

08 October 2010

Circular 11/2010

To: Chief Executives
Personnel Contacts

Dear Colleagues

John Hutton's Interim Report on Public Sector Pensions

Lord Hutton published his interim report on 7 October 2010. He was commissioned by the Chancellor at the June 2010 budget to carry out a review of public service pensions. A further and final report will be published in time for the Budget 2011.

The Northern Ireland Local Government Pension Scheme, as administered by NILGOSC, falls within the Commission's terms of reference however the Regulations of the Scheme are a devolved matter so ultimately any changes to the Scheme are a matter for the Department of the Environment and the Northern Ireland Assembly.

Your employees who are members of the Scheme may naturally be concerned with the headlines around the release of the report - "Pay more, work longer, get less" for example. The purpose of this circular is to provide a brief summary of the Commission's interim findings. From an Employer's perspective the Commission's objective is to reduce the costs of public sector pensions in the long term which is to be cautiously welcomed.

The full report is available at:

http://www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm

Context

The report sets out its case for changes in public service pensions in that people are living longer, the current final salary schemes are unfair as they reward high flyers disproportionately, there is an imbalance of risk between taxpayers and employees and contributions do not reflect the value of benefits received.

The report, in accordance with the terms of reference, considers the options for short-term savings and sets out its ideas for long-term structural reform.

Lord Hutton did however confirm that it is wrong to say that public service pensions are gold-plated. The average pension paid to public sector pensioner members is about £7,800 a year. About half of pensioners receive less than £5,600 a year and 90% of pensioners receive less than £17,000 a year. He also pointed out that although these figures are partly accounted for by part-time or part-career working these pensions provide a modest – not an excessive – level of retirement income.

The comparable figures for NILGOSC are an average pension for the 25,415 pensioners of £3,984 with 91% receiving an average pension of £2,966. Only 34 pensioners receive pensions over £40,000 per year.

Short-term options for reform

The Commission considered three options for short term savings, namely:

- Contracting into the State Second Pension Scheme (S2P);
- Reducing the level of benefits being paid out; and/or
- Increasing employee contribution rates.

The report confirms that the most effective way to make short-term savings is to **increase employee contributions** but it is for the Government to decide the manner and level of any increase necessary.

The Commission advises the Government that any increases should be managed so as to protect the low paid and, if possible, increases should be staged to prevent a significant increase in members opting out.

The option of contracting public sector schemes into the S2P is not a value for money option as the extra S2P paid out in future would outweigh the short-term savings.

The report restates that accrued rights will be protected and therefore there is little advantage in altering benefit levels in the short-term as it would have little or no impact within the spending review period. Changes to the benefit structure to ensure that the system is fair and sustainable in the future will be considered as part of the final report due in March 2011.

Long-term structural reform

Based on the evidence presented in the report Lord Hutton argues that the traditional final salary schemes cannot be justified as they provide disproportionate benefits with the high flyers accruing more generous levels of benefits than employees whose earnings are stable. This is an unfair division of costs between the employer and the employee.

An alternative model which shares risk between the employer and the employee but which provides an adequate pension for members is needed. The Commission plans to examine a whole range of schemes available where the risk is shared between the employer and the employee. The examples being considered are as follows:

- A Career Average Defined Benefit (DB) Revalued Earnings model;
- Notional unfunded Defined Contribution (DC) schemes which will determine the value of the pension at retirement by an assumed return on contributions and annuity rates. This is similar to an innovative international model operated in Sweden;
- Collective funded DC schemes where all contributions are placed into one fund that is managed on behalf of members. Pensions will vary according to the value of the underlying investments. This is similar to a model operated in the Netherlands;
- Cash balance schemes where the employer puts a notional amount into the member's pot every year which is then guaranteed. The credit can be expressed as a percentage of salary for each year worked. If cash contributions from the employee and employer, plus investment returns, do not match the "notional credit" then the employer will have to meet the shortfall. The cash balance is used to purchase a pension annuity on retirement;
- Sequential hybrids which are schemes where members can earn both a DB pension and a DC pension during their career although they can only earn either DB or DC benefits at one time;
- Capped DB schemes where there is a limit on the amount of earnings that counts for pension purposes or on pension payments from the scheme; and
- Combination hybrids, where members simultaneously earn benefits that are part DB and part DC. For example, a capped DB pension, based on earnings up to a certain level and a DC benefit on earnings above this level.

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

- Ensuring normal retiring ages are in line with latest developments in longevity;
- Reviewing rules around flexible retirement before or after normal retirement age to increase labour market flexibility;
- The implication of different indexation options; and
- The accrual rates in the different public sector schemes.

Keeping Up to Date

The Annual NILGOSC Members' newsletters are in the process of being printed and they should arrive at members' home addresses in the week beginning 25 October 2010. Although they refer to the work of the Hutton Commission they do not report on its findings. The newsletter highlights a weblink that will provide more up to date information. I would encourage employers also to check our website for the latest details although I would envisage that we will issue a further circular when the Commission publishes its final report.

There are also a number of other pension related consultations underway at present and we will provide further details by way of a separate circular. In the meantime do not hesitate to contact Deane (deane.morrice@nilgosc.org.uk), Zena (zena.kee@nilgosc.org.uk) or myself (david.murphy@nilgosc.org.uk) if you have further queries.

Yours sincerely

A handwritten signature in black ink that reads "David A. Murphy". The signature is written in a cursive style with a large, sweeping initial 'D'.

David Murphy
Deputy Secretary