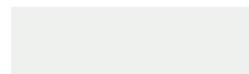
Lord Hutton's final report – on the road to public service pension reform



Lord Hutton's final report – Initial Summary

Introduction

Lord Hutton's 27 recommendations fall into four main sections:

- Scheme design
- Controls
- Governance
- Implementation

We summarise each of these in turn below.

It is worth bearing mind the principles which the Independent Public Service Pensions Commission ("IPSPC") has been using, as each of the recommendations has been measured up against these principles to ensure that they provide the best possible fit:

- Affordable and sustainable

- Adequate and fair
- Supporting productivity; and
- Transparent and simple

The Deal

A key part of the Lord Hutton's final report is what he refers to as "The Deal". This is about seeking to strike the right balance between affordability and sustainability (for the taxpayer) and fairness and adequacy (for public service employees). The Deal is set out as follows (more details are shown on page 37 of the final report):

Taxpayer	**Public service employees**
• FAIRER SHARING OF BENEFIT OF LIVING LONGER • FUTURE-PROOFED • FIXED COST • GREATER TRANSPARENCY OF COST • SINGLE LEGAL FRAMEWORK	• A GOOD PENSION IN RETIREMENT • A DEFINED BENEFIT PENSION • ACCRUED RIGHTS PROTECTED • FAIR PROCESS OF CHANGE • BETTER MANAGEMENT OF SCHEMES

An important point to recognise is that Lord Hutton does not give any final answers. The accrual rate and employee contribution rates are for the Government to decide and negotiate taking into account the level of fixed cost they consider to be appropriate. This means that there is still a huge amount of uncertainty as to what this really means for public sector workers, except for those who are very close to retirement.

Scheme design

The key scheme design recommendations for the new schemes are set out in the table below. The over-arching recommendation is that there should be a common legal framework with limited variation by scheme. The main variations will be the accrual rate and contribution rates. However, for uniformed services there will be a variation in respect of Normal Pension Age (NPA) – see the section below on "The controls".

The accrual rates and contribution rates are not part of the recommendations and are for the Government to decide. However, a key point to note is that with NAE indexation the accrual rate is unlikely to improve from the current position, even if cost levels remain broadly

unchanged

Design feature	Lord Hutton's recommendation
Accrual structure	Career average revalued earnings (CARE)
Pre-retirement indexation for actives	National Average Earnings (NAE)
Pre-retirement indexation for deferred pensioners	Could be NAE rather than CPI
Indexation for pensioners	CPI
High earners	No benefit caps or reduced benefits, but higher employee contributions
Early and late retirement	Fairer adjustments to reflect early or late payment and abatements to cease
Options	Limited options, but tax-free cash option to remain
Pensionable pay	To remain broadly the same
Ancillary benefits	To remain broadly the same
Additional voluntary contributions	Encouragement for simple and transparent arrangements

A more detailed version of this table with KPMG's initial comments is included in the Appendix below.

Controls

There are two key parts to the financial controls being put in place to protect the taxpayer from increasing costs:

1. Adjusting NPA to reflect increases in longevity

The recommendation is that NPA is linked directly to State Pension Age (SPA). This mean that NPA will move to 66 in 2020 and eventually, based on current plans, to 68 in 2046. However, the link is to be reviewed and might not continue if it is no longer appropriate (if for example the Government decides to change SPA in a way which is not linked to changes in longevity).

This is a major change, especially for the many current active members of the NHS Pension Scheme, Principal Civil Service Pension Scheme

and the Teachers Pension Scheme who currently have NPA 60. Uniformed services are to move to an NPA of 60, which is to remain under review, and this is also a major change.

The increase in NPA does not mean that employees necessarily have to work longer, it means that members will get lower benefits if they retire at their current NPA.

2. Cost ceiling

Whilst the NPA link to SPA will deal broadly with increasing longevity there will be other factors which cause costs to increase. Lord Hutton's recommendation is that the Government sets a cost ceiling for each scheme. If the cost ceiling is exceeded then accrual rates and/or employee contributions should be adjusted. We believe the intention is for an accrual rate adjustment to only apply to future service as at the date of change. If agreement cannot be reached between the schemes and the unions then automatic adjustments will apply.

In terms of the basis of such costing, it is suggested that the SCAPE approach should continue to be used (which is currently the subject of separate consultation).

This is a step beyond the current cap and share arrangements which need to be negotiated on a case by case basis.

Whilst in theory this could provide significant protection to the tax payer in practice there many ways to set the cost measure and, depending on what is included this could be a material safety valve or little more than a presentation tool. There will need to be a lot of detailed work to design and agree a legally robust cost ceiling with automatic adjustments.

Interestingly it is recommended the LGPS, which unlike the other main schemes is funded, adopts the same approach as the unfunded schemes. This means that the cost ceiling calculation will ignore the invested assets and instead will be based on the Government's discount rate and notional funding approach.

By implication, having different cost ceilings for each scheme means that accrual rates and contribution rates could also be different for each scheme.

Governance

The main recommendations in relation to Governance are as follows:

- Membership and other **data** should be made available and gathered on a regular basis across all schemes, and is made available in a consistent and useful format to allow simple comparisons to be made
- The Office of Budgetary Responsibility (OBR) should include pensions in its fiscal planning and reporting so that the impact of the schemes is understood and taken into account

- Active members should be provided with **benefits statements** at least once a year
- Each scheme, including each LGPS, has a **Pensions Board** which oversees the day to day running of the schemes and makes operational decisions. The Pensions Board should include both member representatives and independent professionals
- Each scheme should have a **Policy Board** which makes decisions in relation to scheme changes and is, most likely, separate from the Pensions Board
- An external body, probably the **Pensions Regulator**, should collate and publish information in relation to the funding position of the funded schemes and the adherence to the governance requirements
- An external body, probably the Pensions Regulator, should review the **administration** of the pension schemes with a view to ensuring that high standards are obtained across all of the schemes, a consistent approach is taken and taxpayers get value for money. Whilst the cost per head of administration differs across the different schemes this is in part to do with the different levels of service and it has been difficult to carry out a full comparison
- Opportunities should be identified to **reduce costs** through the sharing of services, particularly in the LGPS

Implementation

The key recommendation for implementation is that all members of all schemes should move to the new schemes for future benefit accrual as quickly as possible. For all except the uniformed schemes Lord Hutton encourages the Government to aim for implementation in 2014. But he emphasises that in order to achieve this additional resources will be required over and above “business as usual”

Accrued benefits at the date of implementation will be fully protected. This means that the final salary link will be retained and retirement terms will be protected on accrued service.

For the uniformed services (the Armed Forces, Police and Firefighters) implementation date is likely to be delayed, but it would appear that when implementation does occur the same approach to protecting accrued rights will apply. The reason for the deferral is that the uniformed services have relatively generous pension benefits and therefore it will take longer to integrate changes to wider reward structures and to other terms and conditions into the pension changes. These schemes have acceleration of pension accrual towards the end of employees’ careers so change during this period of acceleration would be particularly painful if the new scheme was to have a single accrual rate. This is an example of how the transition issues can be difficult and complex to resolve.

Other

There are a range of other issues that are dealt with in the report, some of which are about maintaining the status quo, as summarised below. In addition, there are some big issues which have not been dealt with in detail.

- The recommendation in relation to the current unfunded status of most schemes is that this should continue, but with transparent published information so that the fiscal impact can be understood. On the other hand the LGPS should remain funded. There is no detail in relation to how the LGPS should be funded in future
- The recommendation in relation to the admission of private sector organisations into public service schemes is that this should not be extended due to the additional risks taken on by the taxpayer. This will have implications for the outcome of the Fair Deal consultation process.
- The report does not specifically deal with the contracted-out status of the public service schemes, the assumption being that this will continue. This might become an issue if Iain Duncan Smith's current welfare reforms in relation to a flat-rate State pension continue to take shape
- There is not a detailed consideration of the purpose of tax-free cash sum at retirement and whether or not this should continue. Some feared that this might be under review, but we think that this was effectively out of scope because of the wider tax implications and the potential knock-on impact for the private sector

Appendix

The table below includes KPMG's initial comments on the changes.

Design feature	**Recommendation**	**Initial KPMG comment**
Accrual structure	Career average revalued earnings (CARE)	This has been the expected outcome . Lord Hutton seriously considered a cash balance approach based on lump sum accrual, but this would involve a significant communication challenge.
Pre-retirement indexation for actives	National Average Earnings (NAE)	This was not expected. Most CARE schemes provide indexation (or revaluation) in line with price inflation (CPI). NAE is expected to be higher than CPI so is more generous, but if costs are fixed the results would be a less generous accrual rate. NAE is better for low flyers than high flyers and therefore

		is part of Lord Hutton's move to provide a fairer distribution of resources
Pre-retirement indexation for deferred pensioners	Could be NAE rather than CPI	Lord Hutton does not go so far as to make a recommendation, instead suggesting that this is one for the Government to consider. However, he seems inclined to NAE in order to introduce a level playing field between current and ex-employees, and for simplicity of design
Indexation for pensioners	CPI	There is no change here – the rationale being the protection of pensioners' purchasing power. Note that the change from RPI to CPI was announced in July 2010
High earners	No benefit caps or reduced benefits, but higher employee contributions	There has been a lot of speculation about pensionable pay caps or benefit caps, beyond which a funded Defined Contribution arrangement might have been made available. However, in order to keep things simple and because the savings are relatively small, the same benefits will apply to all members regardless of earnings levels. However, Lord Hutton thinks that higher earners (who have greater longevity) should pay more for their pension, as is currently the case in the NHS Pension Scheme and the LGPS
Early and late retirement	Fairer adjustments to reflect early or late payment and abatements to cease	Drawing benefits before and after retirement, all or in part, should come hand in hand with an appropriate actuarial adjustment to reflect early or late payment. This removes the focus away from NPA as an age at which to draw benefits, especially in the context of the proposed removal of compulsory

		retirement ages.
Options	Limited options, but tax-free cash option to remain	The introduction of new options is going to be limited to keep things simple and to avoid members making inappropriate decisions, but the conversion of pension to tax-free cash will continue to be an option.
Pensionable pay	To remain broadly the same	Pensionable pay structures are many and various across the public service pension schemes and this may be a matter for further discussion when the final details are negotiated with the unions
Ancillary benefits	To remain broadly the same	There are differences across the different schemes which will need to be ironed out if there is to be a move to a common framework. Whilst these changes are unlikely to be material overall, they highlight the challenges faced in moving to a unified framework

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