows, this makes little difference to the cashflow gap (between contributions and pensions in payment), which will have to be bridged by the Treasury. Indeed, we can be pretty sure that, without reform, within a decade it will be approaching £15 billion *per year*. Let us introduce £5 billion of gilts seeding every year, maturing from 2012-13.

Table 9: Funding the forecast cashflow shortfall

£ billion	**2012-13**	**2013-14**	**2014-15**	**2015-16**	
Cashflow gap; OBR forecast*	£5.8	£7.3	£8.9	£10.3	
less* additional contributions*	£0.2	£1.3	£1.8	£1.9	
Cashflow gap, unfunded	£5.6	£6.0	£7.1	£8.5	
Seeded gilts; maturity proceeds	£5.0	£5.0	£5.0	£5.0	*etc.*
Residual unfunded gap	£0.6	£1.0	£2.1	£3.5	

**HM Treasury Budget 2010*, Table C13, Total Managed Expenditure
***OBR forecast; Economic and Fiscal Outlook, Table A1,* November 2010

Thus, in the first four years, a total of £20 billion of maturing gilts would be required. In the context of the £165 billion of gilts sales planned just for 2010-11, this is insignificant.[145] If £5 billion of seeding were continued annually, the next step could be to *require public sector employers to reimburse the Treasury its gilts repayments*, commencing in 2020, say, to give employers time to plan contributions levels accordingly (the ultimate source of gilts repayment).

Proposal 9: The Government should seed unfunded pensions schemes with £5 billion (say) of index-linked gilts maturing every year. After 2020, employers should be required to reimburse the Treasury its gilts repayments.

145 Debt Management Office; *Quarterly Review, July-September 2010*.

The benefits of seeding

Seeding unfunded schemes with index-linked gilts would pressurise employers to exert more control on their pension promises, and set in motion the process of transitioning, very slowly, to a funded pensions framework (reversing employers' inclination to defer employment costs). It would also, over time, increase the supply of inflation-linked bonds as schemes diversify their assets by selling gilts and purchasing equities. This would lead to a realistic, rather than artificially distorted, (real) yield curve which would provide a number of benefits including:

- helping to reduce the unnecessarily high cost of private sector DB pension provision, a result of the last decade's artificially low real yields;[146]
- a more efficient allocation of capital, including improved annuity pricing, benefitting pensioners;
- a reduced cost of equity capital, as demand for equities would increase; and
- an accounting benefit. The Government is currently borrowing from public sector workers at a real rate of interest of 3.5%; the discount rate used in the SCAPE model to determine contributions. This is much more expensive than index-linked gilts issuance; currently, real yields on most index-linked gilts are less than 1%, and even negative on short-dated issues (i.e. the return would be less than RPI if held to maturity).

(c) Communication

It will be crucial to clearly, and repeatedly, communicate that gilts seeding would not change the UK's credit worthiness. Indeed, enhanced transparency *reduces* risk; we would be simply crystallising the pensions liability and surfacing it in the national accounts. That said, from a presentational perspective, the Debt Management Office would probably prefer that seeded gilts be separately identify from other gilts issuance in the national accounts, not least so ensure that different nations' financial ratios could be compared on an equal basis.

[146] Accounting and regulatory changes have conspired to create a vicious circle whereby balance sheet volatility has been dampened by de-risking (selling equities and buying gilts). Demand for gilts has outstripped supply, so gilt yields have fallen, leading to inflated liabilities (due to the lower discount rate), catalysing more volatility and further de-risking.

PART THREE: THE REFORMS

6. PREPARE THE GROUND

6.1 Accrued rights must be protected

The Government should be very clear that any reform would only concern *future* accruals; accrued rights should be protected.[147]

Proposal 10: All accrued pension rights should be protected.

6.2 No "grandfathering"

Whilst there is no question that past accruals should be protected, one particularly sensitive issue concerns "grandfathering", i.e. who should pension reforms affect going forward?

From an implementation perspective, the least politically challenging approach would be to restrict changes to those yet to join the public sector; they do not have a voice. But this would not deliver enough savings to the Treasury. Such is the magnitude of the economic challenge that all employees, irrespective of their age, should be included in the reforms, i.e. no grandfathering. This has the merits of simplicity and avoids the risk of workforce schism.

Proposal 11: Pension scheme reforms should apply to *all* members, irrespective of their age or length of service; there should be no "grandfathering".

6.3 The State Pension

(a) One retirement income ecosystem

A pre-requisite to reforming public sector pensions is to step back and look at the broader picture, and consider all sources of retirement income as a single ecosystem. Pensioners are more concerned with the totality of their retirement income than its individual components. Consequently, public sector pensions should not be considered in isolation, and this would also help the Government to demonstrate that it wants to avoid a "race to the bottom". Significant steps are already being taken to simplify the benefits system, and boosting the State Pension would disentangle the benefits regime from other sources of income.

[147] Notwithstanding the change to CPI indexation for pensions in payment; "sailing close to the wind".

(b) Increase the State Pension

The basic State Pension (BSP) should be significantly increased, to a level above the Guarantee Credit threshold,[148] partly funded by ending S2P accruals. The BSP would then simply become the State Pension. A new weekly flat rate of £140 *per person* is rumoured[149] (officially discussed?), which would provide an income of £7,280 per year for singles, and double that for couples, if they have built up their own separate entitlement.

This would lift people above the means testing threshold (making it worthwhile to save in NEST, and elsewhere, without the risk of advice-related conflicts) and catalyse a virtuous circle; the cost of Pension Credit would subsequently fall, significantly (from £8.3 billion[150]). A saving in administration costs should then emerge, thereby releasing more funds which could, potentially, further increase the BSP.

Increasing the BSP to £140 would appear to make little difference to single pensioners' income replacement rate, because those on low incomes receive Guarantee Credit anyway (taking their weekly income to a minimum of £132.60); only a 5.6% increase. But pensioners would get to keep every penny of their savings or occupational pension; it would no longer be sliced away as it is with today's Savings Credit framework. Furthermore, many who are today eligible for Pension Credit do not claim it;[151] with a higher State Pension (replacing Pension Credit), they would effectively receive it automatically.

Proposal 12: As a pre-requisite to reforming public sector pensions, the basic State Pension should be raised to a flat rate above the Guarantee Credit threshold to, say, £140 per week per person (as is currently being discussed).

A much higher State Pension has significant implications for how public sector pensions could be reformed. It should dilute concerns about the low paid entering poverty in retirement, making it easier to justify moving more risk onto the individual, i.e. moving towards a DC-based framework for retirement provision.

148 The basic State Pension is £97.65 per week for a single person and £156.15 for a couple. Guarantee Credit provides a guarantee of a minimum level of weekly income for single people (£132.60) and couples (£202.40).

149 Mid-November 2010.

150 Expected outturn for 2009-10; HMT, *Budget 2009,* DWP Expenditure Table 4, 2009.

151 One in three eligible receiving pensioners do not claim Pension Credit, saving the Government up to £2.5 billion. Sadly it is often the most vulnerable who are not taking up their entitlement.

6.4 Establish one objective for pension schemes

(a) Two related themes

Policy makers are faced with trying to address two related themes:

- closing the cashflow gap, currently being plugged by the Treasury; and
- slowing down, halting, and then, ideally, reversing the growth in the total public sector pensions liability (arising from factors other than changes in the discount rate).[152]

These themes are related because the liability subsequently manifests itself as pension payments, i.e. demands for hard cash. Gaining control over the liability would therefore help close the cashflow gap. What is required is one, unambiguous, requirement of pension scheme management, working with the employers, that encapsulates both themes.

(b) Cashflow self-sufficiency

Public sector pensions schemes should be required to become cashflow self-sufficient. The gap between contributions and pensions in payment should be closed, thereby eliminating the Treasury's (i.e. taxpayers') open-ended exposure. Pension schemes that are cashflow self-sufficient, i.e. not reliant on Treasury pit-propping, are likely to be sustainable. Chapter 8 considers *how* self-sufficiency may be achieved.

Proposal 13: Each public sector pension scheme should be required to become cashflow self-sufficient within a specific timeframe, to be individually negotiated with the Treasury.

6.5 Empower appropriately

Unlike the private sector, employers typically have little or no control over their employees' pension arrangements. This "disconnect" should be addressed, not least because employers should be involved in the design of their employees' total remuneration packages.

Proposal 14: Employers and pension scheme management should be formally linked to establish total remuneration packages alongside a strategy for achieving pension scheme cashflow self-sufficiency.

6.6 Acknowledge that one size does *not* fit all

The benefits and terms and conditions of the public sector's unfunded schemes are not standardised. Accrual rates (career average or final salary), contribution rates (see Appendix III), additional lump sums, draw-down options and ill-health benefits all vary.[153] Additional complexity is provided by different pension arrangements for existing members and new

[152] The main factors that increase the liability are increasing longevity, growth in the size of the workforce and rising pay.

[153] The main features of the largest PAYG schemes are summarised in Appendix 3 of the NAO's report *The Cost of Public Service Pensions*, 12 March 2010.

entrants; the Normal Pension Age of the former is 60, whereas new entrants are now expected to retire at 65 in some (but not all) of the larger schemes.[154]

Consequently, ahead of any reforms, schemes are starting from quite different positions. Harmonising pension schemes across the public sector, by imposing a "one size fits all" universal scheme, would face significant, and unnecessary, implementation challenges.

6.7 Allocate responsibility

(a) Widespread discretion

The responsibility for pensions reform should be placed with the management of individual schemes and employers. Suitably empowered and accountable (not least to provide a sense of ownership), they should be given substantial discretion as to *how* to achieve cashflow self-sufficiency.

Proposal 15: Pension schemes management, working with employers, should be given discretion as to *how* they will make their schemes cashflow self-sufficient. Their plans should be made public.

(b) Political consistency

This allocation of responsibility to achieve pension scheme cashflow self-sufficiency is consistent with the current government's doctrine of localism (or at least the Conservative arm of the coalition). Pension scheme management and employers would have to be accountable for their actions, which would encourage them to act more responsibly by, for example, exerting greater control over the ongoing accumulation of pension promises. It would also enable individual schemes to preserve their identities.

(c) Political expediency

Central government's role would be limited to requiring the pension scheme management and employers to become self-sufficient in respect of pensions financing, removing it from the forthcoming negotiation process with employees' unions.

6.8 Identify a cost control toolkit

Cost control levers ("safety valves") redistribute financial risks amongst different stakeholders, notably employees and taxpayers (directly, and indirectly via employers). They perform an attenuation role, adjusting current or future cashflows to reflect changes in circumstance (notably the ability to pay, a form of "sharing the proceeds of growth"). They should be objective, i.e. readily quantifiable; if subjective, they could become the focus of drawn out debate between different stakeholders (as the Dutch have discovered).

The more familiar safety valves are rarely used, but they are very impactful; the ability to change the Normal Pension Age,[155] the basis of provision (DB or DC) and contribution rates.

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[154] Following a Public Service Forum agreement in October 2005, covering the Civil Service, NHS and Teachers Pension Schemes.

[155] Delaying the NPA reduces the number of years that pensions are in payment, increases the number of years of contributions and increases the number of contributors).

The State Pension Age, for example, has been sent into retreat[156] to help manage the future cost of the basic State Pension, and private sector employers have transferred risk to their employees by moving from DB- to DC-based pension provision.

There is a variety of indexation-based (i.e. automatic) valves to choose from, including:

- conditional indexation of benefit accruals, including any lump sum entitlement. The index could be a measure of economic performance (GDP) or inflation (CPI), or, if a funded scheme, the fund's coverage (i.e. solvency) ratio;
- conditional indexation of pensions in payment. The index could be a measure of life expectancy (at retirement or by age cohort) or economic performance. Through indexation, pensions up-rating could be halted, or even reversed, if financial circumstance so required;
- linking the rate of return on notional DC contributions to a measure of economic performance, gilt yields, earnings or inflation; and
- basing retirement age on Expectation of Life. The retirement age could, for example, be increased by one year for every two years of extra life expectancy.

The control levers should form part of the negotiations between employers, pension schemes management and unions, which is likely to raise some big questions, including whether pensioners should share *any* of the risk sharing burden (by being exposed to the possibility of having their pensions reduced).

Proposal 16: Pension schemes should be free to incorporate whatever safety valves they consider necessary for the purpose of controlling their pension costs. These could include conditional revaluation of benefit accruals and conditional indexation of lump sum payments and pensions in payment.

[156] To the age of 68, in 2046.

7. COMPULSORY PARTICIPATION IN NEST (FOR THE PUBLIC SECTOR)

7.1 Too good an opportunity to miss

One of this paper's guiding principles is that, whilst reforming public sector retirement provision, we have a golden opportunity to catalyse a savings culture amongst 20% of our workforce (many of whom are low earners). In addition, there are strong arguments (discussed in Section 5.3) for starting to tip-toe the public sector towards a *partially* funded pensions framework, with a component of DC-based provision.

7.2 NEST beckons

In 2012 the DC-based NEST[157] will arrive. The proposed employee contribution rate into NEST is 4% of NEST "range earnings" (not salary).[158] By coincidence, for the average earner this is close to the rumoured increase in employee contributions to public sector pensions; 3% of salary.[159] Why not require employees to direct this 3% into their own retirement asset pots? The Treasury would rather have the whole 3% for itself, but "spend to save" thinking is not entirely alien to it.[160]

Proposal 17: All public sector employees with annual earnings of more than £10,000 should be compelled to participate in NEST, contributing a minimum of 4% of NEST "range earnings", with attendant tax relief.

7.3 Employer contributions into NEST

Ideally, public sector employers should be required to adopt the same NEST contributions format as the private sector, initially contributing 1% of NEST range earnings (rising to 3% by 2017). But given that employer contributions to NEST would be invested in assets, rather than going to the Treasury, the Treasury could overrule such a proposal out of consideration for its own cashflow. If this were to happen, the Treasury should at least set an "aspirational" timeframe within which employer contributions could be redirected to NEST, stepping up by 1% every five years, say.

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157 The National Employment Savings Trust; see the Glossary for details. October 2010's CSR confirmed that the DWP will receive the necessary funding for the establishment of NEST.

158 Contribution details have yet to be finalised, but one of the commitments in the Coalition Agreement is to raise the income tax threshold to £10,000, which would then be the salary starting point for NEST contributions. Those above the threshold would then contribute an amount based on earnings in excess of the National Insurance earnings threshold (£5,715 in today's prices), up to a ceiling of perhaps £38,185. Source: page 99 of *Making Automatic Enrolment Work; A review for the DWP*, October 2010.

159 Average earnings of £23,556 (*ONS; Labour Market Statistics, November 2010*) less £5,715 x NEST's 4% = £713, compared with £23,556 x 3% of salary = £706.

160 "Spend to save" thinking is encapsulated in both the Treasury's Green Book and the Office of Government Commerce's Common Minimum Standards (OGC is part of the Efficiency and Reform Group of the Cabinet Office).

Proposal 18: Employers should be free (but not compelled) to contribute to NEST, accepting that they may be overruled by the Treasury out of consideration for its own cashflow requirement.

Prior to committing to make NEST contributions, employers should bear in mind their participation, alongside scheme management, in an agreement with the Treasury to become pensions cashflow self-sufficient within a specific timeframe.

7.4 Personal accounts are popular

The Chilean experience of personal accounts is evidence that people like the personal nature of their accounts because of the direct link between their contributions and the benefits they would subsequently derive from them. Compulsory NEST participation would represent the first step towards confronting the looming inter-generational inequality *within* the public sector, whereby today's workforce pays for today's pensioners, rather than contributing to their own retirement savings.

7.5 Socialisation of risk

To the extent that the Government would be compelling NEST participation for public sector employees, it should ensure that there are investment products available that socialise risk. Absent financial advice, one alternative for mitigating risk is to share it, and it is cheaper to do collectively than individually. Collective-style funds (perhaps With Profits, albeit rebranded) should use controlled inter-generational risk sharing to smooth the effects of market conditions.

7.6 Default funds

Behind NEST, there could be a series of advice-free, age-dependent default funds,[161] operating on a risk sharing (i.e. collective) DC basis and under a common set of rules. Individuals should be free to opt-out of their age-group default fund to select from a wide range of other investments, whilst being encouraged to minimise asset "churning";[162] transaction costs erode capital.

The private sector, not the state, should be responsible for asset management and administration. The delicate matter of default fund asset selection could perhaps rest with "wise councils", again independent of the state.

7.7 NEST compulsion; justification

Equality vis-à-vis the private sector

Auto-enrolment will bring millions of private sector workers into NEST but, currently, public sector employees are unlikely to be involved, given the quality of their occupational pension schemes. If such a scenario were to evolve, the difference in quality between the two sectors' pensions provision would be reiterated. With public sector participation in NEST it could, in time, become

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161 Younger workers would be enrolled into a fund with a relatively high equity content; as they age, they would automatically be moved through default funds which would be increasingly fixed income-based (i.e. less risky).

162 Churning: the buying and selling of assets. High persistency (i.e. minimal buying and selling) helps to keep costs low.

our sovereign wealth fund, in which everyone participates, making real the Chancellor's "we're all in this together" (which rings pretty hollow if it does not include the public sector).

The state is exposed to under-savers

A mood swing is underway, in a number of countries, concerning the extent to which the state can legitimately "encourage" personal saving. It is now accepted that many people do not behave rationally in respect of making provision for their own retirement, and that it is unfair that the state (i.e. taxpayers) has to field the consequences.

This alone justifies the state facilitating saving through a state-sponsored vehicle such as NEST, i.e. a regulated rather than a pure market-based system, the principal regulatory tool being, for the public sector, compulsion.[163]

Economies of scale

Through NEST, the state (as purchaser, not deliverer) is well placed to harness economies of scale to drive down costs. Indeed, the scaling-up of NEST funds should help drive down costs across the whole industry. This would help arrest the erosion of assets, due to the compounding of annual charges over many years, to the benefit of all savers.

7.8 End NEST's subscription charge?

NEST's proposed 0.3% annual management charge is sensible, but the 1.8% subscription charge could deter savers, particularly those who do not envisage saving in NEST for many years, or who may want to preserve their capital by holding cash. Prevailing low interest rates only exacerbate the comparison.

If public sector NEST participation is to be compulsory, perhaps the state should absorb the subscription charge, consistent with the Treasury's philosophy of "spend to save". A crude calculation[164] of the cost comes to some £64 million per annum; given the long term benefit of having a significant proportion of the working population engaged in saving (many for the first time), this could turn out to be a bargain.

Proposal 19: The state should consider absorbing the 1.8% NEST subscription charge, consistent with the Treasury's philosophy of "spend to save".

If such a proposal were to come fruition, (auto-enrolled) private sector participation in NEST would probably have to be similarly subsidised. If the whole working population participated in NEST, the total annual cost of foregoing the subscription charge would come to roughly £320 million (0.024% of GDP).

163 Compulsion could appear inconsistent with David Cameron's "responsibility revolution", in this context the idea that the individual should assume personal responsibility for his retirement income, rather than being told what to do by the state. But the state does have a right to protect itself.

164 {Average earnings of £23,556 less £5,715} x NEST's 4% x 1.8% subscription charge x 5.0 million public sector employees (in 2014-15) = £64 million.

8. PENSIONS REFORM: TWO ALTERNATIVE FRAMEWORKS

8.1 Treasury guidance, not diktat

Whilst pension schemes management, working with employers, should have discretion as to how they reform their pension schemes, it is legitimate for the Treasury to provide a few significant nudges (shoves?). Scheme management should not be *obliged* to follow Treasury guidance, provided they can convince the Treasury that their own plans would achieve cashflow self-sufficiency, within the agreed timeframe.

Proposal 20: The Treasury should issue a guidance package to pension scheme managers, detailing its preferred reforms. Scheme management would not be obliged to adopt the package, provided they can convince the Treasury that their own plans would achieve cashflow self-sufficiency, within the agreed timeframe.

8.2 Two alternative frameworks; one brave, one cautious

The Vision described at the front of this paper is for public sector pensions to become, ultimately, wholly DC-based. However, in a single episode of reform, it is unlikely to be pragmatic to change public sector employees' final salary-based pensions to a wholly DC framework. At a time when the public sector is concurrently facing a pay freeze, the risk of job losses and rising taxes, the risk of reform implementation being disrupted by union action is considerable.

Consequently, the Government should consider two alternative frameworks for pensions reform, one brave, one cautious, before deciding which one to include within the Treasury's guidance package for scheme managers and employers.

Proposal 21: The Government should consider two alternative frameworks for pensions reform, one brave, one cautious, before deciding which one to include within the Treasury's guidance package.

8.3 The "brave" framework

(a) Notional DC (for today's unfunded schemes)

The Government could immediately establish a timetable for closing the DB schemes to future contributions, and moving public sector pensions onto a notional DC basis (an unfunded form of cash balance scheme). Political expediency suggests that implementation should be targeted for 2020, say, i.e. sufficiently far ahead for many employees not to be overly concerned.[165] In the meantime, new entrants would only have access to the DC-based scheme (and the imminent retirement of the baby-boomers is a chance to hire a new generation of workers with different contracts).

Moving to a DC basis would have to be on an unfunded basis, i.e. notional DC, there would be no underlying assets, and contributions would continue to flow to the Treasury to be available to pay pensions in payment. The alternative would be that, from 2020, the Government's cashflow would sharply deteriorate; it is expected to have received £21.1 billion in contributions in 2009-10 (expected outturn).

(b) Growing the notional accounts, pre-retirement

Given the lack of underlying assets, some kind of indexation would be required by which to grow the notional accounts, pre-retirement. In the interests of simplicity and transparency, the Government should seed the accounts with index-linked gilts (issued on a cashless basis), in an amount that reflects the annual increase in the state's liability. In this context, the liability is the present value of the expected balance of the notional account at retirement, i.e. it would be based upon the expected total of future contributions,[166] discounted using the gilts yield curve. It would *not* be linked to longevity expectations, the Government would not be taking this risk.

The gilts would be held in the individual's account until retirement, with annual interest credited in new gilts. Individuals would therefore be accumulating low risk pension pots, but they should be allowed to exchange gilts for other, higher risk/higher return assets, *at their own risk*. The state's obligation would be limited to servicing the gilts.

At first sight, this arrangement (of a promised notional account balance at retirement) may appear to unfairly favour the public sector. But private sector employees with pure DC retirement provision could replicate such a scheme (albeit on a funded basis) by simply investing in gilts.

(c) At retirement, and thereafter

At retirement, a pensioner would be bearing his own longevity risk, but he could use his account balance to purchase an annuity. From a cashflow perspective, the Treasury would prefer to be the annuity seller (albeit then having to assume the longevity risk) using prevailing market rates determined in an appropriately transparent way. If the annuity were sold be a third party, the Treasury would have to monetise the notional account, transferring the cash (financed by additional gilts issuance) to the annuity seller.

Proposal 22: The Government's "brave" approach should be to timetable the closure of the public sector's DB schemes, and then move to a notional DC framework, with implementation by 2020, say. Employees' accounts should be seeded with index-linked gilts, in an amount that reflects the annual increase in the state's liability. The gilts should be exchangeable for higher risk/higher return assets, at the employees' own risk. At retirement, the account balance could be used to purchase an annuity.

8.4 The "cautious" framework

(a) Minimise change?

From an implementation perspective, one objective should be to minimise change. Tough cost control levers could be simply superimposed onto the existing final salary-based arrangements. Adjustments could be made to revaluations (in respect of pre-retirement accrual rates) and indexation (pensions in payment), whenever cost pressures deemed it necessary.

Whilst simple, this approach has several flaws, notably that it would deliver cashflow savings too slowly (unless pensions in payment were dramatically cut; not politically feasible). It would also probably lead to entrenched arguments between stakeholders as to what adjustments were really "necessary" (as the Dutch are now experiencing). And retention of the final salary basis for accruals would surely antagonise the private sector.

(b) A core of CARE-based DB provision

Less risky, from an implementation perspective, is to retain a pensions framework that includes an *element* of income-in-retirement certainty, in the form of unfunded, CARE-based, DB provision. Pension scheme management should be given discretion as to how they parameterise the basic architecture, either unilaterally or working with the unions. The key components are likely to include:

- the pension accrual rate;
- employer and employee contribution rates;
- a salary cap, limiting CARE DB accruals;
- the retirement age; and
- the lump sum accrual rate. Lump sums at retirement currently represent some 15%[167] of the present value of the pension package.

(c) Beyond the salary cap

Frustrated by the NEST contributions limit

Ideally, a framework comprised of NEST and a salary-capped CARE DB scheme should suffice, but NEST has a contributions limit (£3,600), a major flaw in its structure which serves no customer purpose whatsoever.[168] A report[169] has recommended that it should be scrapped (which could boost investment inflows, to the *benefit* of the industry) but, in the meantime, higher earners, wanting to save more than the NEST limit, would be forced to engage with another savings facility. Not only would this add to complexity, but it would compound the communications challenge that is likely to accompany any form of pensions reform.

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[167] Assuming 40 years service accrued at 1/60th and a lump sum accrued at 1/80th, paid with 3 x pension, and 20 years in retirement.

[168] The limit was introduced to protect the vested interests of the pensions and savings industry.

[169] *Making automatic enrolment work; a review for the DWP,* Adrian Boulding, Paul Johnson and David Yeandle, October 2010.

Notional DC

As an alternative, employee and employer contributions in respect of salary above the CARE DB cap could be credited to a notional[170] (i.e. unfunded) account, in a gilts-seeded, notional DC arrangement similar to that for the "brave" framework, described in Section 8.3. Being an unfunded scheme, the Treasury would receive the contributions.

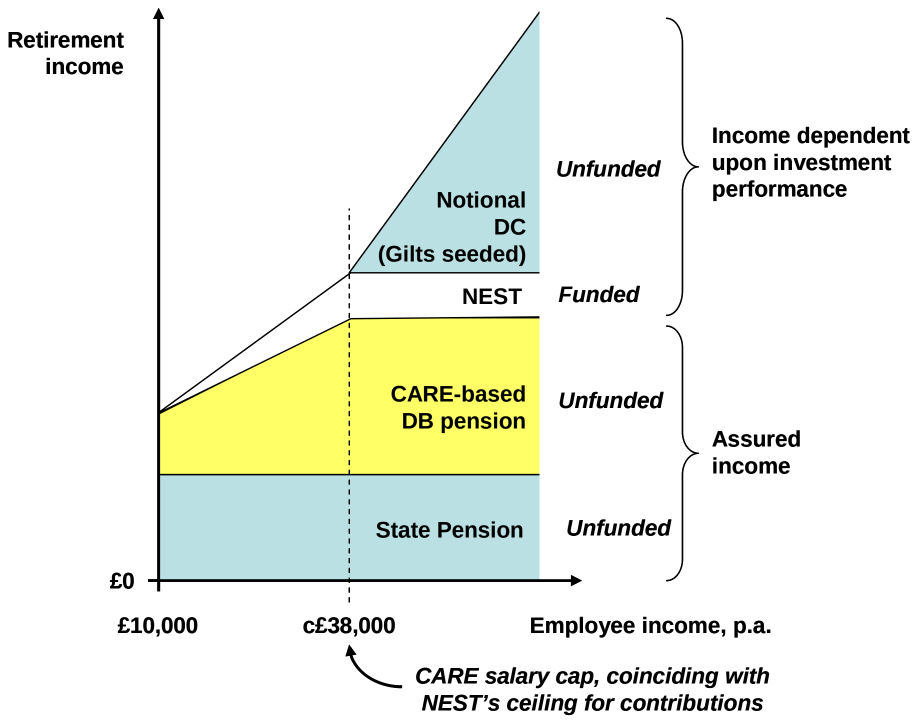
Proposal 23: The Government's "cautious" framework should comprise a CARE-based DB scheme up to a salary cap, with a gilts-seeded, notional (i.e. unfunded) DC scheme in respect of earnings above the salary cap. At retirement, the account balance could be used to purchase an annuity.

(d) The "cautious" framework; overview

Figure 5 shows how the four components of retirement income could fit together if the Government were to adopt the "cautious" framework. In this particular illustration:

- the basic State Pension has been simplified to a flat rate (with no S2P accruals);
- the CARE DB salary cap coincides with the top of the NEST-related contributions range of some £38,000; and
- the growth in income from the notional DC scheme is more rapid than NEST-derived income because contributions to the former are expected to be higher.

Figure 5: The "cautious" framework (not to scale)



[170] The pot is notional because the Treasury would prefer to receive cash rather than have it used to purchase assets.

There are several simplifications that could be considered, including:

- leaving out the notional DC component on the basis that high earners could use existing savings products (with employer contributions) or NEST (assuming the contributions cap is removed). This has the downside that the Treasury would then loses the contributions cashflow.
- reducing the CARE DB accrual rate and removing the salary cap, thereby eliminating the need for the notional DC scheme; and
- removing the NEST layer, but at the price of losing the funded component in unfunded schemes, and with it the attendant benefits of catalysing a savings culture.

Note that if the salary cap were set at the top of the NEST contribution range (c. £38,000), only some 10% of employees would earn enough to be eligible to participate in the notional DC scheme.

(e) Parameterisation

If the Government were to opt for the "cautious" framework, the Treasury should provide a recommended set of parameters within its guidance package; this is discussed in Chapter 9, along with the associated modelling.

8.5 Ancillary benefits

Ancillary benefits should be stripped out of the core pension provision. The comingling of "protection" features (such as death in service benefits, Permanent Disability insurance and Long Term Care arrangements) with core pension provision is expensive and adds to complexity.

Employers should, however, offer employees a menu of "add-ons", including insurance products, and be prepared to harness their ability to negotiate bulk-purchase discounts, at the employees' expense. One particular feature to consider is a spouse's pension (to protect non-working women, in particular); employees with partners could be auto-enrolled into buying this benefit, with the ability to opt-out.

Proposal 24: Ancillary benefits should be stripped out of core pension provision. They should be made available separately, at the employees' expense.

8.6 The consequences of pursuing the "cautious" framework

(a) Longevity risk; at odds with private sector provision

Offering any form of DB pension provision to the public sector requires the state to assume longevity risk. If it were to do this, the state should do so for society as a whole (in the interests of equality). It could, for example, make available longevity bonds to private sector pension funds, to absorb longevity risk. Such an initiative would, however, significantly increase the state's longevity exposure, and probably alarm the credit rating agencies (and the Treasury?).

But by not making longevity bonds available, the Government would be demonstrating a clear bias in favour of the public sector. Why should private sector workers assume public sector workers' longevity risk (through taxation or reduced services), when their own, DC-based, retirement arrangements offer them no such protection?

(b) The "cautious" framework... is risky

The "cautious" framework (retaining an element of DB pension provision) has been described as such because, during implementation, it risks less industrial unrest than the alternative "brave" framework of progressing towards a DC-based scheme. But, post-implementation, the "cautious" framework would probably exacerbate what is already a widespread private sector antipathy towards public sector pensions (and perhaps the public sector more broadly), not least because private sector schemes have become almost a DB desert.

Consequently, if implemented, the "cautious" framework (as described) may well become merely a staging post on the road to a pure DC framework. In the meantime, the concept of a fixed retirement age could become redundant, as people in later life demand more lifestyle flexibility. Indeed, "pensions" (with their attendant inflexibility) may entirely disappear from the landscape, to be replaced by incentivised saving.

9. MODELLING THE "CAUTIOUS" FRAMEWORK

The "cautious" framework, for unfunded schemes, is a CARE-based DB scheme up to a salary cap, with a gilts-seeded, notional (i.e. unfunded) DC scheme in respect of earnings above it, accompanied by compulsory participation in NEST.

9.1 Treasury-recommended parameters

It is envisaged that if the Government were to opt for the "cautious" framework, the Treasury should provide a *recommended* (i.e. not compulsory) set of parameters within its guidance package for pension scheme management (working with employers).

The starting point for the modelling was to replicate the IPSPC's central cost projection for benefit payments (based upon public sector pensions as currently legislated), expressed as a percentage of GDP,[171] and compare it with a variety of parameterisations of the suggested "cautious" framework. The objective was to develop a set of parameters that would produce a meaningful cost reduction, expressed in GPD terms, relative to the IPSPC's central projection. Appendix VI details the modelling methodology and underlying assumptions.

Through trial and error, a "recommended" set of parameters evolved, as follows:

- State Pension: £140 per week (per person)
- CARE-based DB accrual rate: 1/60th with CPI revaluation
- Salary cap: c. £38,000
- Normal Pension Age (NRA): As today for members, 65 for new entrants (retreating with the State Pension Age)
- Notional DC scheme: Equivalent to roughly 19% total contributions revalued at 5% per annum

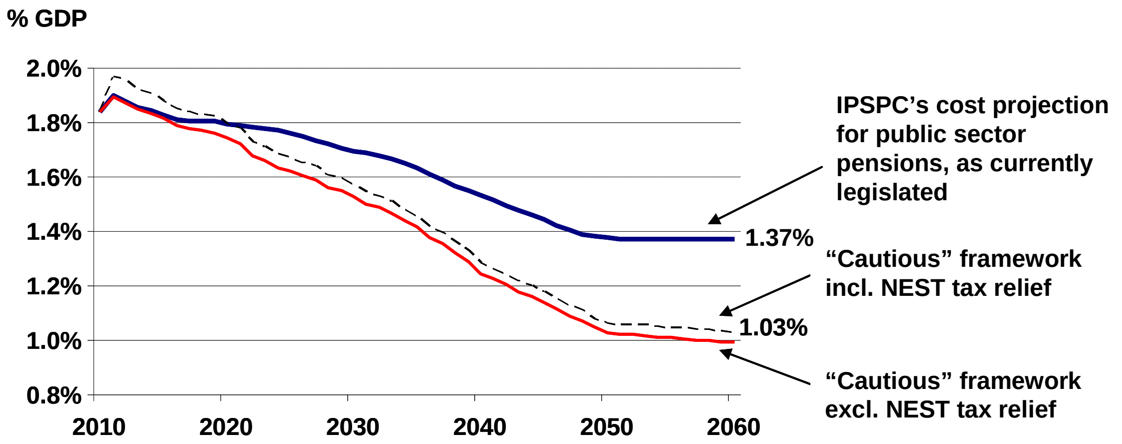
Proposal 25: If the "cautious" framework were to be selected, the Treasury should recommend a CARE-based DB scheme (1/60th accrual rate) to a salary cap coinciding with NEST's contribution ceiling (expected to be c. £38,000). Above the cap there should be a notional DC scheme equivalent to roughly 19% contributions, revalued (pre-retirement) at 5% per annum.

[171] *IPSPC interim report*; Appendix C, Chart C2,.

9.2 Cost as a percentage of GDP

Figure 6 compares the cost of the recommended "cautious" framework with the IPSPC's central cost projection for benefit payments, ahead of any reforms. It excludes employees' NEST contribution (not a cost to the state) but shows the cost including and excluding NEST's 1% tax relief. The latter would be an additional cost to the Treasury; about £680 million per annum (to become 0.04% of GDP in 2060).[172]

Figure 6: Cost as a percentage of GDP; projections



The recommended "cautious" framework starts to produce a saving, relative to the IPSPC's projection, after roughly ten years (including the cost of NEST's tax relief). By 2060 this saving is approximately 0.34% of GDP, reducing the cost to 1.03% of GDP, a 25% reduction on the IPSPC's projection of 1.37% of GDP, for 2060.

The IPSPC's cost projection includes employee contributions equivalent to roughly 0.33% of GDP, which is reasonably consistent over the whole timeframe. This remains the case with the new framework, because all of the increase in employee contributions is absorbed by NEST, rather than going to the Treasury (which explains the lack of an immediate cashflow saving). But because the projected total cost of pension provision in 2060 is 1.03%, the employees' share would rise from 24% (as 0.33%/1.37%) to 32% (as 0.33%/1.03%).

9.3 Contributions

Total contribution rates of 21.7% for the CARE DB benefit and 18.7% for the notional DC scheme are consistent with the modelled recommended structure. These contribution rates are similar to the total contributions of some of the largest public sector schemes, including the Teachers (20.5%) and NHS (19%-22.5%) Pension Schemes. Given the scope for modelling error, we could think of them as being the same, i.e. unchanged.

Proposal 26: Aggregate contributions across the public sector should remain broadly unchanged, *excluding* employees' compulsory participation in NEST. The division of contributions between employer and employee would be for negotiation.

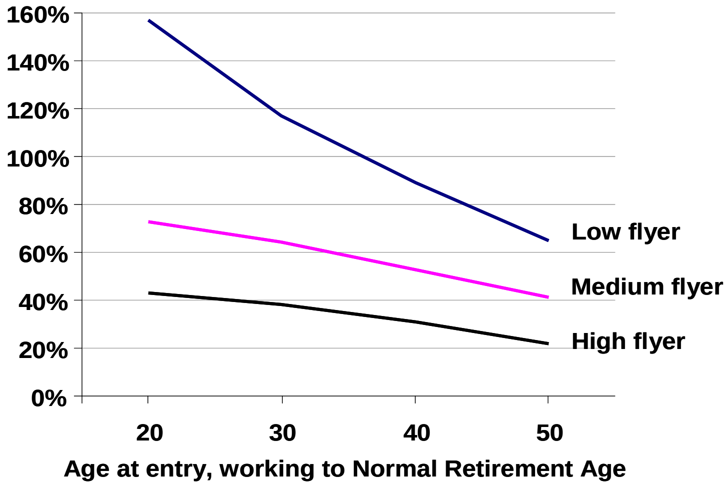
[172] Calculation by Hymans Robertson; assumes NEST introduction in 2015.

Essentially, the "cautious" framework is able to retain today's unfunded schemes' artificially low contribution rates (due to optimistically high discount rates) because of the reduction in future pension benefits (CARE DB and notional DC, rather than final salary-based DB).

9.4 Adequacy and the replacement ratio[173]

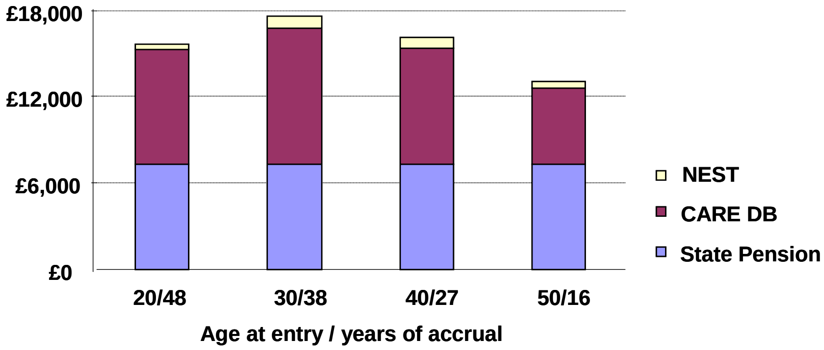
For the purpose of assessing the adequacy of the recommended structure's retirement income, the replacement ratio of three different employees have been considered, on low, medium and high income trajectories; see Figure 7. Appendix VII details the individual salary profiles and the replacement ratio modelling results, taking into account the CARE DB provision, notional DC scheme (as appropriate), NEST and the increased State Pension.

Figure 7: Replacement ratios



The low flyers' high replacement ratio is explained by starting salaries not growing in real terms during their careers. CARE-based and final salary-based accruals are therefore equivalent, and salaries at retirement are low (see Figure 8, expressed in terms of today's money). This, combined with the new, larger State Pension disproportionately enhances the replacement ratio. The recommended structure clearly protects the low paid in retirement.

Figure 8: Low flyers' income in retirement



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173 Retirement income as a percentage of salary at retirement.

Figures 9 and 10 show the corresponding retirement incomes (expressed in today's money terms) for medium and high flyers. The large retirement incomes of those starting at the age of 20 arise because the employees are working for a very long time (to the retreating State Pension Age); their pension accruals are correspondingly high.

Figure 9: Medium flyers' income in retirement

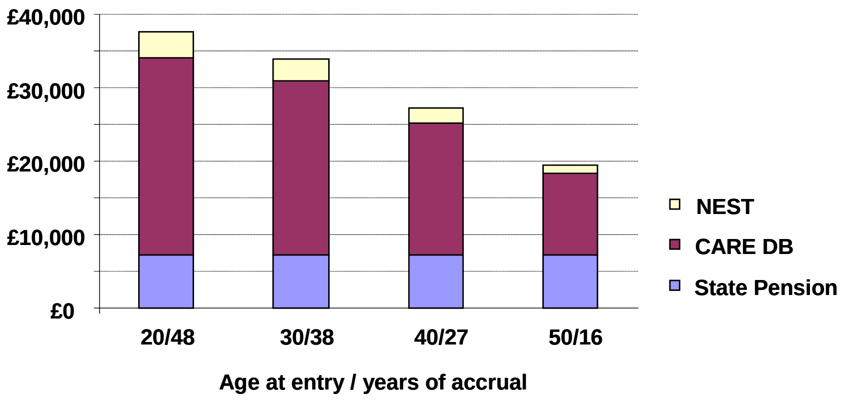
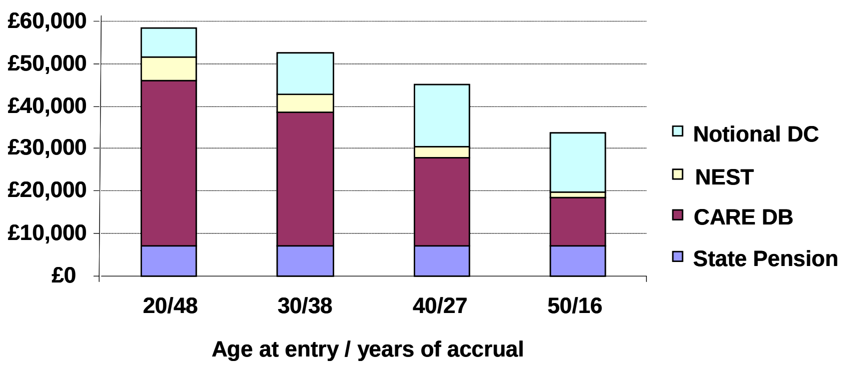


Figure 10: High flyers' income in retirement



9.5 Distribution of longevity risk

One of the consequences of the notional DC and NEST components is that they transfer longevity risk from the state to the individual, increasingly so as salary rises, as Table 10 shows.

Table 10: Proportion of longevity risk assumed by the individual

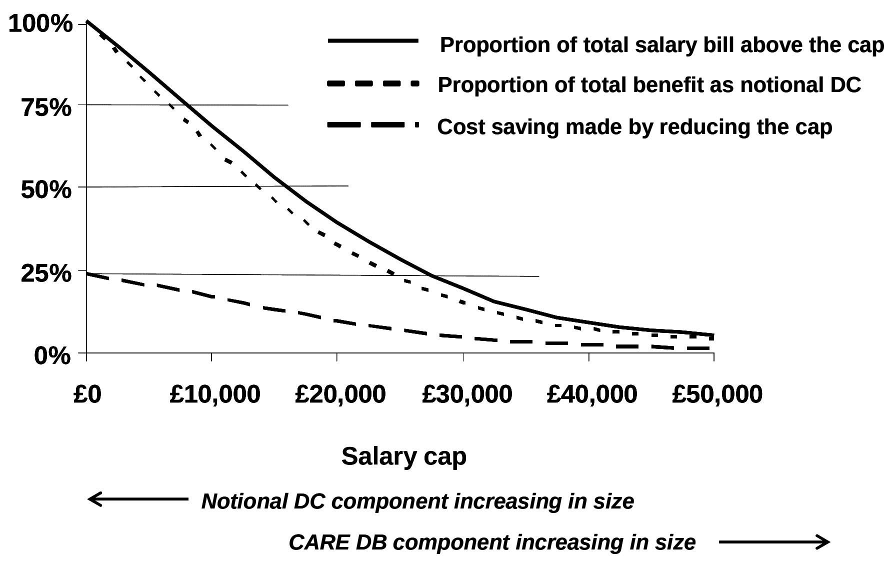
		Age at entry / Years accrual			
		20/48	30/38	40/27	50/16
Increasing salary ↓	Low flyer	2%	5%	5%	4%
	Medium flyer	9%	9%	8%	6%
	High flyer	21%	27%	38%	45%

Low flyers' retirement income is largely immunised from longevity risk, i.e. the risk resides with the state. Conversely, high flyers starting late in the public sector would be assuming almost half of their own longevity risk in retirement, having relatively few years of CARE DB accruals. The value of this risk transfer from the state to the individual is hard to quantify, but it is likely to be significant.

9.6 Change the CARE DB salary cap?

Figure 11 illustrates the impact of changing the CARE DB salary cap on the cost of pensions provision. As the cap is lowered, an increasing portion of the salary bill accrues pension rights within the notional DC scheme, rather than the CARE DB scheme's 1/60th rate. The modelling of the notional DC scheme used 1/80th accruals as a proxy, so the maximum saving is therefore 25%, when all of the pension provision would be provided by the notional DC scheme.

Figure 11: Cost sensitivity to the salary cap



Doing without the notional DC scheme would represent a structural simplification. To retain the overall cost as before, the CARE DB accrual rate would have to be only slightly reduced,[174] from 1/60th to approximately 1/62nd, because only some 10% of the salary bill is above the envisaged CARE DB £38,000 cap. But there is one drawback to having a wholly CARE DB scheme (unfunded); the state's exposure to longevity risk would be increased (with notional DC, the individual assumes the longevity risk).

9.7 Modelling risk

Making decisions based upon long-term projections of pensions costs is risky, and it is not sensible for taxpayers to assume these risks. Consequently, a reformed framework for public sector pensions should include mechanisms to accommodate getting the forecast wrong, i.e. the state needs contractual flexibility within its future pension promises, including conditional indexation.

[174] A crude weighted-average calculation is as follows: (88% x 1/60) + (12% x 1/80) = (100% x 1/62).

10. THE LOCAL GOVERNMENT PENSION SCHEME (LGPS)

10.1 The scheme; different

The LGPS is a funded scheme, and therefore quite different to almost all other public sector schemes. With more than 7,000 participating employers and some four million members[175] (nearly half are active, and 75% are women), it is the largest public sector pensions scheme, albeit divided into 100 administering authorities (81 in England, 11 in Scotland and 8 in Wales), with separate funds.

A high proportion of the workforce is part-time and low-paid,[176] so pensions in payment (final salary-based) are relatively low, averaging around £4,000 a year (£2,600 for women). Consequently, income replacement rates in retirement are of particular concern, along with the interaction with the means-tested benefits regime.

10.2 Financial condition; weak and getting weaker

The two key measures of a funded scheme's health are cashflow and the funding ratio.[177]

(a) Cashflow

The LGPS is currently cashflow positive (aggregating all the separate funds), but it is approaching scheme maturity (when pension payments would then exceed contributions), a process that would be accelerated by workforce contraction and outsourcing. A cashflow surplus of more than £3 billion in 2007-08 shrank to £1.3 billion[178] in 2008-09, and cashflow is expected to be in negative by 2016.[179]

At an individual fund level, a deteriorating cashflow has implications for asset allocation. Fund managers could be inclined to reduce their equity holdings in favour of income-generating assets, notably fixed income (i.e. corporate and government bonds), but such a move would then compromise funds' ability to recover any deficits (fixed income does not produce capital growth).

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175 Scheme members total 4.06 million (1.65m employees, 1.13m pensioners and 1.25m former employees entitled to deferred benefits). *CLG statistical release,* 13 October 2010.

176 59% of LGPS active members have annual income of less than £18,000 (90% below £30,000).

177 Assets as a percentage of liabilities.

178 England only. Audit Commission; *Local Government Pensions in England*, July 2010.

179 Meanwhile, the Unite union's website, in 10 key facts about the LGPS, tells us that "income from investments and contributions exceeding expenditure on benefits by £4-5 billion every year".

(b) *Funding ratio*

More seriously, the LGPS is significantly underfunded; liabilities total some £210 billion[180] but, in aggregate, only approximately 75% are covered by assets,[181] leaving a shortfall of some £54 billion. This widens to £95 billion if liabilities are discounted using the gilts yield curve, rather than the more accommodating, higher, discount rate that is actually used. There is a substantial variation in underfunding between individual funds, due to differences in investment performance and actuarial assumptions (affecting measurement of the liabilities). Note that deficits are effectively liabilities ultimately underwritten by council tax payers.

Looking at the LGPS funds on an aggregated basis, after years of funding ratio decline, full deficit recovery is unlikely because, even after taking into account any surplus cashflow, liabilities are growing faster than asset accumulation. The consequence of permanent underfunding is an intergenerational transfer of wealth, i.e. the same injustice that accompanies an unfunded scheme (which the LGPS is now becoming). The scheme is not sustainable in its current format.

10.3 Options for reform

Addressing the LGPS's lack of on-going affordability requires action by central government (to curtail benefits), local government (to increase employee contributions) and employers (to limit wage rises). Failure to take action would feed through to higher council tax bills (or reduced services, or a combination thereof).

In July 2010 the Audit Commission produced a detailed paper[182] outlining six reform choices for the LGPS. In ascending order of the extent of change required, these are:

- **change employee benefits and contribution rates.** The main challenge would be for the various stakeholders to reach mutually satisfactory, negotiated, outcomes;
- **enhanced local control over pension benefits**. Merging the responsibility for setting benefit levels and funding should be a key objective, but this would require central government to devolve benefit-setting responsibilities to local bodies (i.e. legislative change), requiring some re-skilling at local level;
- **improve risk-adjusted investment returns.** Taking on more risk does not guarantee investment success, and if this were to be the only reform, many years of market out-performance would be required to meet the rate of pension accruals. This is excessively optimistic;
- **fund consolidation.** At first sight, pooling all of the individual funds' assets into one, or several, giant funds is an attractive proposition. Larger funds should be able to harness

180 Using liabilities of £178 billion for England (Audit Commission estimate), scaled up for the UK.

181 LGPS (England) assets had a market value of £132 billion at 31 March 2010. *CLG statistical release,* 13 October 2010.

182 Audit Commission; *Local Government Pensions in England*, July 2010.

economies of scale, cutting operational costs,[183] but it is unclear whether investment returns would materially increase. And how could employer contribution rates be harmonised, to ensure fairness, when they range between 14% and 25%?[184] Furthermore, the financial health of individual funds varies widely, many have quite different investment strategies and employees in stronger funds could have concerns about them being merged with weaker ones. Widespread fund consolidation is therefore likely to present some implementation challenges but, in any event, the merger of the funds' administration functions should be pursued;

- **a permanently lower target funding ratio** (e.g. 75%). There is a view that the LGPS's liquidity position (the ability to pay pensions as they become due) will continue to be sufficient to overcome solvency[185] concerns, so a lower funding ratio is sustainable. This approach is not prudent, nor is it supported by evidence, given the declining trend of the cashflow surplus and uncertainly over investment performance. Furthermore, it would cement the emerging generational inequality (i.e. ending any prospect of reversing it) and increase the risk to taxpayers of subsequent assistance in meeting liabilities. This would not be acceptable; and
- **move to locally managed unfunded schemes**. The LGPS's assets could be sold to raise cash (very attractive to local governments, in the short term), with future pension payments being met on an unfunded basis. Notwithstanding legal issues, this would remove the investment risk, but this approach would have no lasting impact on affordability (which would remain reliant on GDP growth). The key point is what use the released cash would be put to. A cash inflow to the Treasury would reduce net debt but, as the Audit Commission has pointed out, LGPS funds should be able to achieve a better long-term return on investment than the cost of government borrowing. It would be better to keep the LGPS as a funded scheme.

10.4 Reform proposals

(a) Follow the path of least resistance

For ease of implementation, LGPS reforms should seek to minimise (structural) change (and certainly remain funded), and allow funds to retain their individual identity, although the merger of smaller funds should be encouraged. In practice, what is required is a combination of some of the Audit Commission's aforementioned list of reform options but, in particular, changes should be made to employee benefits and contribution rates.

(b) The framework; "brave" or "cautious"

The LGPS's pensions framework should be reformed along the lines of whichever of the "brave" and "cautious" approaches is proposed by the Government, for unfunded schemes. If

[183] In 2009, the Dutch ABP scheme cost €90.8 per scheme member (active and pensioners) to administer. The LGPS cost 27% more, at £99 (€115) per member (4.06 million members with total operating expenses of £403m). *CLG Statistic Release; LGPS Funds, England,* 13 October 2010.

[184] Employee contributions and benefits are already standardised.

[185] Employers' ongoing capacity to meet pension promises, i.e. scheme assets are sufficient to meet all future pension liabilities.

the “brave” route were selected, however, there would be no need for employees to participate in NEST; they would already be enrolled in what would become a funded, DC-based scheme (their current LGPS fund).

If the “cautious” framework were adopted for the LGPS, it would be wholly funded, comprising of a core of CARE-based DB provision, along with a DC-based cash balance scheme (rather than a notional DC scheme) above the salary cap, and compulsory NEST participation.

Proposal 27: The LGPS should adopt a funded version of whichever of the “brave” and “cautious” approaches is proposed by the Government. If the “brave” route were selected, there would be no need for employees to participate in NEST.

For administrative clarity, the LGPS’s cash balance scheme would probably have to be kept separate from the existing LGPS funds. Employees could be offered a default investment option (gilts?), but they should be free to select their own investment asset.

10.5 Governance

(a) Complex and ineffective

There are three different bodies involved in LGPS-related decision making:

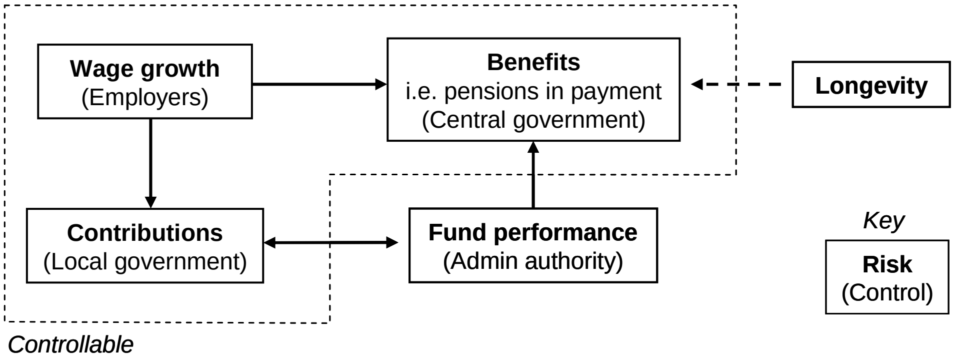
- central government, which sets the rules governing the funds and the level of benefits;[186]
- local government, via the administering authorities responsible for the funding strategy and investment performance; and
- employers (who set wages).

Consequently, there are three different parties involved in managing the three key drivers of pension fund cost (asset performance, benefits and wages); it is perhaps no surprise that the LGPS is in such trouble. This arrangement represents a serious failure of governance, very much like the tripartite regulatory system for banks (the Bank of England, the FSA and the Treasury).

Figure 12 illustrates the main components of risk, their interaction and the controlling bodies.

[186] At present, the LGPS is a statutory scheme whose trustee is the Secretary of State for the Department of Communities and Local Government (CLG). It is governed by Acts of Parliament supplemented by complex regulations and Statutory Instruments issued by a specialist team in the CLG. Any changes go through a statutory consultation process involving the employers and representatives of the employees (Trades Unions). Consultation is then considered by the minister before passing decisions to CLG lawyers for drafting of regulations.

Figure 12: Risk and control; the current framework



(b) Governance reform

Simplify the structure

The governance framework has to be simplified to become more effective. Today, implementing any change involves a multi-layered, convoluted process that has only resulted in tinkering,[187] when radical change is required.

A single, trustee-based body (the LGPS Board) should be established, accountable to the Secretary of State, responsible for all decisions concerned with LGPS sustainability.

Board membership should comprise scheme members' representatives and those responsible for the controllable aspects of pension costs, including employers and local government (representing taxpayers). This is not very different from a proposal from the London Pensions Fund Authority (LPFA), for an Independent Commission to oversee the LGPS.[188] The role of central government should be limited to setting the Board's objectives (notably, to maintain the sustainability of the LGPS) and then monitoring progress.

Proposal 28: The convoluted LGPS governance framework should be replaced by a single, trust-based Board, responsible for all decisions concerned with the sustainability of the LGPS.

Board empowerment

Benefits are currently standardised across the LGPS, so giving the new Board discretion to specify different benefits at local level would appear to be an unnecessary complication to introduce. But nationally standardised benefits fail to take into account the ability of individual funds to meet their obligations, as well as regional differences in incomes and the cost of living.

Consequently, the Board should be empowered to set fund-specific accrual and contribution rates. It should also be able to superimpose indexation-driven safety valves (see Section 6.8)

[187] An example can be found in a CLG letter to LGPS stakeholders, dated 25 June 2009, discussing a possible new employee contribution tariff. If accepted, the yield would have changed from 6.40% to 6.42% of payroll, i.e. no material impact.

[188] London Pensions Fund Authority; *A fair and affordable LGPS,* April 2010.

onto an individual fund, to ensure that it could meet its pensions obligations. The Board could be empowered to go further, for example by being able to set solvency parameters and then place wayward funds into "special measures" (i.e. the Board would assume direct control).

One other option would be to permit individual funds to opt out of the new framework (be it "brave" or "cautious"), *provided* that they have a funding ratio in excess of 90%, say, and can demonstrate a robust recovery plan, lasting no more than ten years. Any funds that do opt out, but which subsequently experience a significant drop in their funding ratio, should then be automatically moved into the new scheme.[189]

It would help the Board if the plethora of different actuarial assumptions were standardised across all funds, rather than continuing to be subject to local negotiation between Actuary and Administering Authority. The Board should not, however, have any say in respect of investment policy (administering authorities should continue to do this), nor wages, which should be left to employers. The Board would need the support of a technical team that produces regular reports of funds' cashflow and funding ratios. Ideally, the Board would be politically neutral, which could be difficult to achieve given the impact that contributions rates have on council tax bills.

Proposal 29: The LGPS Board should be empowered to:

- set fund-specific accrual and contribution rates;
- superimpose indexation-driven safety valves on an individual fund;
- set solvency parameters and then place wayward funds into "special measures" (i.e. the Board would assume direct control);
- permit individual funds to opt out of the new framework (be it "brave" or "cautious"), *provided* that they have a funding ratio in excess of 90%, say, and can demonstrate a robust recovery plan;
- encourage smaller funds to merge; and
- encourage fund administration activities to merge (irrespective of whether funds themselves merge).

[189] Funds would have to be prevented from changing their actuarial assumptions just to "manage" their funding ratio.

Self-sufficiency
It should be made absolutely clear from the outset that the Treasury is not going to provide any financial support to the LGPS; local government has to continue to be self-sufficient. In return, the LGPS funds would be allowed to retain their individual identities, mergers being at their own volition.

Proposal 30: The principles of cashflow self-sufficiency should be extended to the new LGPS Board, with no prospect of any financial support from the Treasury.

One issue that the Board may have to confront is whether fund deficits should continue to only be tackled through contributions, or whether it would be fairer to share the burden between generations (i.e. current employees *and* pensioners), though conditional indexation of pensions in payment.

Information disclosure
It would appear to be impossible to obtain a coherent set of data in respect of all of the individual LGPS funds, such as their funding status, liability profile and cashflow forecasts. Such lack of transparency fuels any reluctance to confront reality, and take necessary measures, as well as hindering the formation of policy.

Proposal 31: Each LGPS fund should be required to adhere to the same standards of information disclosure as private sector occupational schemes. Furthermore, they should adopt the same disciplines, for example in respect of any deficit recovery plan, which should be concluded within ten years.

Financial disciple within the LGPS could be reinforced by placing a cap on the proportion of council tax income that could be allocated to pension funds. This would ensure that pensions-derived financial strain is absorbed within the LGPS rather than impinging upon the delivery of services.

Proposal 32: A cap should be placed on the proportion of council tax income that could be allocated to LGPS pension funds, thereby protecting the delivery of services.

PART IV: IMPLEMENTATION

11. THE COMMUNICATION CHALLENGE

11.1 Crucial, but difficult

Reforming public sector pensions is foremost an exercise in effective communication and negotiation, rather than a technical challenge. The ability to understand, and anticipate, behaviour is critical to enhancing the prospects of achieving, for all parties, satisfactory pensions reform, one that is affordable, fair, sustainable……and peacefully implemented. Industrial strife is in no one's interests, risking our fragile economic recovery.

Much has been written about how to improve pensions communication between employers and employees (irrespective of sector). What is clear is that it is very difficult to achieve.

11.2 Meaningless numbers, meaningless words

Pensions are both complicated and emotive (fuelled by a fear of loss). Pensions analysis is replete with numbers that are hard to contextualise (i.e. meaningless), sometimes representing the present value of a string of very large numbers stretching way out into the future. As we know, the choice of discount rate, for example, often has a huge impact on the answer. In short, pensions offer almost unparalleled scope for information arbitrage, obfuscation and "economies with the truth".

As an example, consider just how unhelpful the word "average" is. The unions regularly claim that the average public sector pension is £4,000 a year. What is missing is the detail; this figure only refers to the LGPS, where many members receive only modest salaries, and short or broken service is commonplace. The average (mean) public sector pension is actually around £7,800 per year which is, of course, also misleading when one then discovers that about half of pensioner members receive less than £5,600 per year and 90% of pensioner members receive less than £17,000 per year.[190]

On top of this we should also take into account various "retirement bonuses" and the lump sums at retirement. In 2008-09, of the £19.3 billion paid to pensioners in the four largest unfunded schemes, £3.5 billion (18%) was in respect of one-off lump sums.[191]

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[190] The Independent Public Service Pension Commission (IPSPC); Interim Report, October 2010.

[191] NAO; *The cost of public service pensions, page 12*, 12 March 2010.

11.3 The challenge to the media

An illustration of the communications challenge followed publication of the OBR's Pre-Budget forecast,[192] when Evan Davis interviewed Dave Prentis, General Secretary of Unison, the largest public sector union.[193] Davis opened the interview by referring to the cashflow shortfall being plugged by the Treasury (i.e. the OBR data in Table 4 relating to unfunded schemes) and asking Prentis whether he had realised that the bill to taxpayers (meaning the cashflow gap being plugged by the Treasury) was rising so quickly.

Prentis responded by talking about the LGPS, blaming "the state of the market" and "falling share prices", which is completely irrelevant. The LGPS is a *funded* scheme, whereas Davis's question specifically related to *unfunded* schemes (the significant majority of public sector pension schemes). Prentis went on to refer to a recent actuarial report and the conciliatory steps that unions have taken to address funding shortfalls. Again, this is irrelevant in the context of Davis's question because it only applies to funded schemes. The press can be equally uninformative, repeatedly referring to "gold-plated pensions", which the vast majority of public sector workers will never enjoy.

Meaningful negotiations between employers and unions can only take place if set against a backdrop of total transparency. Historically, the true value of public sector pensions has not been reflected in pay negotiations and, as if to reiterate the transparency issue, there was a startling reference in a NAO report:[194] *"Neither the Treasury nor GAD could provide us with a complete set of public sector schemes covered by their projections."*

11.4 Communicating with employees

(a) A lack of comprehension

Pensions-related communication between employers and employees is exacerbated by the low level of product understanding and, consequently, a lack of appreciation of the value of a final salary pension. This is now, however, changing as employees (and employers) realise that any pensions reform will lead to each of them losing something. In the meantime, employers could be forgiven for concluding that generous pension provision is not an efficient form of remuneration, the real costs to the employer exceeding the benefit perceived by employees.[195]

A simple step to help overcome this would be for the public sector to provide each employee with a monthly Total Reward Statement (TRS) rather than the conventional pay slip. This should include the value of that month's pension accruals, expressed in terms of present day money. More broadly, the public sector should adopt a "total remuneration" approach to setting pay and conditions, not least to facilitate comparison with the private sector.[196]

[192] 14 June 2010.

[193] The Today programme, 15 June 2010.

[194] NAO; *The Cost of Public Service Pensions, Appendix II*, 12 March 2010.

[195] For example, if asked to choose between a £40 salary plus £10 pension contribution (to a final salary scheme), or a £50 salary, almost all employees would choose the latter option.

[196] The convergence onto CPI-indexation for both public and private sector pensions will make it easier to compare them (although private sector schemes that currently have "hard-wired" RPI-linked increases will need majority support from the trustee board to change the link from RPI to CPI).

Proposal 33: All public sector employees should be given a monthly Total Reward Statement (TRS), rather than the conventional pay slip, to include the value of that month's pension accruals, expressed in terms of present day money.

(b) Online and workplace support from employers

In the private sector, paternalistic employers are actively encouraging their employees to appreciate the benefits of saving, not least because wholly DC-based arrangements are savings, not pensions, vehicles. Consequently, employers are trying to make it easier for their employees to save for retirement, by providing *access* to sensible ways of so doing. This includes making online platforms available, from which employees can view, and manage, their assets; bank accounts, savings vehicles (ISA, personal and DC occupational schemes) and other employer-provided benefits. Tesco, for example, runs a website dedicated to its staff's pensions which, in 2009, got 50,000 hits.

But employers could go further, by asking pensions and savings providers to include employees' liabilities on their platforms. Mortgages, consumer loans and credit card balances could be visible, along with comparisons between interest earned on cash savings and interest charged on credit card balances (expressed in Sterling and in percentage terms). Consequently some employees would begin to appreciate the folly of regularly servicing debt whilst accumulating long term cash savings. This is, of course, at odds with the interests of the financial services industry.

Proposal 34: It should be an objective of public sector employers to emulate the private sector by providing access to workplace-based savings platforms (to include NEST assets).

(c) The advice conundrum

Many well-intentioned employers are keen to encourage their employees to save for the long term, but they hold back because of fears of crossing the "advice" line, and the risk of subsequent legal liability. This is also the case when employers select default funds on behalf of their employees; employers should be exempt from any liability if such a fund were subsequently to perform badly.

11.5 Nudging

Many academics have jumped onto the "nudge"[197] intellectual bandwagon but, within the pensions and savings arena, beyond harnessing inertia through auto-enrolment, there has been a paucity of actionable ideas. A few additional ideas include:

- offering employees a "save back" mechanism attached to NEST, whereby part of any future pay rise is automatically credited to NEST. (People are less likely to miss what they have never actually received);
- paying down debt rather than embarking upon positive new saving; "negative saving". (A parallel idea is to consume less energy; "negawatts");
- encouraging employees to spend less (or more wisely), rather than emphasising the need to save more;
- the use of default funds to reduce the need for decision making (which invites procrastination); and
- regularly disseminating the actual returns achieved on NEST assets, for example, rather than FSA-approved projected returns.[198] This could be combined with "target-dating", in which contributions are initially fixed and the saver checks whether he is on track to accumulate a target asset pool by a specific future date, amending their contributions accordingly.

Ultimately, it should be appreciated that changing people's attitudes towards pensions and long-term saving cannot be shoehorned into a one-off, big bang initiative. It is likely to require a generation to achieve the necessary cultural adjustment, involving repetitive, clear and concise communication and minimal policy interventions.

11.6 Financial education

(a) An inefficient investment

There is an extremely poor understanding of pensions and savings, and the importance of saving for retirement. Financial education would appear to be consistent with the Government's aim of encouraging people to assume more personal responsibility. But should we encourage people to make decisions concerning pensions, when there is compelling evidence[199] that financial education increases confidence *without* improving ability, leading to worse decisions (see Appendix VIII)?

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197 *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Richard Thaler and Cass Sunstein, 2008.

198 Disseminating projected returns is unhelpful; based upon pension funds' investment performance over the last decade, projections lack credibility. Worse, they could sow a false sense of security amongst those naïve enough to still take them seriously.

199 Lauren E Willis, Associate professor, Loyola Law School; *Against Financial-Literacy Education*, 2008.

FSA-sponsored research[200] concludes that: "*rigorous, credible policy evaluation work showing the incremental impact of financial capability is difficult to find*" and "*people's financial behaviour may primarily depend on their intrinsic psychological attributes rather than information or skills or how they choose to deploy them. In this context, the authors conclude that financial capability initiatives which are designed to inform and educate should be expected to have a positive but modest impact".* Note the word "modest".

Given this, it is questionable whether governments should promote (and pay for) financial education.

(b) Australia; "basic money hygiene"

The Australians have recently announced a A$10 million programme to bring financial literacy into the classroom, but they are realistic about what they want to achieve; the objective is not to turn Australians into financial experts. Their approach is best defined as "basic money hygiene"; they want people to know when to go the doctor (i.e. seek financial advice), not to be a doctor. The Australians have also recognised that in a democracy, regulating or legislating for behavioural change is unlikely to work, so they are trying education, whilst not losing sight of what really influences behaviour, including fear. In this context, fear of poverty in retirement.

11.7 Remember that the public sector is different

Whilst the state's role in delivering services is now coalescing with private sector delivery, we should remember that in some respects the public sector is likely to remain different to the private sector, not least because the yardsticks for success are so different. Unlike many private sector employees, perhaps motivated by the pursuit of mammon, i.e. commercial interests, many public sector employees are genuinely attracted to an ethos of public service.

This may partly explain why so many government ministers, irrespective of political hue, have discovered that implementing change within the public sector is notoriously hard to achieve in practice. In particular, ministers with private sector backgrounds find that the public sector's *modus operandi* is unfamiliar, and the significant cultural differences bewildering. The transfer of service delivery can perhaps be measured over a decade, but achieving any deep cultural change will take at least a generation. When it comes to reforming pensions, we do not have that long.

11.8 MP's to lead by example?

MP's currently enjoy a final salary pension scheme to which taxpayers contribute 20% of MPs' £65,000 salary. After 20 year's service, MP's are eligible for a pension of half their salary because the scheme has an accrual rate of $1/40^{th}$. Such pensions generosity is now unknown

[200] FSA Consumer Research 69; *Financial Capability: A Behavioural Economics Perspective*, by David de Meza, Bernd Irlenbusch, Diane Reyniers, LSE, July 2008.

in the private sector, so although their pension arrangements are outside the scope of the IPSPC review,[201] MP's probably have little choice but to accept its findings.[202]

That said, it should be acknowledged that MP's are in a high risk profession. Only a minority survive more than two parliaments, often being unseated in their early 50's. Some then struggle to find gainful employment, perhaps because their past political allegiance counts against them.

11.9 Unfortunate timing?

The arrival of NEST is an open invitation for private sector employers to reduce their contribution rates, from an average of around 7% of salary for DC schemes down to the NEST minimum of less than 3% of salary (by 2017). Consequently, a further deterioration in private sector retirement provision could coincide with the implementation of public sector pension reform; the risk is that, post-reform, public sector pensions may still appear comparatively generous.

[201] As are the schemes of other public sector entities including the Royal Mail and BBC. The latter has been offered a CARE-based scheme (instead of final salary), revalued by inflation up to 4% per year, with employee contributions cut from 7% to 6%.

[202] The Senior Salaries Review Body has already recommended that the contribution rate should be cut to 10.5% and the accrual rate moved to a 60th of salary, which would reduce MPs' pensions to a more conventional one third of final salary.

12. LESSONS FROM THE ISLE OF MAN

12.1 The experience deficit

There are very few examples of pension negotiations between public sector employers and employees. Few countries have yet to really set about reforming public sector pensions,[203] and none on the scale that the UK is likely to experience within this government. Consequently, practical experience amongst stakeholders is limited, but one example is close to home; the Isle of Man.

The Isle of Man's (on-going) experience provides a valuable case study because, as a microcosm of the UK's public sector, it has provided some insights that could be harnessed in the forthcoming negotiations in the UK.

12.2 Background

In early 2007 the Isle of Man's Council of Ministers sponsored a review[204] of their public sector pensions arrangements, concerned by the future cost, the number of schemes and their diversity, making them complex to regulate and administer. There are more than 20 different schemes, all structurally similar to those of the UK, covering some 9,000 public sector employees. The Council laid down some key principles; simplicity, affordability, a total remuneration approach and best practice governance.

The review process looked at benefits, funding, scheme constitution and implementation, and was driven by widespread consultation with stakeholders. What emerged was a classic exhibition of employees moving through the Change Cycle, which describes the emotions that we go through when we receive news of change coming our way; see Appendix IX.

12.3 Resistance to change

(a) The employee perspective

Employees' initial reactions to the first round of consultation were emotional and resistant, rather than logical or reasonable. Subsequently, people refocused; their energy was against change, they thought logically of why change would not work and used disempowering language which implied a lack of ownership ("they", "cannot", "it"). The dominant response was fear of change itself, rather than being based upon any understanding of specific loss (at that stage, no specific proposals had been made). There was very little by way of pro-

203 In February 2009, the Irish government introduced a graduated scale pension levy on all public sector workers, averaging some 7.5% of total earnings; 3% levy on the first €15,000 of pay, 6% on the next €5,000 and 10% levy for the remainder.

204 Hymans Robertson was appointed to carry out the review; negotiations are ongoing.

active suggestion from employees (indicating low energy levels; "poor me"), and it became clear that the unions had a considerable ability to lead their members' thoughts and views.

(b) The employer perspective

Employers, as individuals, are fundamentally conflicted because they themselves are future recipients of public sector pensions. Consequently, they cannot, for example, be viewed as dispassionate agents acting in the best interests of taxpayers.

But employer behaviour can be influenced by external pressures, for example by the Treasury asking Departments to account for the cost of early retirements. This cost has, in recent years, diminished markedly in some areas of UK government (hinting at just one of many areas of past governance failure).

(c) The first proposals: scrapped

Gradually people became more proactive and involved, and in December 2008 a new scheme design was proposed to the Council of Ministers. Subsequent feedback, during a six months consultation period, caused it to be scrapped, such was the strength of feeling that existing staff should be protected against change, particularly those closest to retirement. It also became apparent that people are happier contributing more to keep what they have got, rather than lose benefits (or risk unemployment).

12.4 The current proposals, and the importance of choice

The revised scheme (designed within the same cost envelope) includes much more employee choice (i.e. scheme flexibility); the ability to make decisions gives people a sense of being in control. The idea of a fixed retirement age was abandoned, so the later that people retire, the larger their pension will be.

Choice could be extended to include the ability to decide the “shape” of retirement income (such as smaller amount initially, but subsequent growth), being able to trade off the size of a lump sum at retirement against the pension itself, or a choice of different degrees of pension inflation protection. Employees should also be able to purchase ancillary benefits for dependants. But flexibility comes at the price of structural complexity, adding to the challenge of communicating effectively with employees.

Proposal 35: The behavioural “learnings” garnered from the Isle of Man’s pensions reform experience should be included in the guidance package for scheme management and employers. It would be advantageous, from a negotiation perspective, if schemes were flexible enough to accommodate *individual* needs; for example, a non-specific retirement age (i.e. the later that people retire, the larger their pension).

Table 11 summarises some of the issues confronting the Government, and how they were addressed.

Table 11: Isle of Man public sector pensions reform[205]

Issue	Response/proposals
The communication challenge with employees was hindered by employers, as individuals, not having a full understanding of the issues (compounded by their personal interest in pensions reform).	Subsequently, it has been acknowledged that it would have been beneficial to get employers on-side at an earlier stage. Employers' personal interests have been mitigated by using independent consultants to conduct the employee consultations.
A communication gap; staff do not understand their benefits, let alone appreciate their value. Many believe that their own contributions pay for their benefits in full (employers actually pay the bulk of the cost).	The introduction of the new scheme will be accompanied by a total remuneration approach to pay, to help improve communication.
Considerable disquiet amongst employees when they realised that they are paying different contribution rates for similar benefits. Civil servants, for example, are paying 1.5% for the same benefits that cost an average NHS worker 6.5%.	A single, unified, final salary scheme is now on the table, to include all employees (i.e. existing employees and new staff) with a single level of benefits, targeting a pension of around 2/3 of pay at age 65, after 45 years. The employee contribution rate will be 5% for standard benefits.
People are willing to pay more into their pension schemes to protect the benefits they expect to receive, rather than leave contributions rates unchanged and lose benefits.	A protection mechanism that enables current expectations to be met. Existing employees can protect their future service at existing benefit levels by paying additional contributions (in the range of 1.6% to 4.75%, depending on the scheme).
Opposition from those nearing retirement, but the desire to avoid "grandfathering" within the new scheme.	Staff within seven years of retirement will be exempt from paying the additional protection cost to preserve existing benefit levels (but they still have to pay higher contributions).
Initial opposition to change, particularly from those more familiar with pensions.	It is important to recognise that communication needs to take account of what is likely to be a wide disparity of pensions understanding within any workforce
Choice.	Members with have more choice as to how benefits are structured, and when they retire.
Cashflow concerns; initial proposals were likely to lead to a potential lowering of the average employee contribution rate, in exchange for a slower accrual rate.	A slower accrual rate was sacrificed for higher contributions (5%, plus additional contributions to protect existing benefit levels).
How to sell higher employee contribution rates?	Gentle transition to higher contribution rates; increases will be limited to 1% per year. The transition period could be up to seven years.
Administration of (multiple) legacy schemes.	Accrued benefits will be converted to the new scheme basis on terms that protect their value, confirmed by an independent actuary.
Control.	The "by analogy" link with the UK public sector pension schemes will be broken. This will leave the island with control over its own pension arrangements. Key stakeholders will be directly involved in scheme governance.
Concerns particular to the Isle of Man, notably the difficulty in recruiting key skills from the mainland.	Scheme differentiation. The new scheme will be final salary-based, albeit with some cost control levers in place.

[205] As at December 2010.

12.5 Reform will be slow in coming

A substantial amount of time will be required to complete the Isle of Man's pensions reform process; much has been learnt by all the stakeholders and there is now a broad acknowledgement of the need to change, but reform is not yet a "done deal". The multiple rounds of stakeholder consultation have taken far longer than initially envisaged, and challenges remain, notably concerning risk sharing mechanisms to spread the increase in cost of benefits between employees and employers.

Consequently, implementation is not expected to start until more than five years after project inception (early 2007), and transition is expected to last up to a further seven years. Completing a reform of public sector pensions requires considerable patience.

CONCLUSION

The legacy of our public sector pensions' vast liability is now manifesting itself as demands for hard cash to meet burgeoning pensions in payment. The price of meeting these obligations is generational and sectoral inequality, which is unjust. Reform is therefore essential, i.e. public sector pension provision will have to be cut back, reflected in the prevailing political mood.

It is not just about longevity

The public sector's inefficiency is a major culprit, and successive governments are to blame. Deep-rooted, cultural failings within the public sector have not been confronted, so pay growth has been excessive, given the deterioration in public sector productivity. Pensions reform is a soft substitute, when what is really required is cultural reform, leading to a hugely more efficient public sector. Were that to materialise, then retaining a degree of DB pension provision could be justified. But it is now too late.

Be brave or cautious?

Whilst the "cautious" approach, with its core of CARE DB provision, may be more pragmatic than being "brave", it is likely to be merely an interim step on the road to a pure DC framework. Within a decade, private sector schemes are likely to have become a DB desert, exacerbating the already widespread private sector antipathy towards public sector pensions. A brave government would produce an implementation road map to reach pure DC provision by 2020, say, with the state's exposure to pensions-derived longevity risk confined to the State Pension.

Spend to save?

The second difficult choice facing the Government is whether to start the transition to at least a partially funded framework. It could compel public sector participation in NEST, thereby foregoing immediate cashflow, but this would be at odds with the Chancellor's need for "quick wins". But the opportunity, to catalyse a savings culture amongst 20% of the working population, should be seized. This would also stimulate investment.

Political consistency

The prevailing political ethos is to encourage people to assume more responsibility. NEST compulsion would resonate with this (at a personal level), as would the requirement for pensions schemes to become cashflow self-sufficient (at a corporate level), accompanied by discretion as to *how* this is achieved.

Confronting the reality of our unsustainable public sector pensions architecture is politically difficult as, inevitability, there will be many who lose out financially. But it would help change the perception of our future economic performance, instilling confidence in the private sector, our trading partners and the rating agencies. Furthermore, some voters would reward those politicians who have the courage to confront the institutionalised irrationality of our unsustainable and unfair public sector pensions.

In the meantime, "pensions" (with their attendant inflexibility) may entirely disappear, to be replaced by incentivised saving.

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APPENDIX I:

THE TREASURY'S FOUR MAIN ASSUMPTIONS FOR PROJECTING THE LONG-TERM COST OF UNFUNDED PENSIONS

1. Average life expectancy of pensioners in UK public service pay-as-you-go schemes rising steadily, for example to 94.7 for women and 92.3 for men who reach 65 in 2055, in line with assumptions by the Office for National Statistics, but reflecting the longer-than-average lives of occupational pension scheme members;

2. Real-terms earnings growing by 2.0% a year for employees in UK public service pay-as-you-go pension schemes, linked to the assumptions described earlier of 2.0% annual growth in productivity and real-terms earnings in the wider economy;

3. A constant number of employees covered by UK public service pay-as-you-go pension schemes; and

4. Two-thirds of employees' share of increased future pension costs being taken as reduced future pension payments, and one-third as increased employee contributions, under changes to the schemes.

APPENDIX II:

PRIVATE SECTOR PENSION SCHEMES; UNDER THE COSH

The Pension Protection Fund (PPF) reports on a monthly basis the financial status of the 6,560 defined-benefit schemes that it monitors. These reports have a dominant characteristic; volatility. In the past two years the aggregate position of the schemes has swung from a deficit of £192bn in March 2009 to a surplus of about £53bn in March 2010.[206]

The most recent figure (end-December 2010) shows a surplus of £21.7 billion (total assets were £983.4 billion, total liabilities £961.7 billion). This apparently comforting statistic masks the reality of 3,953 schemes being in deficit (i.e. 60%), with 2,607 schemes in surplus; boardroom stress and shareholder angst is ongoing. *In extremis,* BT, British Airways and Invensys have pension liabilities which are more than double the companies' market value, at £43bn, £16.8bn and £5.4bn respectively.[207]

The FTSE 100's schemes' are equally volatile. Over the last two years the aggregate accounting *deficit* (no surplus has been reported) ranged between £3bn (9 December 2008) and £88bn (25 August 2010), before rapidly recovering to £31bn (9 December 2010).[208] Volatility as high as this makes any business planning (short- or long-term) very difficult.

Furthermore, in 2009, FTSE 100 companies paid a record £17.5 billion extra into their pension schemes (up 50% on 2008) to help pay off their deficits, with four companies making top-up payments in excess of £1 billion.[209] Eight firms paid more in deficit payments than they paid out in dividends to their shareholders, and some are now pledging assets such as property, other than cash, to boost the finances of their pension funds.

The quality of private sector provision is likely to continue to deteriorate, unless there is a sharp reversal in our economic fortunes. 32 of the FTSE 100 companies cannot ever meet pension fund deficits from current discretionary cash flow.[210]

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[206] 7800 Index dataset.

[207] Pension Capital Strategies (PCS).

[208] Hewitt's Pension Risk Tracker (accounting basis).

[209] Shell (£3.3 billion), Lloyds Banking Group, RBS and Unilever. Lane, Clark & Peacock; *Accounting for pensions 2010*, August 2010.

[210] KPMG Pensions Repayment Monitor; "2009 – Tipping point reached in pension financing", August 2010.

APPENDIX III:

CONTRIBUTIONS TO THE LARGEST PUBLIC SECTOR PENSION SCHEMES[211]

Pension scheme	Employer contributions (% of salary)	Employee contributions (% of salary)
Armed forces ***Unfunded***	29.4%	The scheme remains non-contributory for employees, although the value of the pension is taken into account when assessing pay levels.
Principal Civil Service ***Unfunded***	Pre-October 2002: 18.9% (weighted average). Now 3% – 12.5% (age-related)	Since 30 July 2007, new members have contributed 3.5% of pensionable pay; a large closed group of members still contribute 1.5%.
Fire fighters (England and Wales) ***Unfunded***	1992 scheme: 26.5% 2006 scheme: 14.2%	Since 6 April 2006, new members have contributed 8.5% of pensionable pay. A closed group of members contribute 11%.
LGPS (England and Wales) ***Funded***	14.3% for existing members and 11.9% for new entrants	Since 1 April 2008, members have contributed from 5.5% to 7.5% of pensionable pay depending on salary (changed from a standard 6% rate). For members who had a 'protected rate' of 5% before April 2008, the changes are being phased in gradually up to April 2011.
LGPS (Scotland) ***Funded***	Average of 13.3%	Since 1 April 2009 all active members have paid a contribution rate of between 5.5% and 12% depending on salary.
NHS ***Unfunded***	14.0%	Since 1 April 2008, members have contributed between 5% and 8.5% of pensionable pay depending on salary. Previously, members contributed 6% (5% for manual workers).
Police (England & Wales) ***Unfunded***	24.2%	Since 6 April 2006, new members have contributed 9.5% of pensionable pay. A closed group of members contribute 11%.
Teachers (England & Wales) ***Unfunded***	14.1%	Since 1 January 2007, all members have contributed 6.4% (increased from 6%).

211 *Pension Trends, Chapter 8: Pension contributions,* 9 April 2010 and the *Independent Public Service Pensions Commission Interim Report, Table B1,* October 2010.

APPENDIX IV:

THE INDEPENDENT PUBLIC SERVICE PENSION COMMISSION – TERMS OF REFERENCE

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

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

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

As part of the review, the Commission is invited to produce an interim report by the end of September 2010. This should consider the case for delivering savings on public service pensions within the spending review period – consistent with the Government's commitment to protect those on low incomes – to contribute towards the reduction of the structural deficit. The commission is invited to produce the final report in time for Budget 2011.

APPENDIX V:

THE SIX LARGEST PUBLIC SERVICE PENSION SCHEMES

Unfunded

The five largest unfunded schemes represent more than 95% of total unfunded liabilities.[212] They are:

Scheme	Active members,[213] 2007-08
Armed Forces (AFPS)	196,060
Civil Service (PCSPS)	577,000
NHS (NHSPS)	1,336,576
Police (PPS)	140,000
Teachers (TPS)	628,370
Total	**2,877,946**

Funded[214]

Local Government (LGPS)	**1,656,000**

Other schemes

In addition, there are a number of smaller schemes for the Fire Service (34,700 active members), MPs, the Judiciary, and employees from other public corporations, totalling some 500,000 workers.

212 Government Actuary's Department, *Unfunded Public Service Pension Schemes. 2007-08 Cashflow Projections. Methodology, assumptions and data*, 9 December 2009, paragraph 1.5.

213 *NHS Pension Scheme and NHS Compensation for Premature Retirement Scheme Resource Accounts 2007-08*, HC 87, 27 January 2009; *Teachers' Pension Scheme (England and Wales) Resource Accounts 2007-08*, HC 21, 21 January 2009; *Armed Forces Pension Scheme Resource Accounts 2007-08*, HC 84, 17 December 2008; *Cabinet Office, Civil Superannuation Resource Accounts 2007-08*, HC 60, 22 January 2009; HC Deb, 1 April 2008, c769W.

214 DCLG Statistical Release, *Local Government Pension Scheme Funds England 2007-08*, 15 October 2008.

APPENDIX VI:

MODELLING METHODOLOGY AND ASSUMPTIONS[215]

The purpose of the modelling was to quantify the reduction in the IPSPC's projected cost of the unfunded public sector pension schemes resulting from the introduction of an alternative scheme design for the future service of current members and future new entrants. The Commission currently measures cost by projected benefit payments as a percentage of GDP (central projection) as set out in Appendix C (Chart C2) of the Interim Report.

The output from the model is a series of future annual cash flows that represent the total nominal value of benefit payments each year. For a particular alternative scheme design, the cash flows combine benefit payments to existing members on the current terms for past service and on the new terms for future service, along with benefit payments to future members on the new terms. This was modelled over the same time period as Chart C2 above. The model uses a salary distribution for the main unfunded schemes (NHS, Police, Teachers, Armed Forces and Civil Service), the data being received from the Commission.

The base case model was run using a typical public sector scheme design (60th accrual, final salary benefit, CPI benefit indexation and normal retirement age of 65 for new entrants) to represent the existing unfunded public sector pension schemes. Each alternative scheme design was then put through the model on the same assumptions (with the retirement age moving to the accelerated State Pension Age) which gave a series of annual cash flows.

Chart C2's yearly projected benefit payments data (expressed as a percentage of GDP) were then scaled by the ratio of the annual cash flows of the alternative scheme design to the annual cash flows of the design representing the existing unfunded public sector pension schemes. This gave revised yearly projected benefit payments as a percentage of GDP figures which is an estimate of the projected cost of that alternative scheme design.

A constant set of assumptions were used throughout the modelling exercise. The key assumptions are as follows:

[215] The model was built by Hymans Robertson LLP, pensions and benefits consultants.

Measure	Currency	Salary growth	Discount rate	Retirement age
Cash flows	Nominal	2% inflation, 1.5% non-promotional salary increase and 0.5% salary increase. The salary cap was increased at the same rate.	N/A	60 existing, 65 for new entrants SPA for new designs
IPSPC's % GDP	Real (2008-09 prices)	2% real (relative to RPI)	N/A	Existing. (Not specified in Appendix C of Interim Report)
Replacement ratio	Real	Sensitivity of 0%, 2%, 4% real (to take into account career prospects, age at entry and starting salary)	N/A	SPA for new designs
Accrual cost (% pay)	Allows for inflation of benefits in payment	2% real	4.5% (as 2.5% real plus 2% CPI)	60 existing; 65 new entrants; SPA new designs

The notional DC benefit is broadly equivalent to an 18.7% of salary contribution rate with an assumed pre-retirement revaluation rate on the accumulating notional account of 5%. The annuity conversion rate is based on long-term gilt yields.

Other financial assumptions in the cash flow model include:

- pension in deferment/payment increase rate 2.0% p.a.
- a static population i.e. payroll is kept constant (in real terms) with a 1:1 member replacement ratio; and
- NEST asset return: a real return of 2% relative to CPI.

APPENDIX VII:

REPLACEMENT RATIOS

Real salary increases are assumed to be 0%, 2% and 4% per annum for a low, medium and high flyer, respectively. All the £ figures are expressed in terms of today's money.

Low flyer

Age at entry/Years accrual	20/48	30/38	40/27	50/16
Starting salary	£10,000	£15,000	£18,000	£20,000
Final salary	£10,000	£15,000	£18,000	£20,000
CARE (replacement ratio)	£8,000 (80%)	£9,500 (63%)	£8,100 (45%)	£5,334 (27%)
Cash balance (replacement ratio)	-	-	-	-
NEST (replacement ratio)	£352 (4%)	£813 (5%)	£743 (4%)	£478 (2%)
State Pension (replacement ratio)	£7,280 (73%)	£7,280 (49%)	£7,280 (40%)	£7,280 (36%)
Total replacement ratio	**157%**	**117%**	**89%**	**65%**

Medium flyer

Age at entry/Years accrual	20/48	30/38	40/27	50/16
Starting salary	£20,000	£25,000	£30,000	£35,000
Final salary	£51,924	£53,206	£51,308	£48,104
CARE (replacement ratio)	£26,774 (52%)	£23,656 (44%)	£17,871 (35%)	£10,974 (23%)
Cash balance (replacement ratio)	-	-	-	£12 (-)
NEST (replacement ratio)	£3,465 (7%)	£2,978 (6%)	£2,116 (4%)	£1,204 (3%)
State Pension (replacement ratio)	£7,280 (14%)	£7,280 (14%)	£7,280 (14%)	£7,280 (15%)
Total replacement ratio	**73%**	**64%**	**53%**	**41%**

High flyer

Age at entry/Years accrual	20/48	30/38	40/27	50/16
Starting salary	£20,000	£30,000	£50,000	£80,000
Final salary	£133,704	£135,001	£145,579	£150,705
CARE (replacement ratio)	£38,876 (29%)	£31,165 (23%)	£20,703 (14%)	£11,274 (7%)
Cash balance (replacement ratio)	£6,772 (5%)	£9,799 (7%)	£14,668 (10%)	£13,882 (9%)
NEST (replacement ratio)	£5,379 (4%)	£4,190 (3%)	£2,541 (2%)	£1,246 (1%)
State Pension (replacement ratio)	£7,280 (5%)	£7,280 (5%)	£7,280 (5%)	£7,280 (5%)
Total replacement ratio	**43%**	**38%**	**31%**	**22%**

APPENDIX VIII:

FINANCIAL EDUCATION; A WASTE OF MONEY?

Financial education is effectively a policy tool requiring savers to become their own regulators, as an alternative to imposing regulation directly. As such, the pursuit of improved financial literacy is one mechanism to deflect calls for more effective (i.e. better quality) market regulation. Given the difficulties that even the professional regulators of the pensions and savings industry have, this would appear to be a ludicrous aspiration. We do not act as our own doctor or lawyer, so why be our own financial expert? An economist would suggest that it is not an efficient division of labour.

There are at least five intractable barriers to contend with:

- mis-aligned interests between saver and industry; good financial decisions by savers are often less lucrative for many industry participants;
- information asymmetry between provider and saver, caused by ludicrous product complexity and the speed at which products change;
- savers' poor analytical skills;
- widespread decision-making biases that impair saver behaviour; and
- those doing the educating (assuming they are not part of the industry) are financial outgunned by the industry; the latter's vested interests are hard to suppress.

There is at least one paradox concerning financial education. Whilst the Government is encouraging people to assume more personal responsibility and, with that, more control over their lives, should they have less control over decisions concerning pensions, when there is compelling evidence that financial education increases confidence without improving ability, leading to worse decisions?

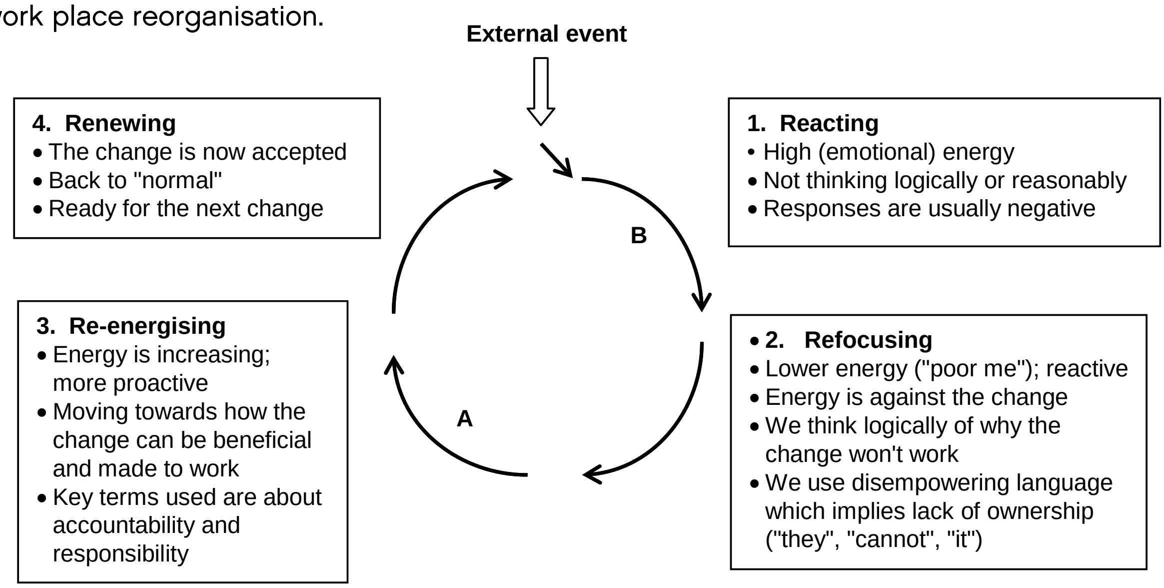
Consider an example: the sharp drop in US home ownership over the last few years is partly attributable to the Federal Reserve Board's decision not to regulate the sub-prime mortgage market. Consequently people were able to obtain mortgages that they could not afford (as well as borrowing against their homes); they subsequently became bankrupt, lost their homes and ended up with less control over their lives (and not just in financial terms). Given this, should we limit consumer choice (through regulation) to give individuals more autonomy, ownership and control over their daily lives?

APPENDIX IX:

THE CHANGE CYCLE

Whenever we receive news of an event that potentially has an impact upon us, we go through the Change Cycle, starting with the "reacting" phase. Given that most behaviour is habitual (accompanied by considerable inertia), people need strong reasons *and* a fast payback *and* support to motivate them to accept change. The rate at which we go round it partly depends upon whether we like change in general.

The Change Cycle starts with an externally-driven event impinging upon us, such as the introduction of a new regulation (the result of the Civil Service executing a new policy), or a work place reorganisation.



Typically, when management (or government) announce an initiative or a change, they are at point A whereas the recipients are at point B, i.e. management are ahead of the recipients (because have had longer to consider the changes). Consequently, the initial reaction to the announcement usually disappoints management.

People who like change (they spot differences rather than similarities; 10% of the population) go round the Change Cycle very quickly, rapidly accepting change and soon ready for more. Conversely, most people (65%) are not keen on change; they search for similarity and notice what is different. They get stuck at the **refocus stage**; they are reactive, their energy is against the change ("poor me") and they think logically of why the change will not work. It is at this stage in the Change Cycle that things often have to get worse before they can get better.

GLOSSARY

Basic State Pension (BSP)	The basic (or "old age") State Pension is a government-administered flat-rate pension based on the number of qualifying years gained through National Insurance contributions (NICs), paid throughout working life. It is a basic flat-rate pension funded on a pay-as-you-go basis, which aims to provide a pension of approximately 20% of national average earnings. The BSP is increased each year in line with the Retail Prices Index (RPI). The Pensions Act 2007 restores it to being indexed to earnings, by the end of the next Parliament at the latest (in 2015). To receive the full basic State Pension, men and women need 44 and 39 qualifying years, respectively. After 6 April 2010, this reduces to 30 qualifying years for men and woman. For 2009-2010, the weekly full basic State Pension is £95.25 (singles) and £152.30 (couples).
Career Average Revalued Earnings (CARE) pension scheme	A CARE-based pension scheme gives members a pension pot after each period of membership (usually a year) that is based on a percentage of the salary earned in that year. Those pots are then usually revalued until the date a pension is taken, by a factor related to prices or national or occupational earnings. Those individual pension pots are then added together for periods of scheme membership to produce an overall pension. The amount of pension payable in therefore dependent upon: • the length of time served in the scheme ("pensionable service"); • career averaged earnings ("final pensionable salary"). This matches each year's benefit accrual to earnings in each year, rather than the final year's earnings. The earnings figure will be up-rated in line with prices rather than the actual increase in earnings; and • the scheme's accrual rate. The accrual rate is the proportion of salary that is received for each year of service. So, if the scheme has an accrual rate of 60, the member will receive 1/60ths of their final pensionable salary for each year of service completed. For example, if the scheme provides a pension calculated as 1/60 of pay for each year of service and the member retires with 30 years' service, then to calculate pension, each year's pay will be up-rated with inflation and then aggregated. It will then be divided by 30 to provide the "average" pay, which in the example would be multiplied by 30/60 to arrive at the pension.
Defined Benefit (DB) occupational pension schemes	DB, or final salary, pension schemes entitle employee members to pension benefits defined by a formula linked to their length of pensionable service and salary when they leave the scheme. Employees are typically provided with 1/60 of final salary for each year of service up to a maximum of 40/60, i.e. two thirds of final salary. At retirement a tax-free lump sum may be taken at the expense of a reduced pension. DB pension promises are unrelated to the contributions made to the underlying fund. Many schemes now face large deficits as liabilities (due to such factors as increased longevity) have outgrown the funds' assets. Consequently, many sponsors, struggling to meet their statutory funding requirement and deterred by the increase in company accounts volatility (care of accounting standard FRS 17), are closing their DB schemes in favour of (less costly) DC schemes.

Defined Contribution(DC) occupational pension schemes	DC, or money-purchase, schemes are pension schemes into which an employer pays a regular contribution, fixed as an amount or percentage of the employee's pay. The employee may also make contributions into the scheme. Contributions are invested to provide employee retirement benefits, with investment risk and investment rewards assumed by each employee/retiree, and not by the sponsor/employer. Employers increasingly favour DC schemes over DB schemes because they cost less to run and result in a predictable cash outflow. The "cost" of a DC scheme is readily calculated, but the benefits are dependent upon the amount of contributions and investment performance. Consequently, participants bear the risk of outliving their assets. This risk can be mitigated by using accumulated savings to purchase an annuity upon retirement (a legal requirement before reaching 75), to provide a regular income until death. Although DC scheme participants typically have control over investment decisions, the sponsor retains a significant degree of fiduciary responsibility over investment of plan assets, including the selection of investment options and administrative providers.
Guarantee Credit	This guarantees anyone over 60 an income of at least £132.60 per week if single, £202.40 for couples (2010-11). Thus, a single person with weekly income of £90 would receive Guarantee Credit of £42.60. “Income” is defined as including basic State Pension and State Second Pension payments, some state benefits, private pensions and earnings, but excludes Disability Living Allowance, child tax credit, child benefit, etc. Guarantee Credit is up-rated in line with earnings.
Local Government Pension Scheme (LGPS)	The LGPS is a statutory scheme whose trustee is the Secretary of State for Communities and Local Government. It is governed by Acts of Parliament supplemented by complex regulations and Statutory Instruments issued by a specialist team in the Department for Communities and Local Government (CLG). Any changes go through a statutory consultation process involving the employers (Local Government Employers (LGE, part of the Local Government Association (LGA)) and representatives of the employees (Trades Unions). Consultation is then considered by the minister before passing decisions to CLG lawyers for drafting of regulations.
National Insurance Contributions (NICs)	NICs, collected through the pay-as-you-earn (PAYE) income tax collection system, are paid into the National Insurance Fund (NIF) by most employers, employees, self-employed, and some unemployed people. The amount paid depends upon earnings and employment and marital status. NICs, via the NIF, finance a range of benefits, including state pensions (but not the means-tested pension credit), incapacity benefit, widows’ benefits, maternity allowance, guardian’s allowance, jobseeker’s allowance and the Christmas bonus. Part of the contributions is not paid into the NIF but goes towards the cost of the National Health Service.
NEST (National Employment Savings Trust)	NEST is intended to encourage employees without access to work-based pension schemes to save for retirement; the target audience is intended to be the low paid and those in intermittent work. There will be auto enrolment, but workers will be able to opt-out if they choose not to participate, i.e. “soft” compulsion. Contribution details have yet to be finalised, but one of the commitments in the Coalition Agreement is to raise the income tax threshold to £10,000, which would then be the salary starting point for NEST contributions. Actual contributions, however, will probably be based on earnings in excess of the National Insurance earnings threshold (£5,715 in today’s prices), up to a ceiling of perhaps £38,185. Employers will be required to contribute 3%, plus roughly 1% from the Government through normal tax relief. Contributions are limited to £3,600 per year (based on 2005 earning levels), up-rated by earnings year on year. There will be a choice of investment funds, including social, environmental and ethical investments, as well as branded funds, as well as a (lifestyle smoothing) default fund for those not wishing to make an investment choice. The maximum administration charge likely to be capped at 0.3% of the fund under management. There has been much debate around this issue, not least because the low take-up of Stakeholder pensions is partly blamed on the lack of incentive for the financial services industry to push the product.

	When savers reach the State Pension Age they are required to purchase a lifetime annuity with their account proceeds, having assumed the investment risk in the interim, (akin to a defined contribution ("DC"), or money purchase, scheme). There is a general ban on transferring rights into and out of the scheme. NEST will be regulated in much the same way as existing trust-based DC schemes.
Retail Distribution Review (RDR)	The RDR was launched by the FSA in June 2006 to address persistent problems in the retail investment market, notably insufficient consumer trust and confidence in the products and services supplied by the market. The FSA is seeking to go beyond simply treating the symptoms of the problems and address the root causes. The RDR is intended to modernise the industry. In Consultation Period (CP)09/18 the FSA set out the changes that it is proposing, notably to: • improve the clarity with which firms describe their services to consumers; • address the potential for adviser remuneration to distort consumer outcomes; and • increase the professional standards of investment advisers. In December 2009 the FSA published CP09/31, "Delivering the Retail Distribution Review: Professionalism; Corporate pensions; and Applicability of RDR proposals to pure protection advice". This consultation is open until 16 March 2010.
State Pension Age (SPA)	The State Pension Age (SPA) is 65 for men and 60 for women. However, the SPA for women is changing; it will gradually rise from 60 to 65 from 2010 to 2020. The SPA for both men and women is to increase from 65 to 68 between 2024 and 2046, with each change phased in over two consecutive years in each decade. The first increase, from 65 to 66, will be phased in between April 2024 and April 2026; the second, from 66 to 67, will be phased in between April 2034 and April 2036; and the third, from 67 to 68, between April 2044 and April 2046.

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For the brave option, the Government could set out a timetable for the closure of the public sector's defined benefit schemes, and then move to a notional (i.e. unfunded) defined contribution framework (NDC), with implementation by 2020. Employees' accounts should be seeded with index-linked gilts. The cautious framework could comprise a CARE-based defined benefit scheme, with a gilts-seeded, NDC scheme above a salary cap.

But whichever option is chosen, it is clear that the *status quo* is unsustainable.

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