The Actuarial Profession
making financial sense of the future

# Consultation response
## Independent Public Service Pensions Commission

Call for evidence for final report

December 2010

**About the Actuarial Profession**

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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17 December 2010

Lord Hutton of Furness
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Dear Lord Hutton

I am writing on behalf of the Actuarial Profession in response to your call for evidence for the final report of the Independent Public Service Pensions Commission. The Actuarial Profession represents the members of the Institute and Faculty of Actuaries, the chartered professional body for actuaries in the UK, and regulates those members for the benefit of the outside world.

Approximately 2,000 of our 6,000 UK based Fellows advise the sponsors or trustees of pension schemes either private or public sector. Our submission therefore draws on this considerable pool of experience.

The Actuarial Profession welcomes the evidence based approach within the interim report of the Independent Public Service Pensions Commission. In particular, we welcome the publication of previously unavailable data that will inform the debate, the focus on the appropriate use of statistics such as average pensions and, most of all, the recognition of the paramount importance of how the choice of discount rate in pension scheme calculations can have a material impact on comparisons and decisions.

We will be making detailed comments regarding discount rates in our response to HM Treasury's consultation on the discount rate used for a number of purposes including the setting of unfunded public service pension contributions in due course. We identify in a few places questions where the results of that discount rate consultation are likely to have a significant impact on that particular issue.

Our answers to the questions posed in the call for evidence are set out below. Please note that we have not answered questions where we believe it is appropriate for comments to come from other bodies closer to the issues raised.

*Q2 Which risks associated with pension saving should the scheme members bear, which by the employer and which should be shared? Why?*

Our collective private sector experience suggests that many people are ill equipped and therefore averse to taking investment risks personally. This is particularly true for those with smaller pensions, for whom their pension is critical to a basic level of retirement well-being. Those on higher earnings – and consequently higher defined benefit pensions – may be able to entertain a degree of personal investment exposure, for

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example if part of their pension were to be provided on a defined contribution basis rather than a defined benefits basis. We understand that the FSA has substantial consumer research in this area.

This experience suggests that a greater degree of risk to be borne by employees brings with it a greater need to educate and communicate and, perhaps, provide 'safe harbour' default options for those not able to make their own informed choices.

Although not as well understood as we might wish, in our experience longevity risk is better understood than investment risk. Longevity risks are also more easily shared with employees, in relation to future earning of pension. For example, it may be suitable to change pension ages for future service in response to emerging longevity, or equivalently to expect higher member contributions for subsequent service to reflect that increase in life expectancy.

The benefit design commonly described as "cash balance" often puts the investment risk in the pre retirement period with the employer. An annuity is purchased at retirement which puts the investment risk at the point of retirement with the employee who also effectively bears the longevity risk in the pre retirement period but offloads the post retirement risks to an insurance company. This design is not uncommon in the US but relatively rare in the UK (though Barclays Bank is quoted publicly as having adopted this approach). Historically, some public sector schemes have provided a formula based lump sum as of right. In some ways this is analogous to the cash balance.

*Q3 What mechanisms could be used to help control costs in public service schemes? For example, is there merit in flexible normal pensions ages linked to changes in longevity? What indexation factor should be used in a career average type scheme to ensure a reasonable balance of risk between scheme members and taxpayers?*

It may help control costs if pension ages were linked to changes in longevity. Objectively this may best be done by reference to an independently calculated index designed for the purpose rather than by linking to a politically sensitive reference such as the State Pension Age. However we recognise that there are simplicity benefits in linking to a well understood measure such as State Pension Age.

Normal private sector practice has been to increase pension ages for future service where applicable, rather than to try to alter them for past service already earned. However, a simple focus on a normal pension age will not deal well with the wide range of actual retirement ages and subsequent life expectancies associated with public sector occupations. This could be addressed directly through a benefit design that accrued a lump sum at retirement that may then be used to buy an annuity (the "cash balance" approach described above). Members in poor health could then retire early by taking advantage of impaired life annuity rates. Another key area of control lies in the proper financial assessment of the costs of options, for example the purchase by members of "added years". In particular, early retirements (through redundancy or otherwise) should be properly costed and inform management decisions on allowing / encouraging early retirements.

We consider the degree of indexation funded by the employer to be essentially a political decision and therefore have no view, except to emphasise that comparisons between design options will only be valid if appropriate and consistent assumptions are adopted for the purpose.

*Q4 Where and how have risks associated with pensions been effectively shared in private sector companies?*

In the private sector, there have been some attempts to share risks. These break down into a number of forms:

- investment risk – this has mainly been transferred to the employee by the introduction of defined contribution arrangements where all the investment and longevity risk is taken by the employees. It is unusual to find any kind of investment underpin.

- longevity risk – in a normal defined contribution scheme this is also taken on by the employee. Employees can be protected against longevity risk by guaranteed annuity rates, but these have had a difficult history in the UK, particularly as used by insurers.

- longevity risk – in a traditional or modified defined benefit scheme the risk may be shared in such a way that the pension age depends on an objective measure of longevity. Thus, the pension earned or future periods of service might each be adjusted based on the outturn. In the “cash balance” approach the longevity risk is transferred to the employee who then offloads part or all of it to an insurance company.

- generally other risks are no longer borne by employees. For example, in the past it was not uncommon for dependants’ pensions to have to be allocated by the members out of their own pension rights. This practice is now rare. One consequence of defined contribution schemes is that the decision on the extent to which dependants are covered is a matter of individual choice. In the public sector, Government may wish to consider an element of compulsion in this area.

*Q5 Which international examples of good practice in the area of risk sharing should the Commission consider when compiling the final report? Why?*

Some international experience gives more insight into some of these risks. In particular:

- changes in population life expectancy normally result in increases in pension age, to the detriment of what might be termed “accrued rights”, for example in the Netherlands.

- investment return underpins manage some of the investment risk, for example in the Danish public system, where minimum returns of from 2% to 5% apply depending on the time period.

*Q6 What should the split between member and employer contributions look like?*

We believe that the split is a matter of public policy in the context of general pensions and total reward practice in the UK. It may be a matter for each individual sponsoring Government department to decide on the individual circumstances of the split for their employees.

However, it is important to note that if the choice of discount rate has a significant impact on the total apparent cost it must also then have a significant impact on the proportion of that total which any given employee contribution represents.

For example, a particular set of benefits may be valued at 18% of pay using a high discount rate but 30% using a low discount rate. An employee contribution rate of 6% of pay therefore looks very different depending on the discount rate chosen (one third of the cost in the first example but one fifth in the second). The question may not therefore be susceptible to a unique answer.

*Q7 Should there be different treatment of different professions (for example, lower normal pension ages for some public service employees)?*

A “one size fits all” approach is unlikely to be appropriate unless there is substantial flexibility for members to tailor their own benefits. Lower pension ages are, for instance, likely to fit the needs of employers as well as staff in the uniformed services better than some other areas of the public sector.

It is not clear to us that distinguishing groups of employees ‘by profession’ necessarily gives the most homogeneous groupings. It may be more productive to look at the underlying characteristics of different professions; e.g. typical retirement age, earnings (both quantum of earnings and how it progresses through a career), average length of service, whether there are comparable jobs in the private sector to benchmark against etc. We suggest that perhaps it is these characteristics rather than ‘the profession’ which should drive the benefit design.

*Q8 Should there be different treatment for those at different income levels?*

Again, we believe this is a matter of public policy in the context of the tax regime (e.g. the Lifetime Allowance) and the State Scheme (which impacts more significantly on the lower paid) and any particular issues affecting individual groups of employees.

*Q9 What is the appropriate normal pension age for the different public service schemes? Should this vary across schemes and, if so, why?*

Please see our response to Q3 above.

*Q10 How should the Commission think about measuring adequate levels of resources in retirement?*

It is the Profession's perception that private sector benefit design is governed largely by market forces in the context of overall remuneration: i.e. the objective of offering an adequate level of retirement income is not a key driver. Indeed we suggest that private sector employers take the view that the pension scheme is only one part of an employee's retirement planning and that without information about the other resources available to each individual, it is not possible to calculate a meaningful post retirement income for that individual.

On this question we defer to the Pensions Commission chaired by Lord Turner and the recent work of the Joseph Rowntree Foundation.

*Q11 What should be considered an adequate level of resources in retirement?*

Please see our response to Q10.

*Q12 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?*

Please see our response to Q10.

*Q13 How should this change where people work part careers in public service?*

Please see our response to Q10.

*Q14 How much do workers value and understand pensions? Is there any evidence this differs between groups (for example, by age, by income)?*

The recent industrial disputes arising from proposed changes demonstrate that workers do value pensions. However it is also the case that when members are given a Total Reward fund and a choice between paying defined contributions and buying defined benefits at the full economic cost, few choose the latter: i.e. there is evidence that the value that members place on defined benefit pensions is less than the economic cost to employers of providing such pensions. We would be happy to supply further information on this on request.

*Q17 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?*

Consistent with our responses to earlier questions, our private sector experience would tend to support a benefit design that allowed members an opportunity (limited on grounds of practicality) to tailor benefits to meet their own requirements.

*Q18 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?*

We will leave others to respond on the question of benefits. We will be responding on the substantial issue of discount rates as part of HM Treasury's consultation on the discount rate used to set unfunded public service.

We observe that some aspects of the 'uneven playing field', for example the very different regulatory regimes, are beyond the scope of the Commission's terms of reference.

*Q19 Which non-public service employees should be eligible for membership of public service schemes?*

Any move in this direction should be kept to a minimum to avoid creating a greater burden for future taxpayers.

*Q25 How have accrued rights been protected or transferred during changes in schemes in the private sector?*

The definition of the term 'accrued rights' can vary from scheme to scheme and from advisor to advisor.

In general, accrued rights have been preserved during changes to private sector schemes in the UK, which can be very complex as a result. There may not be the same degree of legal protection applying in the public sector (compare the RPI to CPI difficulties in the two sectors) but the general view of many people is that any pensions earned up to the date of a change should be protected in order to deliver confidence in the pensions promise.

We note that there has been a variety of practice in the private sector as to whether or not the linkage to final salary is included as part of the 'accrued benefits'. Our understanding is that this is typically based upon legal and Industrial Relations considerations.

I hope you find these comments helpful. We would be happy to provide any further assistance that the Commission might wish as you progress towards your final report.

Yours sincerely

Ronald Bowie
President
Institute and Faculty of Actuaries