Hutton Report

Lord Hutton published his final report on public sector pensions on 10th March 2011. You may remember that this follows his interim findings which were the subject of a member newsletter back in October 2010.

The objective of this report was to make a series of recommendations for public sector pensions which are affordable, adequate and fair but also support productivity as well as being simple and transparent.

The final report contained 27 recommendations to Government, all of which can be found analysed in detail on both LPFA’s website, and www.affordable-lgps.org.uk our special website on the future of the LGPS, along with the full version of Lord Hutton’s report.

These recommendations apply to the majority of public sector schemes but it will now be for the Government to decide if and how they should be developed into scheme regulations. As you are aware LPFA is an administering authority for the Local Government Pension Scheme (LGPS) and is unable to change the regulations of the scheme.

What are the key recommendations?

☆ Normal retirement age to be tied to the State Retirement Age for all public sector schemes, apart from the uniformed roles – firefighters and armed forces for example. Currently it is 65 in the LGPS but the State Retirement Age is expected to move to 66 by 2020.

☆ Move to a career average rather than final salary scheme but maintain the defined benefit nature of the scheme.

Career average means that you still receive a defined benefit pension but it is based on your average earnings over the working period, rather than your final salary. For each year you work you receive a pension entitlement and these are added together when you come to retire. (Please see worked example overleaf)

☆ Rights accrued or built up to the date of the new scheme are likely to remain untouched and retain their link to final salary – but any years under the new scheme will be on a career average basis.

(continued...)
Please note therefore that this update is for information only at this stage and it is likely to be a some time before it becomes clear which of these recommendations are applied to the LGPS. However the Chancellor did state in the March 23rd Budget that the Hutton Report would not be “cherry picked” and that further proposals will be published in the autumn.
Scheme member consultation for any of the proposed changes – it is unclear how this will be managed at present.

Nominated members on a Pensions Board to manage the fund – this may well mean an opportunity for scheme members to play an increased role in the governance of the pension fund.

Contribution rates should remain tiered, i.e. higher earners contributing more. However the Government is looking at contribution rates separately and these may be increased in the future.

**Why do we need to change?**

LPFA has been campaigning for changes to the LGPS for the last two years. As a funded scheme the LGPS is in a much healthier position than the majority of the public sector schemes which operate on a pay as you go or unfunded basis. The LGPS has £120bn of assets nationwide.

However there are challenges to the future affordability of the scheme. The 2010 valuation indicated that LPFA was 83% funded in the active sub-fund and 77% funded in the pensioner sub-fund. There is no need to worry immediately about this and there is an investment strategy in place to return the fund to 100% solvency levels, but it did again call into question the long term sustainability of the scheme.

Also, the positive reality that people are living longer has to be balanced with the fact that this is putting additional strain on the pension fund.

As an example the normal retirement age of 60 was set in 1935 when it was expected that the average person would spend 10 years in retirement, now most people live well into their 90s and the normal retirement age has only recently moved to 65.

For these reasons LPFA is supportive of Lord Hutton’s recommendations although it will mean a slightly less generous LGPS for some members moving forward. LPFA campaigned hard for the scheme to remain a defined benefit scheme and this was included within Lord Hutton’s report.
How does CARE (Career Average Revalued Earnings) work?

Assume Jeff is in the scheme for 3 years and the pension rate is 1/60th as the current scheme.

Year 1 – Jeff’s pay is £18,000 and therefore in that year he earns £300 of pension i.e. 18000/60 = 300. This is in effect put aside and increased annually in line with inflation or earnings depending on which rate the Government decides so by retirement it might actually be worth £318.

Year 2 – Jeff’s pay is now £18,400 which therefore earns a pension of £307. This is also increased annually in line with inflation so when he retires it is worth £316

Year 3 – Jeff’s pay is now £19,000 which provides a pension of £317 and Jeff is about to retire.

The pension from each year is added together to give a yearly pension of £951 and if he likes he can still swap some of this for a tax free lump sum.

We have assumed a 3% inflation rate but the exact method to calculate pension build up will depend on whether the Government links this to wages or prices.

What is a Defined Benefit scheme?

Under these schemes employee members are entitled to a particular level of benefit depending on their length of service and the level of their salary when they retire.
**What does this mean for me?**

Remember these are recommendations at the moment and it may take a couple of years for regulations to be drafted to include these in the scheme rules.

All new members would be placed directly into a career average scheme but the situation is more complicated for current members who have been building up their pension rights.

Potentially it means that a current member who joined the scheme pre 2008 might have three elements to their pension. For example:

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<thead>
<tr>
<th>Pre 2008 Final Salary benefit</th>
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<tbody>
<tr>
<td>1/80&lt;sup&gt;th&lt;/sup&gt; of your final salary as pension plus 3/80&lt;sup&gt;th&lt;/sup&gt; lump sum for pre 2008 membership calculated on pay at leaving. Normally payable at age 65</td>
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<table>
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<tr>
<th>Post 2008 Final Salary benefit</th>
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<tbody>
<tr>
<td>1/60&lt;sup&gt;th&lt;/sup&gt; of your final salary as pension for membership from 1.4.2008 to start of new scheme calculated on pay at leaving. Normally payable at age 65</td>
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<tr>
<th>New CARE Scheme benefit</th>
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<tr>
<td>CARE for membership from start of new scheme calculated on pay for each year. Normally payable from State Retirement Age</td>
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**Impact**

Pros - protection of existing rights
Cons - Complex calculation at retirement requiring equally complex processes and member communications
You might have joined the scheme in 2003, have 5 years until 2008 under the old scheme, then assuming the new scheme rules come in from 2015 you will have 7 years under the current scheme.

All this is based on your final salary when leaving the scheme at your retirement age i.e. the link to your final salary remains for the purpose of these first 12 years.

If you stay in the scheme until 2023 you will also have 8 years on a career average basis. So to get to your final pension you will have to take all three elements into account.

But let’s wait and see how the regulations are enacted. LPFA will of course keep all members updated over the coming years and please keep checking the website for more detail on any of these recommendations.

**What are accrued rights?**

Accrued rights are pension benefits you have built up already – the Hutton report has recommended that these are protected and for example the link to final salary will remain for the years achieved up to the introduction of the new scheme.

**What is the difference between a final salary scheme and a career average scheme?**

Career average tends to be fairer to the average member. It is a more favourable method of calculating pension benefits if the person has a similar level of salary throughout their working life. It is less generous to those who receive multiple promotions, especially those on higher than average earnings. Given that the average pension paid to a member is £4,000 per annum it will mean that the majority of members will not be worse off.

For those who receive regular or large promotions this will not be as beneficial, however you are still encouraged to remain members of the scheme since the recommendations did not suggest any type of salary cap.

(continued…)
Next steps:

Lord Hutton has indicated that these recommendations should be in place by the end of the current Parliament i.e. 2015.

In the budget statement on 23rd March George Osborne said that the Government accepted the recommendations as the basis of a consultation process to take forward proposals by the Autumn of this year.

There are many elements of detail to discuss and finalise and legislation to draft before any new scheme is implemented, however LPFA believes this is a step in the right direction to secure a sustainable future for the LGPS and to continue to strike a right balance of fairness.