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The Future of the Public Sector Pensions

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The Future of Public Sector Pensions

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- Where do we start from?
- What are the policy objectives?
- What are the possible reform options?
- What are the implications of the different reform options?

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Where do we start from?

The seven main schemes have almost 5 million members

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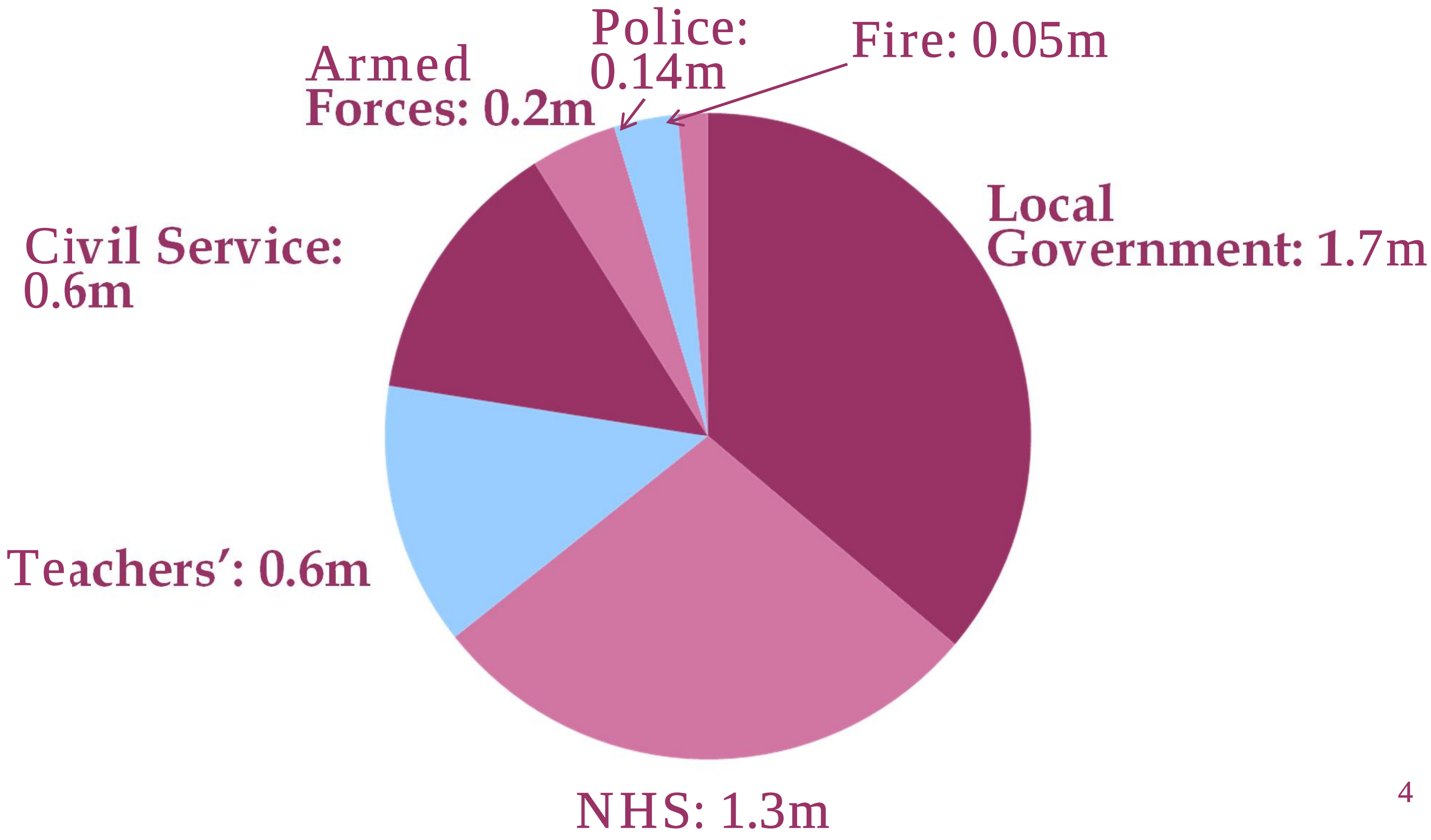
Number of active members at 31 March 2008



The main four public sector pension schemes

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	NHS and Teachers' (for new entrants)	Civil Service (for new entrants)	Local Government (for future service)
Normal pension age	60 to 65	60 to 65	Remains 65, Rule of 85 abolished
Basic design	Remains final salary	Final salary to career average	Remains final salary
Accrual rate	80ths to 60ths, separate lump sum abolished	60ths to 2.3%	80ths to 60ths, separate lump sum abolished
Member contributions (future service)	6% to: 5-8.5% (NHS) 6.4% (Teachers')	No change from 3.5%	6% to 5.5–7%
Cost sharing and cost capping	Certain unanticipated future increases in costs to be shared 50:50 members and employers, subject to employer cap		

Average benefit rates have fallen as a result of recent reforms and uprating changes

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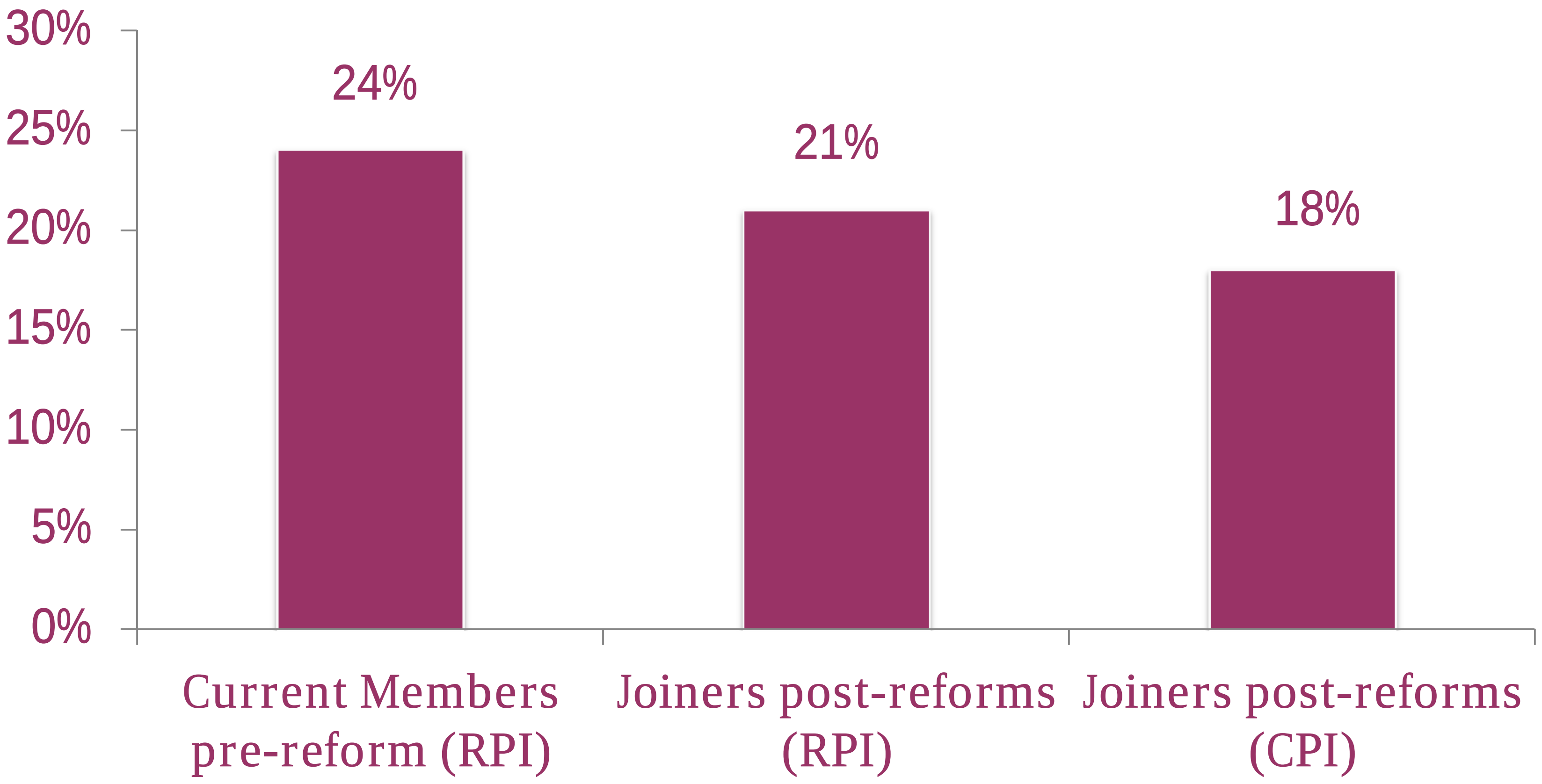
Evolution of the average effective employee benefit rates for the seven main public sector schemes



The public sector schemes are still more generous than the average DC scheme

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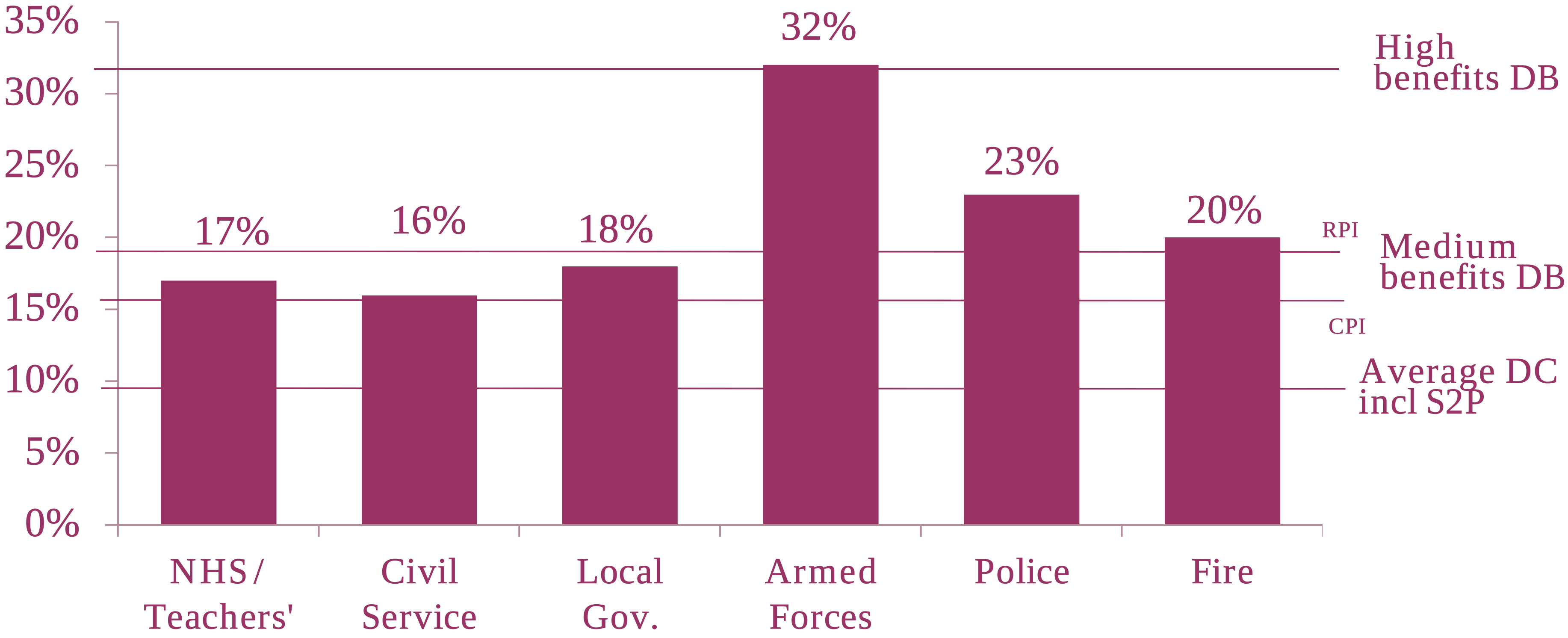
Average effective employee benefit rates for the reformed public sector schemes for new entrants and for the private sector DB and DC schemes (post CPI change)



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What are the policy objectives?

Any future reforms should be tied to specific objectives

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- Potential objectives for reform could be
  - To ensure adequacy of retirement provision for public sector employees
  - Improve affordability and sustainability
  - Increase fairness between public and private sector pensions
  - Address unfairness between members within the same public sector scheme
  - Enable the public sector to recruit and retain high quality staff

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What are the reform options?

Risks inherent in all pension schemes

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- Longevity
- Investment
- Interest rate
- Price inflation
- Salary inflation
- Workforce growth

Direction of further reform to public sector pensions

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- Continue Current Policy
- Changes to existing Final Salary schemes
- Structural Changes – Career Average or Hybrids
- Defined Contribution

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What are the implications of different reform options?

Continue Current Policy

Current final salary schemes may allow median earners to achieve their benchmark replacement rate

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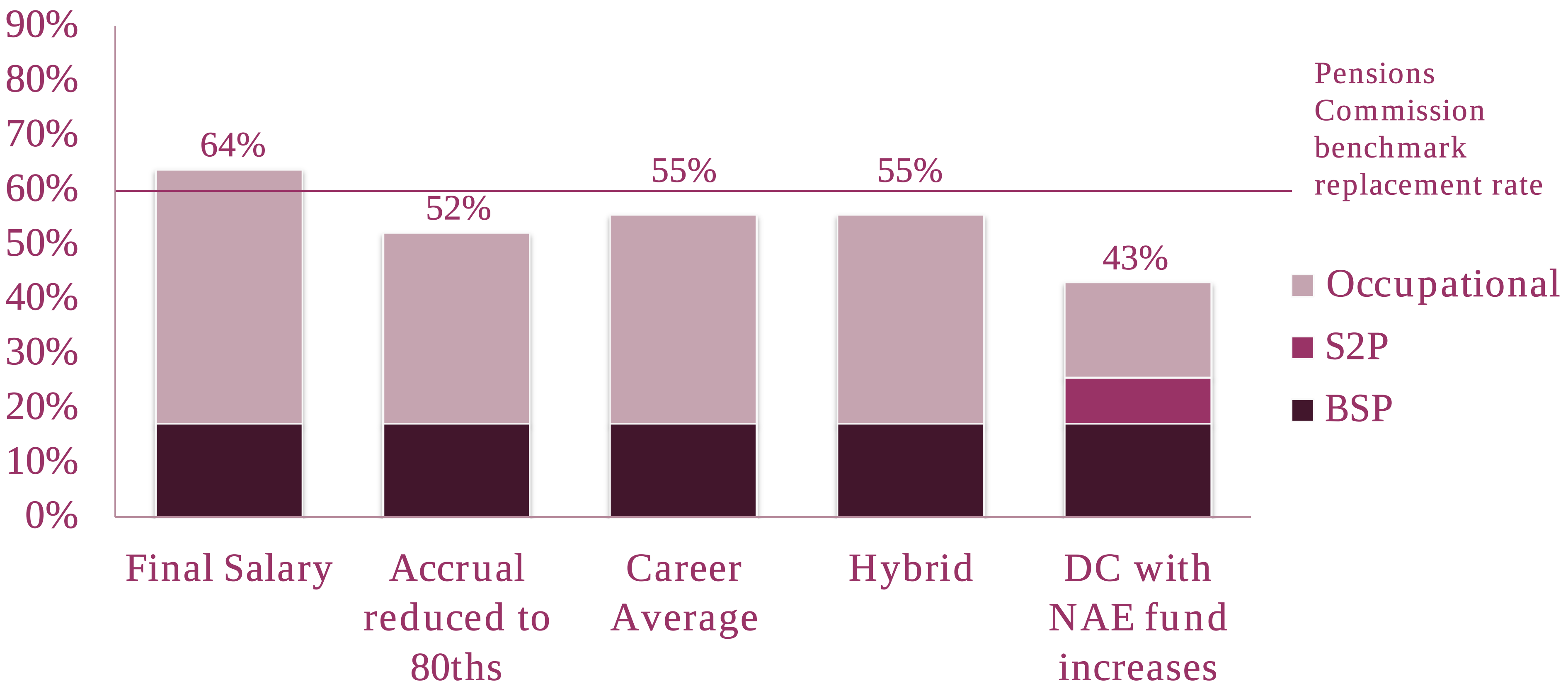
Gross replacement rate at 68 for a male employee aged 25 in 2010 who retires at age 65 on a median salary after 40 years service in the public sector



Leaving a final salary scheme early reduces the value of future pension benefits

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The weekly pension received at retirement in respect of the first twenty years of service in a final salary scheme for a median earning member who leaves early vs a member who remains until retirement

Tiered contributions do not fully offset the subsidy to high flyers

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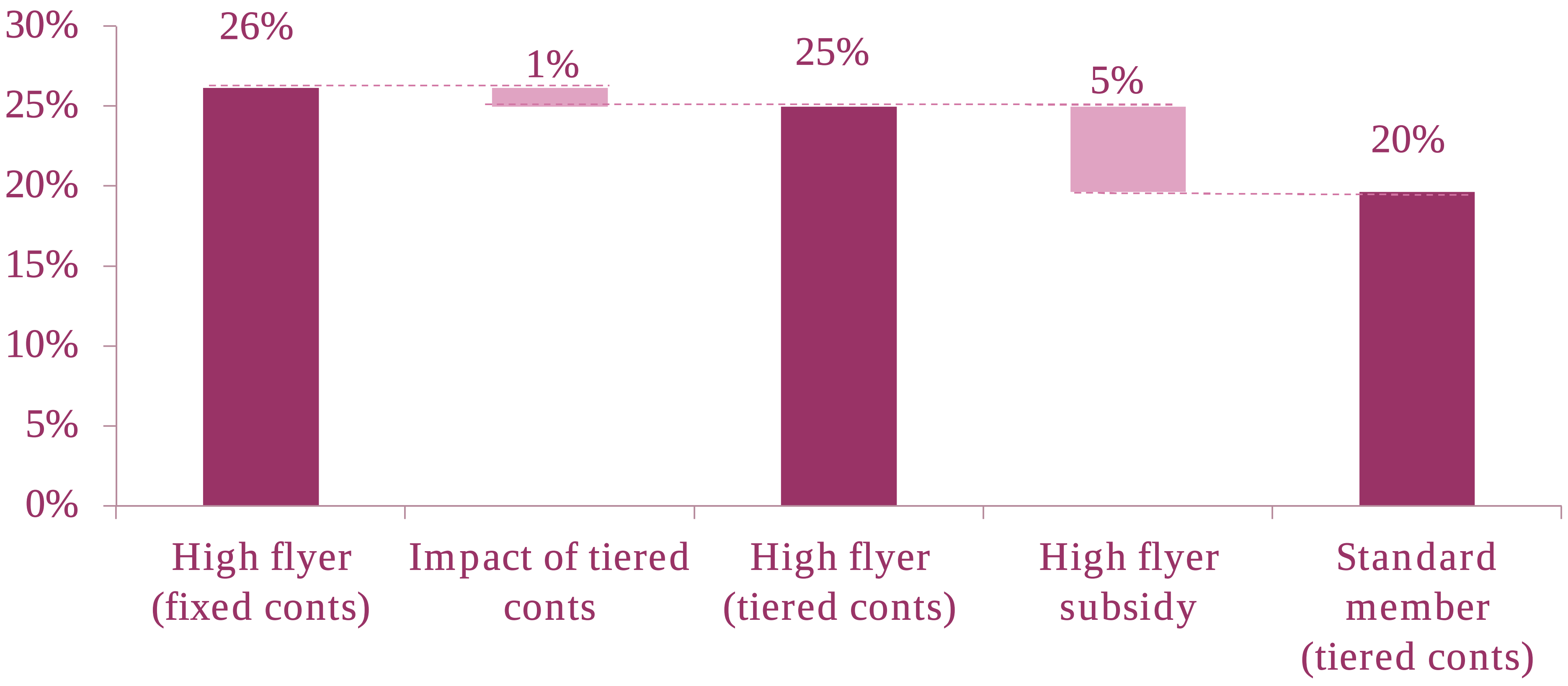
Effect of tiered contributions on the effective employee benefit rate to a high flying 20 year old throughout their employment compared with a employee with standard salary progression



Switching from RPI to CPI reduces the long-term cost of unfunded public sector pension schemes

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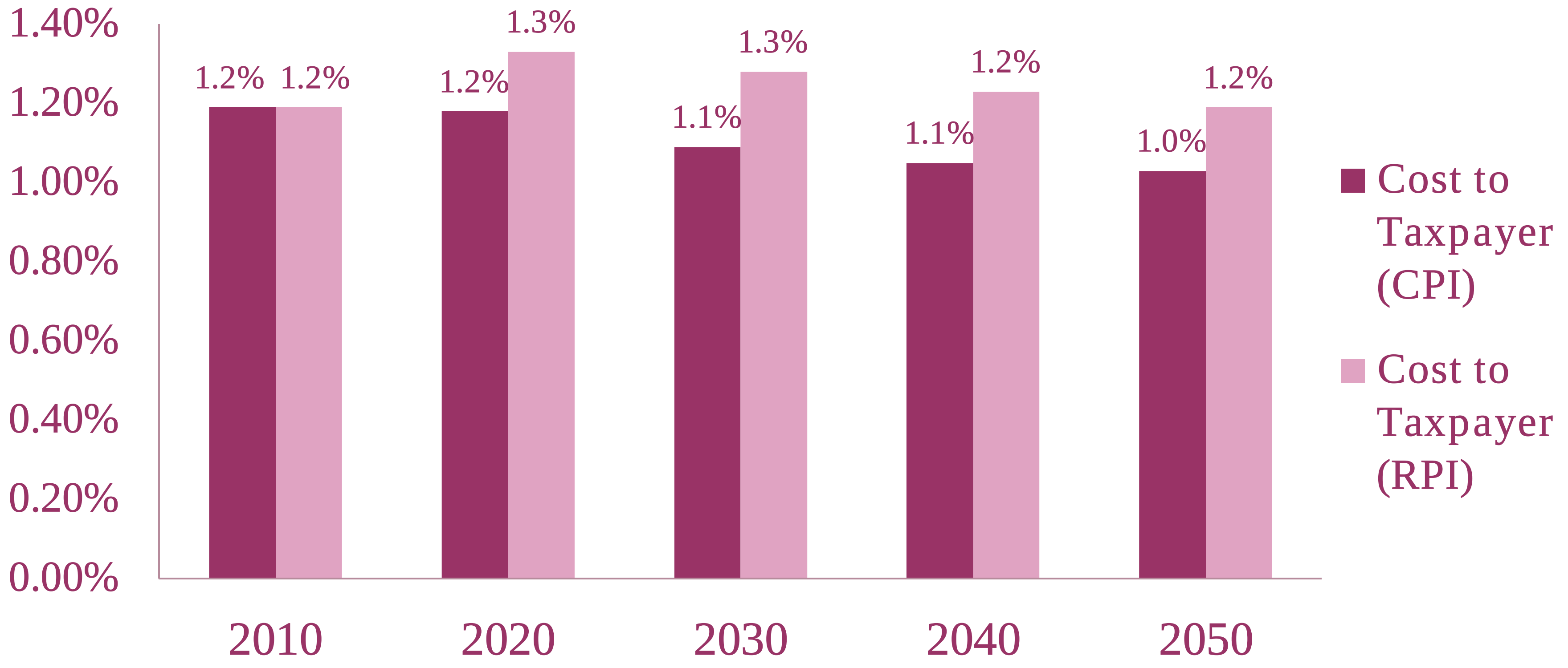
Projected future annual cost to the taxpayer of the unfunded public sector schemes, after deducting member contributions, as a % of GDP



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Reforms within Final Salary

Reforming final salary scheme: reducing accrual rate has the largest impact on employee benefit rate

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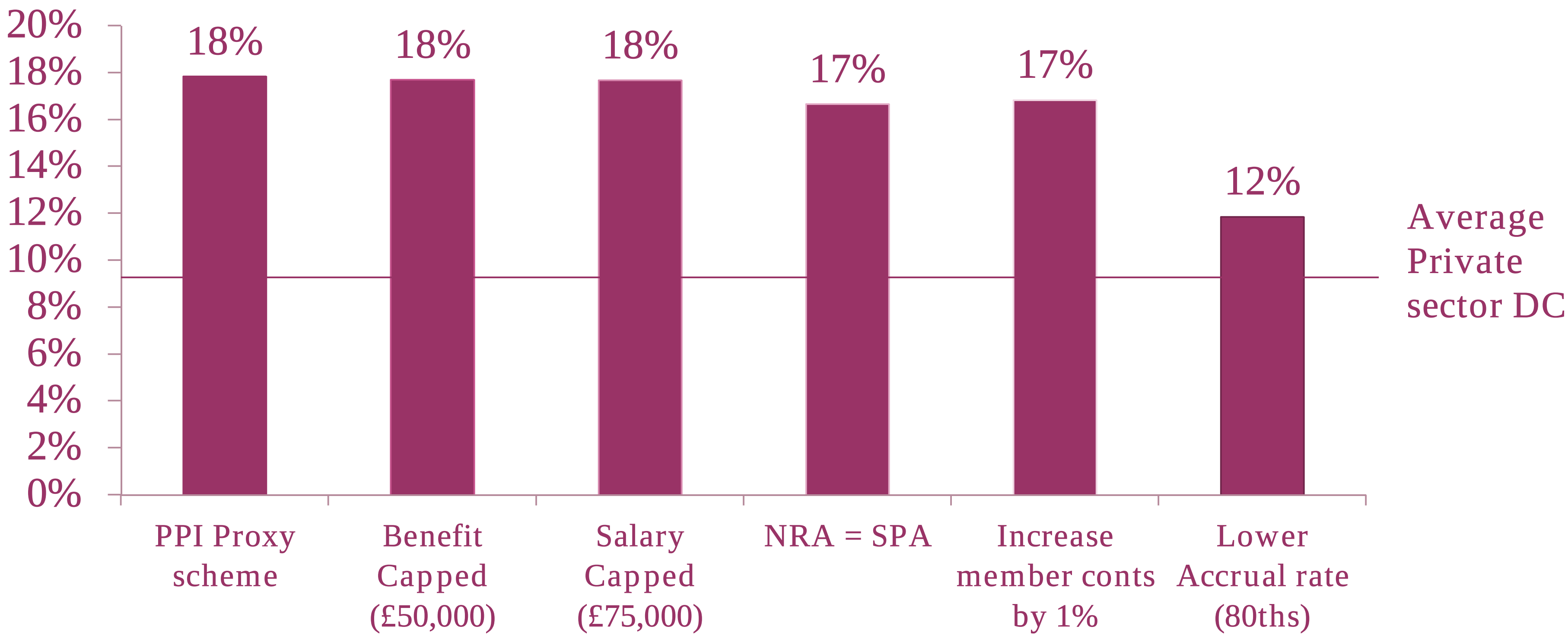
Average employee benefit rate for public sector pension schemes



Scope: NHSPS, TPS and LGPS members
Based on CPI indexation

Median earners are likely to meet their replacement rate under reforms to final salary schemes unless the accrual rate is reduced

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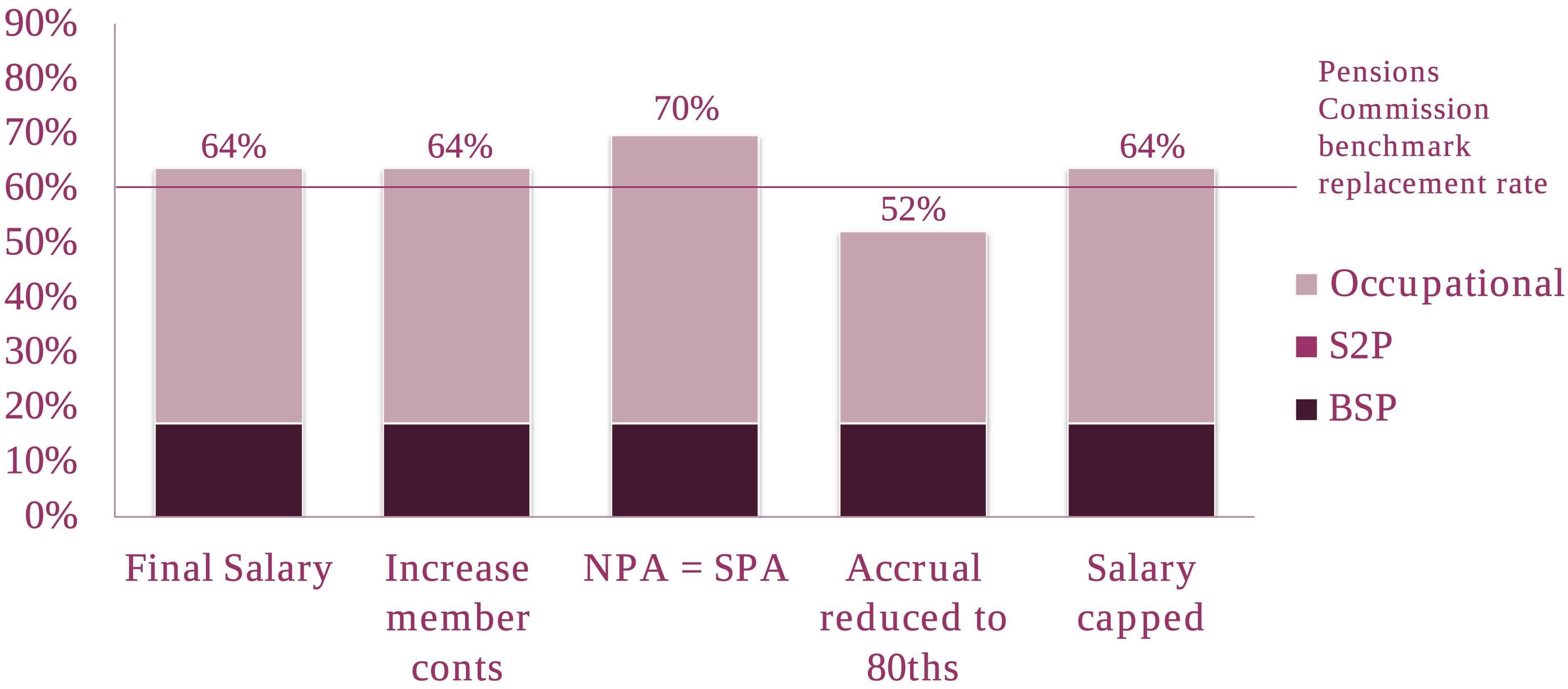
Gross replacement rate at 68 for a public sector male employee aged 25 in 2010 who retires on a median salary at their normal pension age



Amending final salary schemes for new entrants would have little impact on costs to the taxpayer

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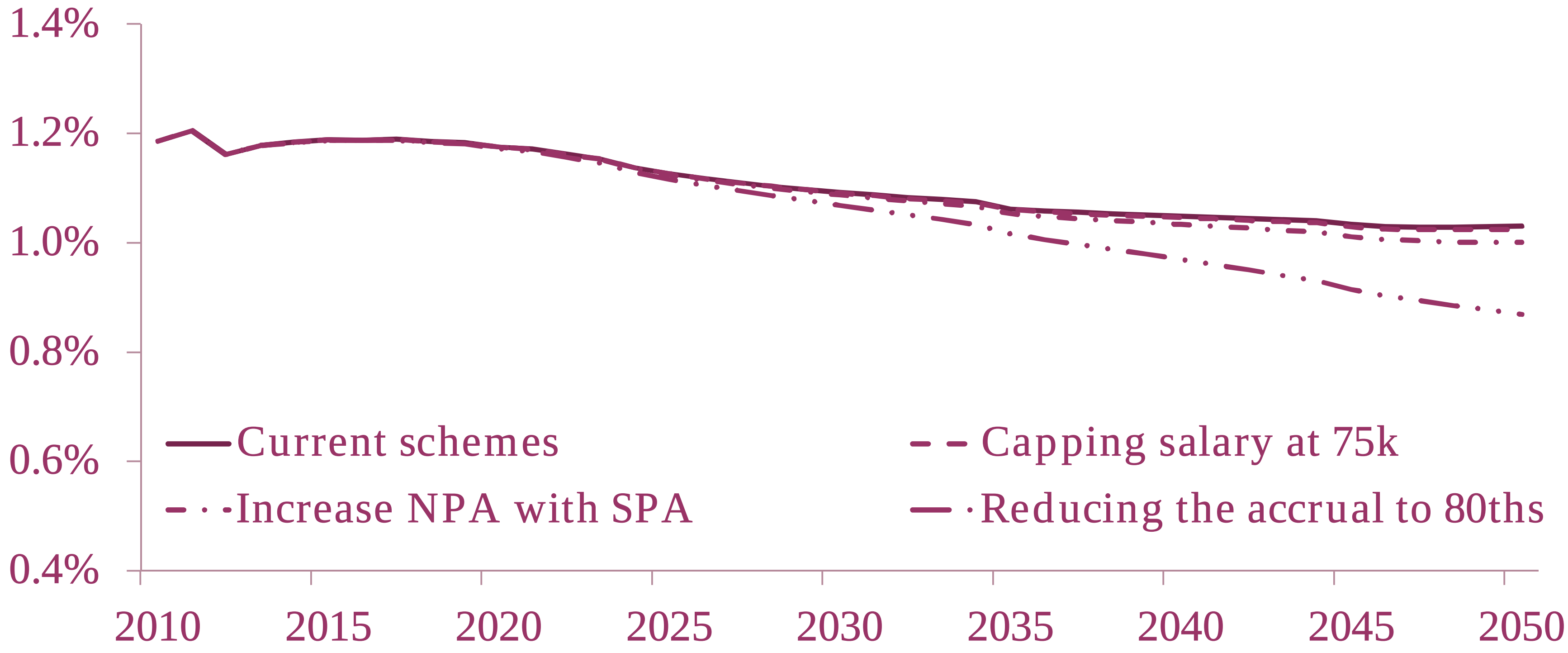
Projected payments to public sector pension provision as a % of GDP after reforming final salary schemes for new entrants



Scope: Unfunded public sector pension schemes

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Structural Change

- Career Average
- Hybrids

Career average or hybrid schemes may offer lower levels of adequacy for median earners than final salary

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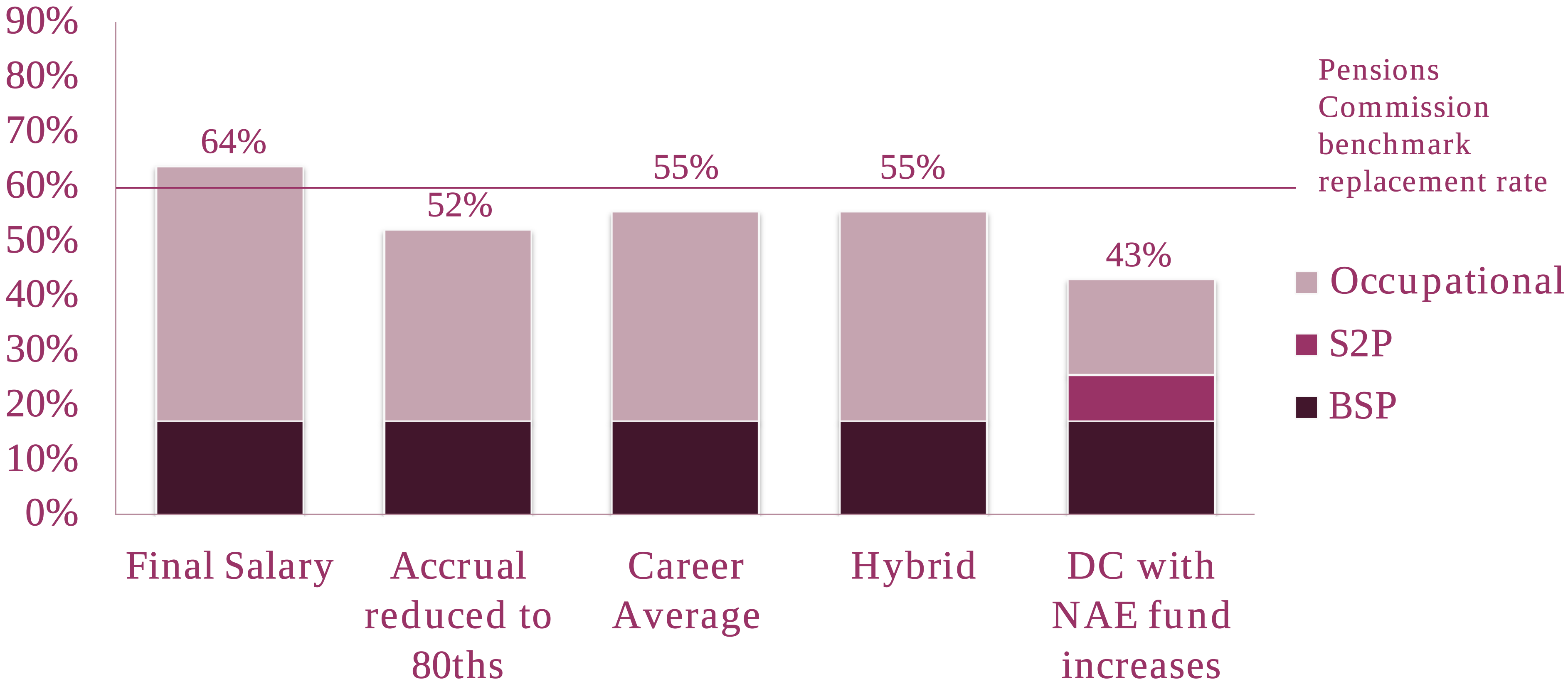
Gross replacement rate at 68 for a male employee aged 25 in 2010 who retires at age 65 on a median salary after 40 years service in the public sector



A Career Average pension scheme does not subsidise high flyers

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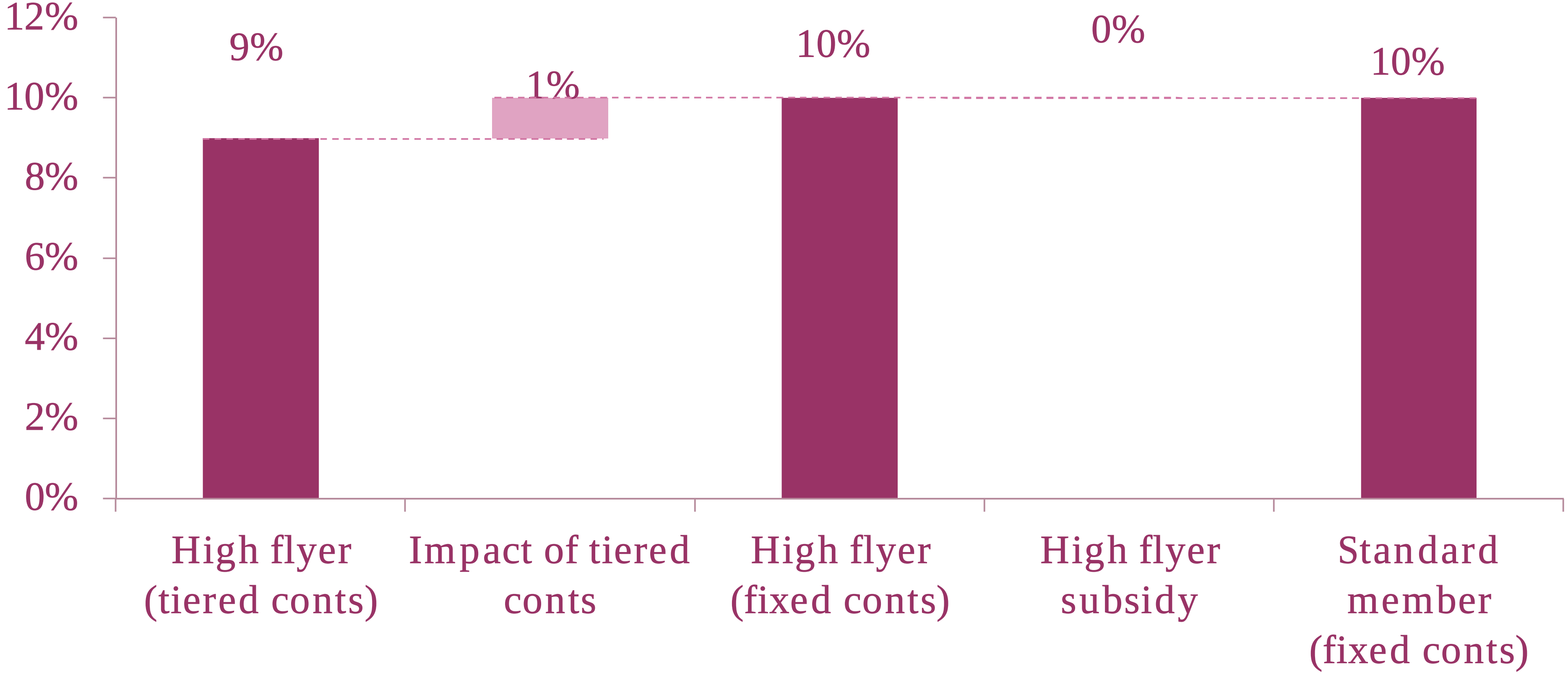
Effect of tiered contributions on the effective employee benefit rate to a high flying 20 year old throughout their employment compared with a employee with standard salary progression



Risk sharing schemes could reduce the cost to the taxpayer of public sector pension schemes

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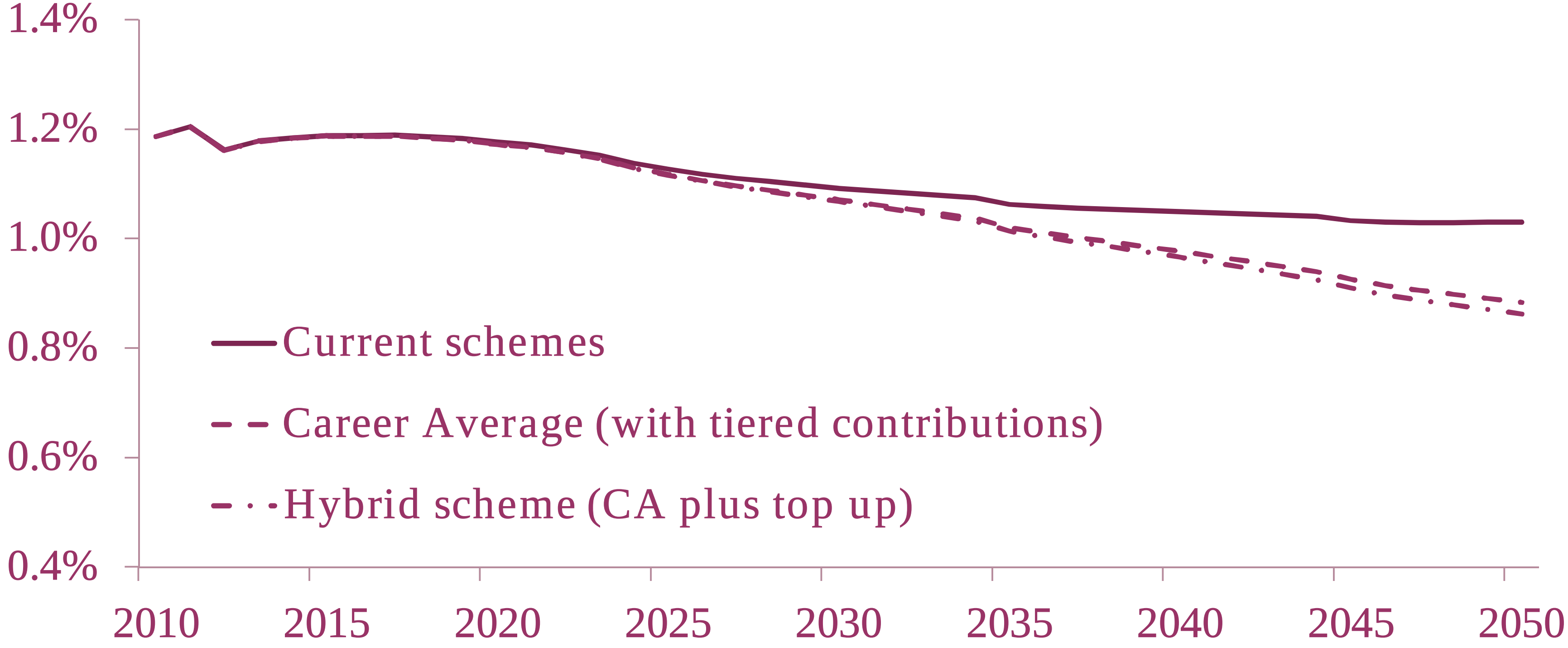
Projected payments to public sector pension provision as a % of GDP after adopting risk sharing schemes for new entrants



Scope: Unfunded public sector pension schemes

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Defined Contribution

- Funded
- Notional

Moving to a funded scheme would increase costs in the short to medium term

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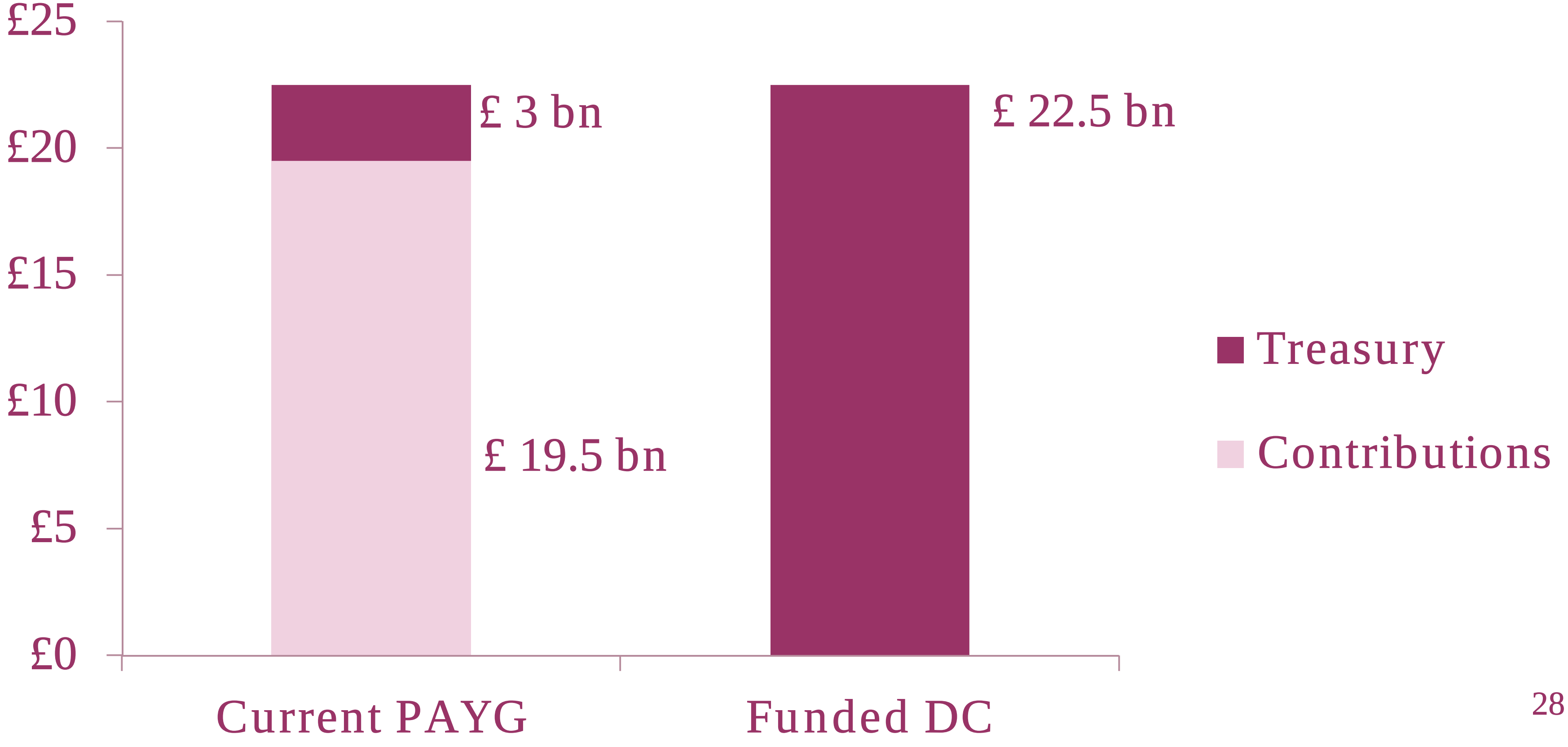
In 2008-09 £22.5 billion was paid out to public sector pensioners, of which £19.5 billion was financed from contributions and £3 billion was financed by the Treasury. In a hypothetical funded DC scheme contributions would have been invested, so the Treasury would have to finance the total of £22.5 billion



Notional DC with combined contributions of 15% gives lower adequacy for median earners

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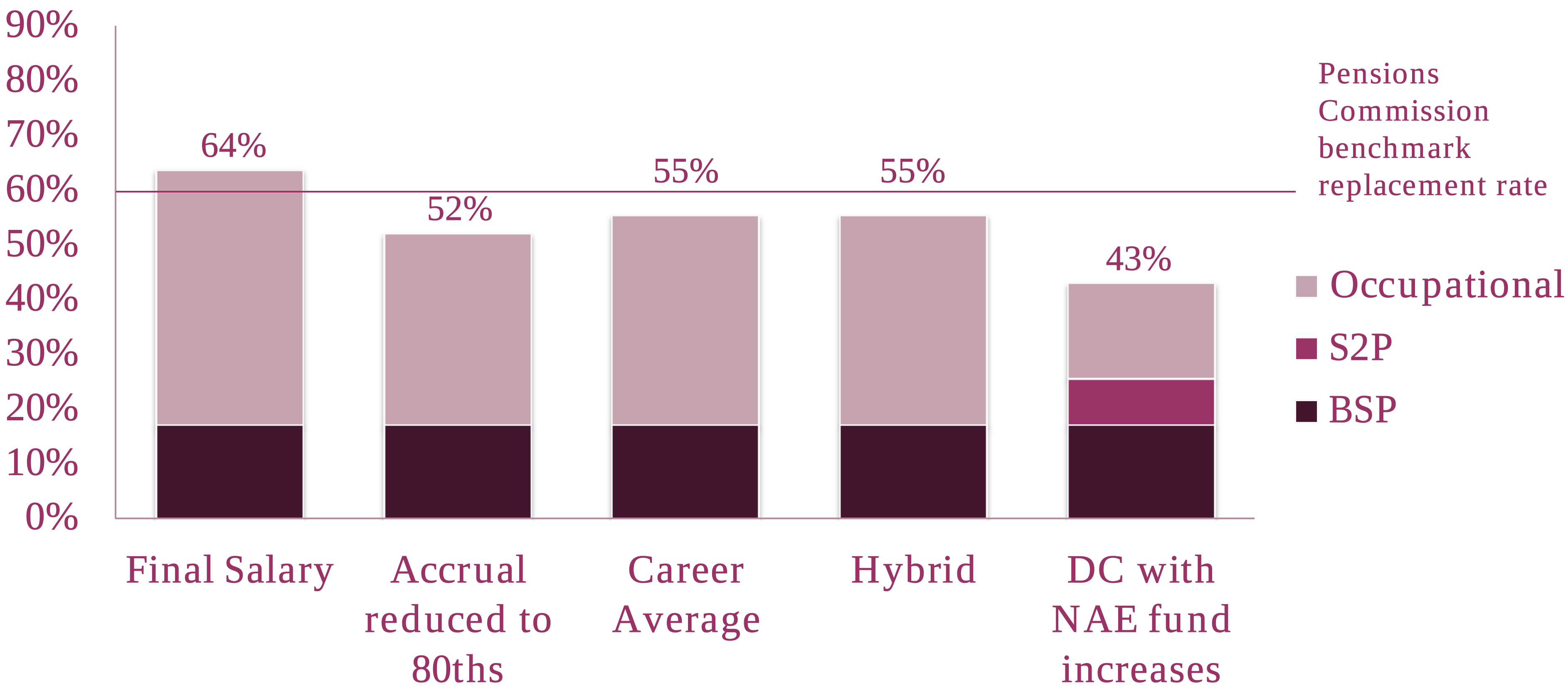
Gross replacement rate at 68 for a male employee aged 25 in 2010 who retires at age 65 on a median salary after 40 years service in the public sector



Moving to a notional DC scheme could significantly reduce the cost to the taxpayer of public sector pensions

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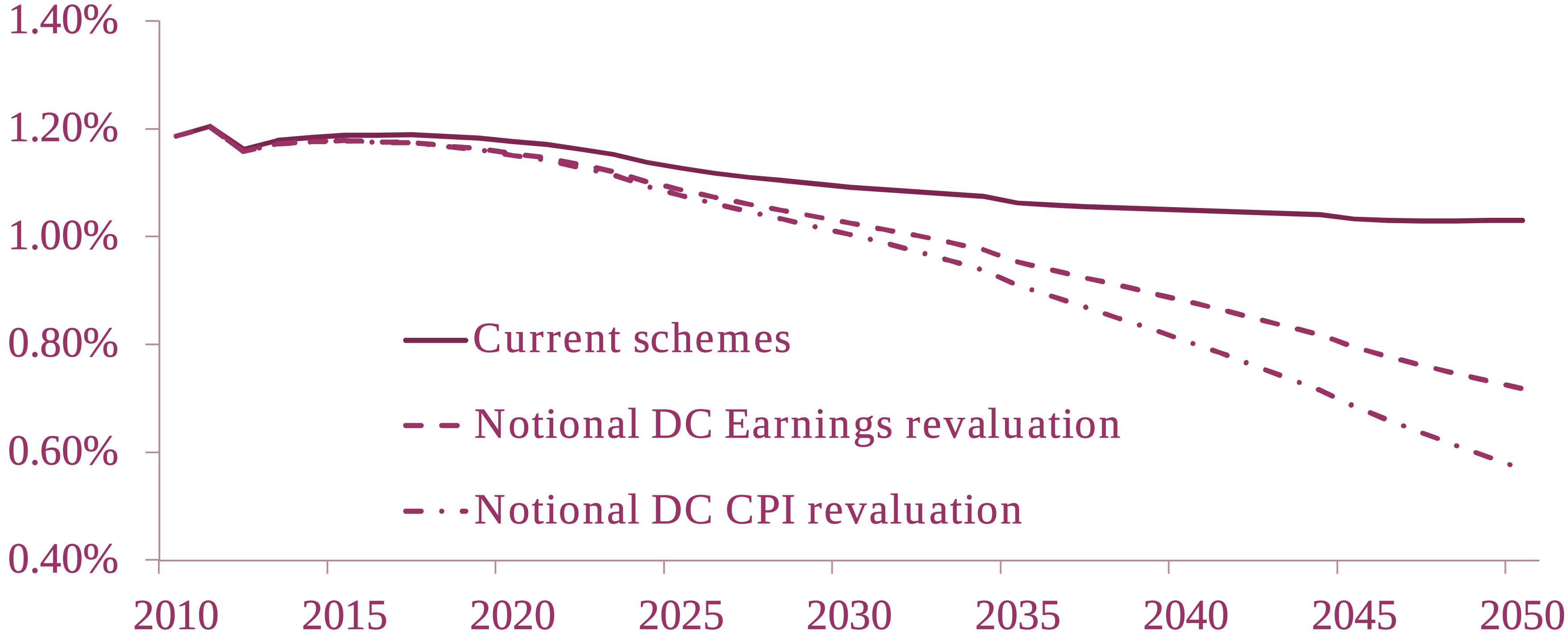
Projected payments to public sector pension provision as a % of GDP after reforming final salary schemes for new entrants (including allowance for net spending on S2P)



Scope: Unfunded public sector pension schemes

The impact of reforms on the cost to the taxpayer will depend on whether reforms are applied only to new entrants or to all members

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Projected annual expenditure on public sector pensions as a % of GDP

Year	2010	2050	
Members that reforms are applied to	Baseline	New Entrants	All Members
Current Policy	1.2%	1.0%	1.0%
Career Average	1.2%	0.9%	0.8%
Hybrid	1.2%	0.9%	0.8%
Notional DC (linked to earnings)	1.2%	0.7%	0.7%

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- Government may want to address adequacy, fairness, labour market mobility and affordability and sustainability in any reforms
- Reform options range from changes within existing schemes to more structural changes and a move to DC arrangements
- All the reforms could reduce the generosity of the current schemes
- Changes within the final salary schemes could have little impact on costs. Structural changes and a move to DC may decrease costs significantly, especially in the long term