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Securing the future of pensions

# The Future of Public Sector Pension Schemes

## The NAPF Submission to the IPSPC's Final Call for Evidence

## Executive Summary

**The NAPF is the voice of workplace pensions for both the private and public sector. We believe that all workers deserve access to good workplace pension provision, regardless of where they work.**

The UK pensions system is in crisis. Further reform of both public and private sector pensions is necessary to re-energise occupational pensions in the UK. Because of the scale and coverage of public sector pensions, changes to scheme design could result in innovative and creative arrangements which could be replicated in the private sector.

**Scheme Design**

- Any reform to public sector pensions needs to place the system on a sustainable footing for the long term. The Commission should build on the best features of the current system.
- A career average (CARE) scheme appears to be the most promising option for providing a sustainable, affordable and "implementable" public sector pensions system when compared against the NAPF's seven principles for public sector pensions reform.
- There may be a case for capping the level of CARE benefits based on salary, but additional arrangements like top-up DC should be made available for those employees who want to save more.
- There should not be a one-size-fits-all approach to scheme design. CARE should sit at the core of public sector pension benefits, but options like top-up DC or the ability to make additional voluntary contributions (AVCs) could provide more flexibility within and between schemes.

**Risk-Sharing**

- There are many types of risks involved in running pension schemes such as investment risk, salary inflation risk, and longevity risk.
- Risk sharing schemes like CARE schemes can effectively share risks between the employer and employee while also ensuring a fairer outcome for the low paid.
- Cost-saving "levers" such as Normal Retirement Age (NRA), accrual rates, employee contributions, and indexation requirements could be used to control future costs to public sector schemes. But consideration must be given to the impact these levers may have on employee opt out rates and whether they can be used with the same effectiveness in the private sector.

**Adequacy**

- The NAPF believes all workers deserve adequate income in retirement. At the heart of an adequate UK pensions system should sit the state pension system, with a more generous "Foundation Pension" set above means-tested benefit levels. This would encourage and enable people to save for their retirement.
- Together, a full state pension and a full public sector pension should provide an adequate pension. But it must be a baseline and not an end goal. People should have the opportunity to save more if they want to, and should be incentivised to do so.

**Employee Understanding and Choice**

- Many people understand and value pensions, but do not have confidence that pensions will deliver. Good quality communications is key, as demonstrated in the private sector in the communication standards for the NAPF's Pension Quality Mark initiative.
- Choice in pensions increases cost and complexity. The NAPF recommends that the core CARE element of public sector pensions should be simple and provide the same framework for all employees. Benefits offered in addition to the core CARE element could offer a degree of choice.

**Administration Costs**

- Administration costs in some public sector schemes are lower than in the private sector because of scale. The NAPF has proposed the creation of large-scale schemes in the private sector to help achieve administration efficiencies.
- Consolidating Local Government Pension Fund administering bodies would be complicated. However, we believe there is potential to reduce costs and increase efficiency by encouraging "pooled fund management procurement" or Framework Agreements.

**Transition Issues**

- The key to a successful transition to a new public sector pensions system is consensus from all the main players, as demonstrated by the consensus around the Pensions Commission's proposals.
- To build a lasting consensus, key players need time and clarity. For reform of public sector pensions to produce a lasting and sustainable settlement, it must share risks between the employer and employee, protect the low paid, and build on the best characteristics of the current system.

## Introduction

1. The NAPF is the voice of workplace pensions for both the private and public sector. We represent 1,200 pension schemes, with some 15 million members and assets of £800 billion. A range of large and small public sector pension funds are

NAPF members, including 75 of the 99 funds that make up the Local Government Pension Scheme (LGPS). This mixed membership gives us a unique insight into the public sector pensions debate.

2. The NAPF believes that all workers deserve access to good workplace pension provision regardless of where they work. Earlier this year, we set out our blueprint for revitalising workplace pensions in *Fit for the Future – The NAPF's vision for pensions*.

3. In the private sector, a considerable amount of change has already occurred. The NAPF's 2009 Annual Survey revealed that only 23% of private sector defined benefit (DB) schemes are currently open to new members. Yet just 10 years ago, over 70% of private sector schemes were open to new members. Increasing longevity, rising scheme costs, a tough regulatory environment and challenging market conditions have forced many private sector schemes to alter the way they provide pension benefits to their employees.

4. Public sector schemes are facing similar challenges. Looking to the private sector is one way to learn how to manage the transition from final salary DB schemes to other types of arrangements. However, pension saving in the private sector has waned over the last decade. Currently, only 45% of workers are saving into a workplace pension scheme, and almost half of these savers are using public sector schemes.

5. So great is scale of the savings crisis in the UK that the previous Government created the Turner Commission, which recommended a series of reforms to the UK pension system. Changes to the state pension system and the introduction of automatic enrolment in 2012 will go some way towards tackling the problem of undersaving by getting more people saving into a pension for the first time. But there is still a long journey ahead of us. Further reform to all types of workplace pensions is necessary to re-energise the UK's savings culture.

6. It is in this environment of wider workplace pension reform that public sector pension reform should be placed. The NAPF is working to help the Coalition Government fulfil its commitment to help "reinvigorate occupational pensions." Because of the scale and wide coverage of public sector pensions, reforms to scheme design could result in innovative and creative arrangements which could be replicated in the private sector. In considering the options for scheme design and in answering the Commission's specific questions, we have pointed out what would need to change in the private sector for similar arrangements to work there.

## The case for structural reform

7. In our response to the Commission's first call for evidence, the NAPF set out our case for further reform of public sector pensions. We have long recognised that further reform to public sector pension schemes is inevitable. As we mentioned above, all pension schemes need to adapt to the challenges they are facing.

8. We are therefore pleased that the Commission's interim report set out the current landscape of public sector pensions and considered the case for reform in a reasoned and balanced way. We agree with the Commission that the long term reform of public sector pensions must not be a "race to the bottom" resulting in the private and public sector pensions competing to provide the worst pensions. We also agree low paid workers in the public sector must be protected to help maintain participation rates.

9. Earlier this year, the NAPF set out the seven principles which should guide public sector pension reform. We have used these principles in considering the best option for scheme design outlined in the Commission's final call for evidence.

**Box 1: NAPF Principles for Public Sector Pension Reform**

**The NAPF's seven principles for public sector pension reform**

1. **Fit for purpose:** public sector pensions should be an integral part of pay and reward and support the recruitment and retention of staff needed to deliver vital public services.

2. **Adequacy:** public sector pensions should not be 'dumbed down' but must continue to provide good standard of living in retirement.

3. **Affordability:** public sector pensions must be affordable in the long term. The scheme should be designed to meet changing circumstances and ensure intergenerational equity.

4. **Transparency:** the costs of public sector pensions must be clear and transparent.

5. **Shared responsibility and risk:** the employer and employee should share the burden of contributions and the risks of costs increasing.

6. **Quality and efficiency:** public sector schemes should demonstrate efficient and high-quality administration and governance.

7. **Mobility:** public sector pensions should not put up barriers between the public and private sector workforces, which might make the UK workforce and economy less flexible.

10. In the sections below, we respond to the specific questions raised by the Commission. Given the limited amount of time over which the call to evidence was conducted, we have not provided in depth answers to every question posed by the Commission. The NAPF is happy to continue assisting the Commission over the coming weeks and months in developing its thinking as we approach the publication of the final report.

## Scheme Design

**Q 1) What is an appropriate scheme design for public service pensions? Why?**

11. The NAPF's vision for the UK pensions system is one that provides an adequate retirement income for all people, whether they work in the private sector or public sector. In *Fit for the Future: NAPF's Vision for Pensions,* we set out a series of proposals for the state pension system and workplace pensions which we hope will provide a stable and sustainable system for the future. In thinking about developing a more sustainable system for the public sector, it is important that the debate is not focused on ending the so-called "pensions apartheid". Simply levelling down to the lowest common denominator found in the private sector would drive a "race to the bottom" to provide the least generous pensions. This would not deliver a lasting solution or an adequate public sector pensions system.

12. The NAPF recognises the need to put the public sector pensions system on a more sustainable footing for the long term. Although public sector pensions have already undergone reform over the past couple of years, there is a need to go further and put in place a lasting and enduring settlement. The last round of public sector reforms showed that transitioning to new arrangements is difficult and time-consuming. To ensure an efficient and successful transition to the new system recommended by the Commission, we must build on the on the best features of the current system. We envisage evolution rather than revolution.

13. In considering the most appropriate design for a new public sector pensions system, the NAPF has looked to our seven principles for public sector pensions reform as outlined above. We agree with the Commission and the Chancellor that the central feature of any new public sector pensions system should remain at the core a DB system.

14. A system built on a baseline of DB benefits will protect the millions of low paid public sector workers. And as it is similar to the current final salary arrangements, it will allow a relatively smooth and quick transition for scheme administrators.

15. There might also be a case for limiting DB accruals based on salary in order to target benefits on those who need them most. If this were the case, additional arrangements such as a top-up DC scheme or by making additional voluntary contributions (AVCs) should be made available to employees so they have the opportunity to save as much as they want.

16. But what kind of DB arrangement should be at the heart of the new public sector arrangement? The Commission has already suggested that final salary DB no longer fits the needs of the modern public sector workforce and that final salary arrangements also disproportionately reward higher paid workers. In contrast, career Average (CARE) arrangements benefit lower paid workers, especially those who remain in the public sector for long periods.

17. The NAPF compared the many scheme design options outlined in the Commission's final call for evidence against our seven principles for reform. We believe a CARE arrangement has the most potential for delivering a sustainable, affordable and "implementable" public sector pensions system.

18. A new public sector pensions system based on core CARE benefits must provide a decent level of retirement income for public sector workers. While CARE might be the most appropriate structure for the public sector, there should not be a one-size-fits-all approach across all public sector schemes. The levels at which the benefits and contributions should be set are, of course, a political decision and one for negotiation with the main parties. It is also one which must take account of the wider remuneration policies for public sector pension employees, and in particular the current public sector pay freeze. When considering benefit levels, the Government should turn to the Pensions Commission's analysis of adequate income in retirement to inform its decision. The Government must also lead by example by providing good quality public sector pension provision and by not joining the "race to the bottom".

19. Overall, the NAPF firmly believes that the design of the core DB element must provide a stable and lasting settlement for the millions of public sector workers who will depend on it for their retirement income. Looking into the future, the Commission needs to consider ways the public sector pension system can manage costs going forward, such as changing NRA, accrual rates, employee contributions, and indexation requirements. Flexibility in these areas will ensure the long-term sustainability of the new public sector pensions system. The NAPF would like the same flexibilities to extend to the private sector to create a level playing field and help counter the "race to the bottom."

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**Table 1: Measuring CARE against NAPF's Seven Principles**

| *Principle* | *CARE compared* |
|---|---|
| 1. **Fit for Purpose** | A CARE scheme can provide benefits at levels which complement the wider public sector remuneration package. While the specific level is a decision for the Government to make and will ultimately be a matter for negotiation between employers and trade unions, it should take into account the incomes of current public sector employees. |
| 2. **Adequacy** | CARE can provide adequate levels of income (depending on accrual rate). Benefits should be skewed to protect low paid workers. |
| 3. **Affordability** | The affordability of CARE depends on the generosity of the scheme and accrual rates. But it can provide a solution for the long term by possibly capping CARE benefits to focus the core pension on low to medium income workers. We believe that it is important to ensure a lasting public sector pensions settlement, so in considering affordability the Commission should consider other cost-saving tools such as flexible Normal Retirement Age (NRA) and changing accrual rates and contribution levels to control costs in the future and to ensure intergenerational equity. The switch from RPI to CPI as a measure for future indexation increases has re-set the benchmark and is likely increase mobility between public sector and private sector DB schemes. |
| 4. **Transparency** | Transparency is not necessarily about scheme design. But a simple, easy to understand design like CARE can provide more predictable benefits and builds on the features of the current system. The NAPF is pleased that the Commission and the Treasury are looking at how best to measure the long-term costs of public sector pensions. We do not think the current "snapshot" way of reporting liabilities on an FRS17 basis is helpful for either public or private sector schemes but we recognise the need for greater transparency about the costs of public sector pensions. |
| 5. **Shared Responsibility and Risk** | The CARE benefit itself shares risks between the employee and the employer. The Government, as an employer, will bear more volatile risks like investment risk while employees will bear more responsibility for other risks like salary inflation. Core CARE will also allow for future risk-sharing, especially if other arrangements like top-up DC scheme are recommended as part the package of reforms proposed by the Commission. |
| 6. **Quality and** | Because CARE builds on the best features of the current |

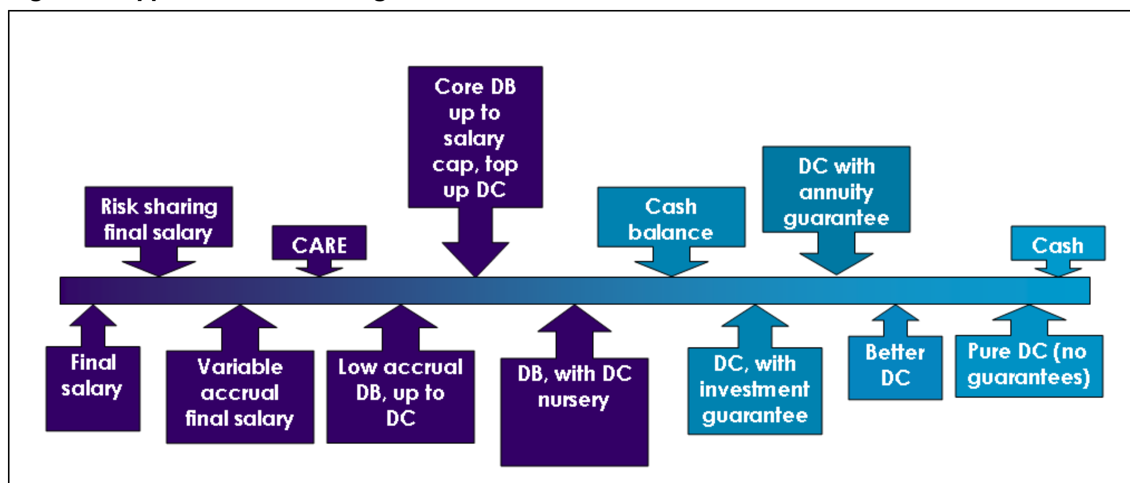
| Efficiency | system, scheme administrators will be able to provide good quality and efficient administration and governance. The core elements of the system are also simple, which reduces administrative complexity. Transition to the new system would also be easier as CARE is more evolution than revolution. |
|---|---|
| 7. **Mobility** | CARE will increase mobility between the public and private sector compared to final salary arrangements, especially for higher paid public sector employees. |

## Risk Sharing

**Q 2) Which risks associated with pension savings should the scheme member bear, which by the employer and which should be shared? Why?**

20. The "risk-sharing" label covers a multitude of scheme designs. Some do not share risks at all, but are simply a less generous form DB than the traditional final salary models. Models such as final salary with reduced accrual rate or increased normal retirement age fall into this category. In our first submission, the NAPF outlined the different types of risk sharing models, set out along a spectrum:

**Figure 1: Types of Risk Sharing Schemes**




21. There are six kinds of risk associated with running a pension scheme:

- Longevity risk. Employers risk having to pay out pensions for longer than they expected due to rising life expectancy. Individuals risk outliving their savings, especially if they do not purchase an annuity.
- Investment risk. Investments purchased with pension contributions could underperform expectations or predictions. If investments underperform in a DB scheme, employers have to make up the difference or change the scheme. In DC schemes, employees will receive reduced benefits if investments underperform.

- Annuity rate risk. Individuals risk lower annuity rates at the time when they purchase an annuity.
- Inflation risk. Inflation could rise faster than expected, thus reducing the value of scheme benefit.
- Salary inflation risk. Salaries could rise faster than expected especially towards the end of a scheme members' service.
- Interest rate risk. Lower than expected interest rates could reduce the scheme's ability to pay out pensions with the assets available.

22. Although a wide variety of risk sharing models are available in theory, in practice very few private sector schemes are currently using them (see the NAPF response to Q4). The NAPF 2009 Annual Survey found that only 8% of 221 DB-type private sector schemes described themselves as "hybrid". 75% of private sector DB schemes are classified as final salary and 13% as CARE.

Risks borne by the scheme member

23. A 2009 report by the Department for Work and Pensions found that many people have limited financial capability and understanding of pensions,[1] even on relatively basic pension concepts. For example, a survey conducted by the ABI showed that 45% of respondents thought a pension and an annuity were the same thing.[2] Some pension professionals estimate that only 10-15% of people understand the investment risk they face when saving in a pension.[3] Many people, especially those with limited financial awareness, are not best placed to bear investment or annuity risk.

24. In CARE schemes, salary inflation risk is borne primarily by the scheme member, especially if they experience significant salary increases later in their career. Salary inflation risk is also borne more heavily by higher paid employees compared with lower paid employees.

Risks borne by employer

25. Like individuals, employers have varying risk tolerances based on characteristics such as size and structure. The Government as an employer can bear even highly volatile types of risk such as investment risk because there is no risk of insolvency. In the state pension system, the Government bears a larger proportion of the risk of providing the Basic State Pension and State Second Pension.

[1] DWP, *DC Pensions*, 2009.
[2] ABI, *Serious about saving- Annuities: Bonus or Burden?*, 2005.
[3] *Ibid*, p. 105.

Shared risks

26. Some risks are less volatile and therefore can be shared between the employer and the employee, even with limited employee understanding. Many people feel comfortable with the concept of inflation. Inflation risk (wage or general) could be shared through CARE schemes and/or indexation requirements. In the private sector, inflation risk is shared between the scheme member and employer by capping inflationary increases at 2.5%. Inflation risk above this level must be borne by the scheme member.

**Q 3) What mechanisms could be used to help control costs in public service schemes? For example, is there merit in flexible normal retirement ages linked to changes in longevity? What indexation fact should be used in a career average type scheme to ensure a reasonable balance of risk between scheme members and taxpayers?**

27. There are four cost-saving "levers" available to the new public sector pensions system going forward: Normal Retirement Age, accrual rates, employee contributions, and indexation requirements:

- Normal Retirement Age. Changing NRA could help control costs by managing longevity risk. Rather being fixed, the NRA could be linked to changes in longevity or to increases in State Pension Ages so that it rises over time. Currently such flexibility would be difficult to replicate in the private sector because of heavily-regulated protection of accrued rights. Private sector schemes that want to change their NRA must first consult with scheme members. The new NRA can only be applied to accruals going forward, so often scheme members end up with pots payable at different ages –this creates confusion and inconsistency. The Government is currently looking at Section 67 of the Pensions Act 1995, which protects accrued rights for private sector scheme members and we would encourage the Government to consider extending any flexibility on NRA available to public sector schemes to the private sector as well.

- Accrual Rate. Reductions in the rate at which pension benefits accrue can positively affect scheme liabilities and reduce deficits. But reduction in accrual rates also affects the adequacy of scheme benefits. Any changes to accrual rates must be made with lower paid workers in mind. The NAPF also recommends that accrual rates remain relatively steady as constantly changing accrual rates create administrative complexity.

- Contributions. Increasing employee contributions is perhaps the quickest and simplest way to increase public sector scheme cash

flow (as increasing employer contributions effectively recycles Government money). As we said in our response to the first call to evidence, we recognise that employee contributions will have to increase, but there is a real risk that too high an increase could cause employees to leave public sector pension schemes to the detriment of long term saving. The Chartered Institute of Public Finance & Accountancy (CIPFA) has estimated[4] that the revenue increase from a 1% increase in employee contributions would be wiped out by a fall in scheme membership of 15%.

- Indexation requirements. Changing indexation requirements could also reduce scheme costs, as the recent switch from RPI to CPI demonstrates. The 2010 Emergency Budget reported that the switch to CPI will save £1.1 billion by uprating means tested benefits, tax credits and public sector pensions by CPI. Further changes or the introduction of indexation caps for public sector schemes could also help to reduce costs.

28. The NAPF does not have a specific indexation factor for career average schemes in mind but we would urge the Commission to consider the Pensions Commission's benchmark replacement rates and the desire for public sector pensions to maintain adequacy over the long term when considering indexation factors.

**Q 4) Where and how have risks associated with pensions been effectively shared in private sector companies?**

29. Although some private sector employers have successfully implemented risk sharing schemes, a range of impediments stand in their way. These barriers range from "hard barriers" (legislative issues such as mandatory indexation) to "soft barriers" (complex communications or future regulatory risk).

30. Hard barriers can be the most difficult to overcome. In the private sector, risk sharing arrangements with any DB element are often treated as pure DB. Employers then have to meet indexation requirements, PPF levies, accounting standards, and the risk of "double regulation" if they have both DB and DC elements.

31. Soft barriers arise because risk-sharing is a relatively new concept. Employers are uncertain about their ability to change the scheme in the future. Risk-sharing schemes are more complex, making them more difficult to communicate to members. And employers have expressed concern about finding the right advice or advisers.

[4] The Public Sector Pensions Commission – CIPFA response to the Call for Evidence, CIPFA, July 2010.

32. But the NAPF believes risk-sharing must be allowed to flourish if we are to "reinvigorate occupational pensions". More innovative types of risk sharing such as conditional indexation require legislative changes before private sector schemes can use them, although they could go some way in reducing scheme costs and promoting good quality workplace pensions.

**Q 5) Which international examples of good practice in the area of risk sharing should the Commission consider when compiling the final report? Why?**

33. Many examples of effective risk-sharing exist internationally. The NAPF believes the Commission should look at: the Dutch model of conditional indexation and the example of scale provided by the Danish collective DC.

   - Conditional indexation. In the Netherlands, indexation of scheme benefits to account for inflation is not mandatory. This system allows schemes to index benefits when it is affordable instead of placing strain on schemes that are already facing the possibility of closure.

   - Collective DC. The NAPF thinks there is much to learn from the efficiencies of scale present in the Danish model. Collective DC schemes in Denmark can operate at 0.04% DKK. The NAPF estimates that large-scale trust-based DC schemes ("Super Trusts") would be suited to any DC top-up arrangement provided in addition to the core CARE benefits. Super Trusts are a form of collective, multi-employer workplace pension which are able to capture efficiencies from lower administration costs, wider ranges of investment options, and more effective governance arrangements than smaller private sector trust-based schemes. Many private sector schemes feel unable to form Super Trusts because of legislative barriers.

**Q 6) What should the split between member and employer contributions look like?**

34. In a typical DB scheme in the private sector, employees pay a third of the contributions and employers contribute the remaining two thirds. According to the 2009 NAPF Annual Survey, the average employer contribution into a private sector DB scheme was 19.2%. The average employee contribution was 6.0%.

35. However, the rate of DB scheme closure in the private sector might suggest that this contribution ratio is untenable in the long term. A more equitable split could ensure a scheme's viability and prevent future benefit reductions. But some employees, especially those on low incomes, may not be able to afford to fund a larger percentage of contributions.

36. In considering the split between employer and employee contributions, special attention must be given to the impact on lower paid employees to prevent lower scheme take-up and to ensure adequacy of retirement income. To make the

scheme more progressive, the contribution split could remain 1/3rd employee contribution and 2/3rd employer contribution for lower paid staff. The ratio could gradually increase higher up the income scale so that the employees pay a greater share of their pension costs the more they earn. Contribution levels are currently structured like this in the LGPS and NHS schemes.

37. Shared cost arrangements in the private sector are rare. The main example is provided by the Railways Pension Scheme where the ongoing costs of future accruals and deficit recoveries are reflected in the split between employer and employee contributions. In some shared cost schemes, employees bear 40% of the costs while the employer bears 60%. The split does not need to remain fixed but can be reviewed following triennial scheme valuations.

**Q 7) Should there be different treatment of different professionals (for example, lower normal pension ages for some public sector employees)?**

38. Current trends in longevity hide the fact that different socio-economic groups have different outcomes in terms of life expectancy. Earlier this year, Sir Michael Marmot published his findings on health inequalities in England and Wales. The Marmot Review found that people living in the poorest neighbourhoods will, on average, live for seven years less than people living in the wealthiest neighbourhoods.[5]

39. Likewise, work patterns and life expectancies vary considerably between members of public sector workforces and between the workforces themselves. Therefore, a flexible approach might be the most appropriate.

**Q 8) Should there be different treatment for those at different income levels?**

40. The Government is committed to widening access to workplace pensions for those workers who need it most through the introduction of automatic enrolment and mandatory employer contributions in 2012. In the public sector, employers should pay a higher proportion of contributions towards the pensions of lower paid workers. This way, employees who may not have otherwise been able to afford to save in a pension can save for their retirement.

41. To keep public sector pensions sustainable and affordable for the long term, there might be a case for capping accrual of CARE benefits for higher paid employees. If this were the case, the NAPF recommends that a top-up DC scheme be in place so these employees have the opportunity to save more. As described earlier in paragraph 33, we believe a multi-employer Super Trust structure could provide an efficient and low-cost top-up DC scheme design.

[5] Fair Society, Healthy Living, The Marmot Review of Health Inequalities, 2010.

**Q 9) What is the appropriate normal retirement age for the different public service schemes? Should this vary across schemes and, if so, why?**

42. The appropriate NRA for public sector schemes will depend on the Commission's and the Government's desire to take account of varying employment patterns and different life expectancies and healthy life expectancies across the public sector workforce. The NAPF does recognise that NRAs need to rise in both the state pension system and occupational pensions to reflect the general increase in longevity.

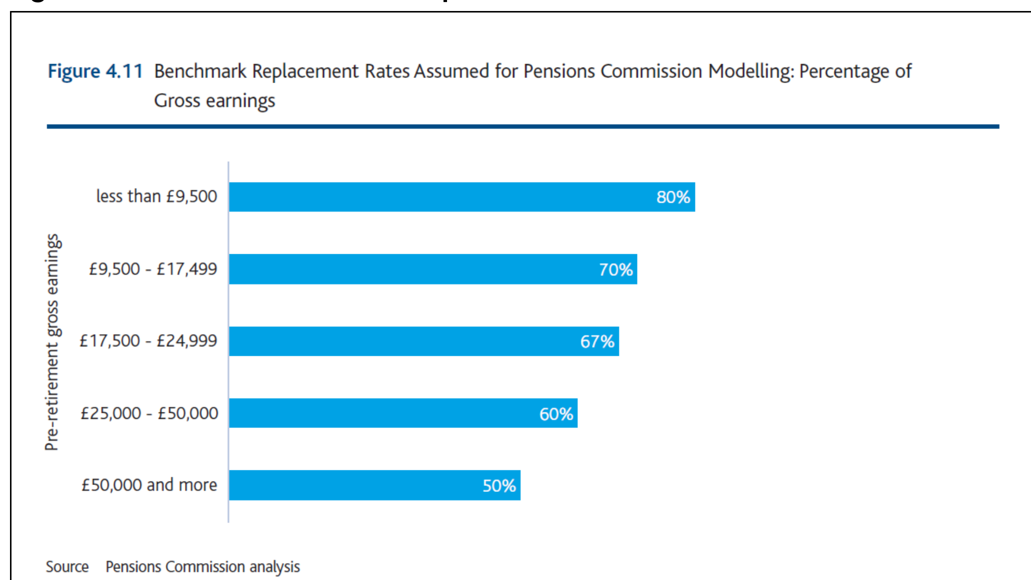
## Adequacy

**Q 10) How should the Commission think about measuring adequate levels of resources in retirement?**

43. The UK pensions system is in crisis. And it is a crisis of adequacy. Too many people are not saving at all or they are not saving enough for their own retirement. Today, almost 3 in 5 pensioners rely on means tested benefits. And for the average single pensioner, benefits from the state make up 55% of their total income in retirement.[6] This cannot be right.

44. The Pensions Commission examined this issue in depth. Although adequacy is difficult to define, it proposed a series of benchmark replacement rates to guide its work:

**Figure 2: Pensions Commission Replacement Rates**




Source: Pensions Commission First Report, *Pensions: Challenges and Choices,* 2004.

[6] ONS Pension Trends.

45. The Pensions Commission's analysis looked at current trends in replacement rates for recently retired pensioners and considered people's preferences and spending habits when setting their benchmarks. The Pensions Commission concluded that these replacement rates reflected reasonable assumptions about the needs of pensioners.

46. The NAPF is not aware of any evidence to suggest that the Pensions Commission's benchmark replacement rates are no longer relevant or accurate. We believe that lower paid employees need higher replacement rates than higher paid employees. Without higher replacement rates, lower paid workers are less likely to have adequate income in retirement.

**Q 11) What should be considered an adequate level of resources in retirement?**

47. Earlier this year, the NAPF outlined our vision for transforming the UK pensions system in *Fit for the Future: NAPF's Vision for Pensions.* We set out a series of proposals and simplifications for the UK pensions system which builds upon the principles set out in the Government's 2012 reforms. As a package, our proposals ensure that people retire with an adequate income long into the future.

48. The NAPF believes the building blocks of any pension system providing adequate retirement incomes is a decent, more generous state pension system. In *Fit for the Future*, the NAPF suggested a simpler, more generous state pension system combining the Basic State Pension and State Second Pension into one pension – the Foundation Pension. We suggested that the Foundation Pension could be set at £8,000, but this could be flexible to depending on costs. What is important is that the Foundation Pension is set above the current means tested benefits threshold of £6,760[7] so that people know that whatever they save in addition to the Foundation Pension will not be eroded away by means tested benefits.

49. Because the Foundation Pension would provide public sector workers with a more adequate income from the State, the need to contract out of the State Second Pension would no longer exist. In the long term, this may increase adequacy for public sector pensioners. In the future the State Second Pension will become flat-rate, but the Foundation Pension would increase in line with the "triple guarantee".

**Q 12) Should a full state pension and a full public service pension ensure people have adequate resources in retirement? Or should room be left for individuals to make their own arrangements?**

50. The UK pension system as a whole (state system together with workplace pensions, both private and public sector) should encourage people to take

[7] The current Guarantee Credit level.

responsibility for themselves by saving for their own retirement. A full state pension and full public sector pension should ensure people have an adequate income in retirement, but it should be a baseline and not the end goal. If people want to save on top of these arrangements, they should encourage them to do so.

51. A simple Foundation Pension would incentivise people to save more for their retirement. Because people would be able to predict how much they would receive from the state, they would be able to make informed decisions about how much to save on top of it.

**Q 13) How should this change where people work part careers in public service?**

52. The NAPF believes that all workers deserve access to a good quality workplace pension, whether they work in the private or public sector or whether they move between the private and public sectors. In the future, people will have a greater mix of private and public sector pension pots which reflect changing work patterns. Pensions shouldn't act as a barrier to labour market mobility but should promote productivity and encourage further saving.

## Employee Understanding and Choice

**Q 14) How much do workers value and understand pensions? Is there any evidence that this differs between groups (for example, by age, by income)?**

53. Many people already understand the importance of pensions and consider them a valuable part of the remuneration package. Research conducted by the NAPF earlier this year showed that 44% of employees said pensions were the best way to save for retirement. And 41% of employees thought pensions were the most important employee benefit, even before bonuses and flexible working.

54. Despite the recognition that pensions are valuable, only a third of employees said they were confident that pensions would provide them with an adequate income in retirement. Because the current system is made up of a complex mix of the Basic State Pension, State Second Pension, means tested benefits, and workplace pensions, people cannot predict what they will receive in the future. We need a stable, easy to understand public sector pension system with a Foundation Pension as a base to restore confidence in pensions.

55. Part of the puzzle of restoring confidence and improving employee understanding in pensions is good quality communication and engagement, not just about the benefits employees will receive in the future but also around reform to current arrangements. The Commission needs to recommend a robust employee communication and engagement plan around their proposals for public sector pension reform.

**Q 15) Which forms of scheme design will encourage employees to save for their retirement? Is there any evidence from pension scheme reforms influencing opt out rates in the private sector?**

56. The introduction of automatic enrolment in 2012 is designed to harness savings inertia in the UK. Pensions are notoriously complex and difficult to understand. As a result, people fail to engage with them. The 2012 reforms have taken the guess-work out of pensions, making the decision to save simple and easy to understand. The 2012 reforms will be successful when saving in a pension becomes the default position for most people.

57. But for the NAPF, the 2012 reforms are only a starting point. There is still much work to be done to ensure people have an adequate income in retirement. The 2012 reforms require minimum contributions from both the employer and employee, but at 8%, they are likely to deliver only a modest income.

58. It is therefore vital that employees understand the value of good quality existing schemes in both the private and public sectors. The key challenge is to get more people saving more for their retirement in existing, good quality pension schemes. The NAPF's Pension Quality Mark (PQM) gives existing schemes a way to highlight the excellent benefits they provide. PQM schemes must provide contributions of at least 10%, with at least 6% from the employer, which is well above the statutory minimum required under auto-enrolment. The NAPF is pleased that the Coalition Government is committed to "reinvigorating occupational pensions" and we will work with the Government to get the UK saving again.

**Q 16) What best practice exists in the private sector around communication of benefits with scheme members?**

59. The NAPF's Pension Quality Mark initiative requires, as one of its three standards, good quality communication between private sector schemes and scheme members. In our view, best practice in scheme communications includes:
    - Avoiding jargon or technical language that will not be understood by the average employee.
    - Short documents (1-2 sides) or providing key messages in a short summary or covering letter.
    - Setting out choices in a clear and simple format that allows employees to compare options and make decisions.
    - Encouraging scheme members to make decisions and take action where appropriate, such as by reviewing their contribution levels or options for retirement.
    - Using bullet points, pictures, charts or diagrams where appropriate to make information easier to visualise and understand.

60. Some private sector schemes also provide regular seminars, access to independent financial advisers, and face-to-face communication for their scheme members. The use of targeted communications based on scheme trend analysis is also becoming more popular.

**Q 17) Should any new scheme design offer members a degree of choice in the level of contributions paid and benefits received? For example, should members be able to receive a higher pension if they want to take the pension later? Why?**

61. In theory, introducing an element of choice into the design of public sector schemes could increase employee engagement with the scheme. Allowing scheme members to choose lower contribution rates in exchange for reduced benefits could reduce opt out rates, especially during a pay freeze.

62. However, the experiences of many pension providers and scheme administrators would suggest that choice increases scheme operating costs, complicates scheme administration and reduces simplicity of design. And it could limit mobility between public sector schemes and between the public and private sectors if other schemes do not offer the same degree of choice.

63. The NAPF recommends that the core CARE element of the new public sector pensions system should be simple and provide the same benefits for all employees. Benefits offered in addition to the core CARE element, such as a DC top-up or AVCs, could offer a degree of choice.

## Pensions and Plurality of Provision of Public Services

**Q 18) Whether and how public service pensions could be structured to support a more level playing field between the public and private sectors when tendering for contracts?**

64. The NAPF believes public sector pensions, like all workplace pensions, should promote productivity and not act as a barrier to labour market mobility. Competition between the public and private sectors creates efficient and good quality public service. Some stakeholders have argued that healthy competition is stifled by the Fair Deal. The Fair Deal requires employers who transfer staff from the public sector to the private sector to provide pension benefits that are equivalent to those they would have received in the private sector.

65. The Fair Deal can add considerable cost and complexity for private sector companies wishing to do business with the public sector, many of whom remain unclear about the costs they are responsible for even after signing contracts. More clarity is needed, from the outset, about who is responsible for costs at the start, during, and upon termination of outsourcing contracts.

66. Outsourcing of services might be easier if the requirement to include pension benefits from contracts was removed, but this would require considerable negotiation with scheme members, trade unions and politicians. This issue could be revisited once the wider public sector pension reforms have been fully implemented.

**Q 19) Which non-public service employees should be eligible for membership of public service schemes?**

67. The NAPF does not have a view on this issue. It is a matter for negotiation between public sector pension schemes, employers, and trade unions.

## Administration Costs

**Q 20) What evidence is there on administration costs (excluding fund management costs of private sector pension schemes? How do these compare with those in the public service schemes?**

68. Private sector scheme administration costs vary considerably depending on the size and structure of the scheme. According to the Capita Hartshead Annual Pension Scheme Administration Survey 2010, the average administration charge per member for the largest private sector schemes is £47 per member.[8]

69. In contrast, scheme administration costs within the Local Government Pension Scheme are much lower at with an average of £24 per member.[9] CIFPA's Benchmarking Club shows the average administration cost per LGPS scheme member of £18.88.

70. This demonstrates the benefits of large-scale workplace pensions in lowering administration costs. NAPF research indicates that a Super Trust with 800,000 members could operate with an administration charge of £15.75 per active member.[10]

71. Earlier this year, the Audit Commission published a report on the Local Government Pension Scheme which looked at scheme administration costs. The report found that "funds may be able to achieve savings on fees and administration at the margin, but these are small in comparison to fund investments."[11]

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[8] For schemes with more than 10,000 members. Scheme administration charges were £47 per member with in-house administration and £41 with outsourced administration.
[9] The NAPF 2009 Annual Survey found the average Local Authority scheme administration costs to be £1.1million in total. The average number of scheme members per Local Authority scheme is 46,000.
[10] NAPF, *Super Trusts: Putting members first,* 2005.
[11] Audit Commission, "Local Government Pensions in England", 2010.

**Q 21) How do private sector schemes ensure that there is good quality and efficient scheme administration? Which measures can be applied to public service schemes?**

72. There are many examples of how to provide good quality and efficient scheme administration in the private sector and there is no one size fits all approach. Some of our private sector members have attended or will be attending roundtable discussions with the Commission on scheme administration. We are happy to facilitate further such meetings between the Commission and our members and to provide any additional information the Commission may require.

**Q 22) Is there scope for rationalising the number of local government pension funds? If so, how could this be achieved?**

73. The issue of reducing the number of LGPS administering bodies is itself complex:

- Local authority funds have different funding levels. Amalgamation might increase deficits for some funds.
- Efficiencies increase as funds grow larger. Beyond the "optimal size" efficiencies decrease. There is a risk that Local Authority funds could become too large.
- Consolidation could be expensive. Schemes will have to employ advisers, consultants and actuaries to assist them. It is unclear who would bear the cost.
- The project would require a long transitional period extending over many years.
- Local authority funds would no longer be locally accountable.
- The admitted bodies process would become more complex and overwhelming, especially for smaller organisations.

74. Pooled fund management procurement, however, might provide significant savings. The cost of a single procurement process for one investment mandate can run between £20,000 and £30,000. This only a one-off cost of the procurement process itself and does not account for transitional costs and the on-going costs of the mandate period (which can last between 5 to 10 years). Some Local Authorities are already working together to reduce the cost of fund management procurement using "Framework Agreements" to procure similar fund management mandates.

## Transition Issues

**Q 23) How can the Commission ensure an effective transition to the new arrangements?**

75. The Independent Public Service Pensions Commission is attempting to solve a problem which, until now, has had no permanent, long-term solution. The transition from the current system to the reformed public sector pensions arrangements will be successful only if all interested parties approach reform in the spirit of compromise and with a view to achieving a lasting settlement.

76. The Pensions Commission and the consensus built around it's recommendations provide an excellent example of how radical pensions reform can be implemented smoothly, harnessing political and stakeholder consensus. Like the Independent Public Service Pensions Commission, Lord Turner's Commission was tasked with solving a seemingly insurmountable problem. The scale of the UK's savings crisis and the long term nature of the Pensions Commission's recommendations meant that consensus had to be built by all the main political parties, employers, trade unions and the pensions industry. This required compromise on all sides. Through many Pensions Bills and reviews, that consensus has remained and it will be vital to the success of the 2012 reforms. Lasting consensus is something the Independent Public Service Pensions Commission should build around public sector pensions reform as well.

77. The building blocks of an enduring consensus are time and clarity:

- Time is needed to discuss and debate the issues thoroughly but the transition must not be drawn out. The political will to implement the reforms successfully must remain.
- Clarity ensures that everyone understands the task ahead of them. Clarity early on in the transition process is vital, especially around the treatment of existing accrued rights and communication with scheme members.

**Q 24) What can the Commission learn about moving to a new scheme from best practice in the private sector and internationally?**

78. Moving to a new scheme in the private sector can be difficult and time-consuming. Success often depends on the structure of the old scheme, the design of the new scheme, and the resources available to the scheme administrators. We are happy to facilitate meetings between the Commission and members who have undergone scheme transitions and to provide any additional information the Commission may require.

**Q 25) How have accrued rights been protected or transferred during changes in schemes in the private sector?**

79. In the private sector, legislation dictates the treatment of accrued rights during scheme changes. Section 67 of the Pensions Act 1995 requires actuaries to certify that any changes to private sector schemes have not been made to the detriment of its members. The Department for Work and Pensions is currently working to clarify the impact of Section 67 in specific circumstances. But in practice, private sector scheme sponsors feel restricted in their options for reducing scheme liabilities. Section 67 often limits private sector schemes' ability to raise a scheme's NRA.

80. Private sector schemes are also required by law to index deferred rights and pensions in payment. This issue has received considerable media attention recently because of the switch from the Retail Prices Index to the Consumer Prices Index as the measure of indexation. Public sector schemes and some private sector schemes will now be able to use CPI when uprating pensions. The NAPF has repeatedly called on the Government to introduce a limited statutory override or scheme modification powers for private sector schemes that have RPI written into their scheme rules. With scheme modification powers, these schemes could use the same flexibility offered to public sector schemes. Private sector DB schemes are already facing escalating costs and we are disappointed that the Government has not provided such breathing space for these private sector schemes.

## Conclusion

81. The Commission has the opportunity to suggest a new design scheme for the public sector which is affordable and sustainable for the long term. The NAPF believes that CARE is the most appropriate option for a new public sector pensions system. CARE builds on the best features of the current system: it is simple and easier to implement, it is fair (especially to the low paid), it shares risks between the employer and employee, and it will allow for a quick transition. With the right accrual rate, it will provide adequate incomes for public sector pensioners well into the future.

82. To keep the new system affordable in the long term, there may be a case for capping CARE benefit accruals based on salary. The NAPF recommends that an additional DC top-up scheme be made available for employees who wish to save more. Large scale, multi-employer Super Trusts could provide top-up DC benefits efficiently and at a low cost. There may be other ways to improve efficiency and lower costs within public sector schemes by pooling fund management procurement or by encouraging "Framework Agreements".

Catherine Cunningham
Policy Adviser: Pensions
Catherine.cunningham@napf.co.uk
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