



St Clement's House 27-28 Clement's Lane London EC4N 7AE
Tel: 020 3207 9380 Fax: 020 3207 9134 Email: acahelp@aca.org.uk Web: www.aca.org.uk

Review Body on Senior Salaries

REVIEW OF PARLIAMENTARY PENSIONS

**Submission by the
Association of Consulting Actuaries**

31 July 2009

Executive Summary

1. Members of the **Association of Consulting Actuaries (ACA)** provide advice to thousands of pension schemes, including most of the country's largest funded schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes. The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

The over-riding theme of the ACA's submission is that any significant revision of the Parliamentary Contributory Pension Fund (PCPF) should await a wider review of all public sector pension schemes that seems likely to take place following the General Election next year.

That wider review will need to go beyond the scope of earlier reviews of the PCPF and look across at the rapidly changing nature and level of pension provision in the private sector and, as a result, what the taxpayer should be expected to contribute going forwards to the pensions of public sector employees in both funded and unfunded arrangements. We note from Chapter 4 (4.8) of this consultation that such a wider review goes beyond the SSRB's current remit.

Following the oral evidence given by the ACA on 28 July 2009, we recommend below a number of changes that would help cap and reduce the annual costs to the taxpayer of the PCPF in the period running up to the wider major review of public sector pensions referred to above. As the wider review might take some time to report and for any changes to be implemented, the interim reforms proposed by the ACA should ensure that the cost of the PCPF is kept within the cost constraints currently placed on the scheme by the Exchequer.

Longer-term issues: should await major review

2. Both main Opposition political parties have indicated that given the rapid changes taking place in private sector pensions, where matters have moved on from the overview at Annex G of the consultation, there should be a review of public sector pensions, where changes have been less dramatic over recent years. We believe that in the current political climate the present Government party, whether they are re-elected or not, will find it difficult to justify not undertaking such a review. Indeed, this present SSRB review, whilst having a narrower remit, is reflective of an awareness by Government that extra costs for the PCPF cannot simply be passed onto the taxpayer at present as in the past – a view echoed by the recent vote in the House (25 June 2009) calling on the Exchequer funding of the scheme to be capped at 2008-09 levels.
3. As we have stated above, such a wider review looking across at pensions in the private sector, and assessing how the PCPF and other public sector schemes might need to be reformed to bring greater perceived equity between private and public, goes beyond the current remit of the SSRB and this consultation. We believe that a number of the issues raised in Chapter 5 ought properly to be addressed by that wider review, such as the ‘special circumstances of parliamentary life’ (which are probably over-stated), the ‘interaction with remuneration and total reward’ and ‘international comparisons’. These issues are clouded by the huge changes that have taken place in the private sector and a longer-term approach to PCPF needs to take proper account of these changes.
4. Necessarily, therefore, the ACA evidence and submission looks to address the particular concerns of the Exchequer, Parliamentarians and the public about the cost (and the potential for rising costs) of the PCPF and what measures could usefully be applied in the near-term to hold down those costs and, over time, to reduce the presently rising funding deficit. In making these recommendations, it is accepted that some may also help shape the longer-term reforms to apply to public sector schemes into the future.

ACA recommendations

5. **The ACA supports the continuation of a defined benefit style structure to the PCPF, but with additional mechanisms to control costs.** We detail below a few of the reasons why this is our recommendation, certainly in the near-term:
- The flight to DC in the private sector is as much about cost reduction as cost control in a difficult economic environment. The typical DB employer rate of contribution is now at least *three times* the DC rate (source: *ACA 2008 Smaller firms pension survey* and, shortly to be published, the *ACA 2009 Pension trends survey*).
 - As we understand it, the focus of the current PCPF review is about containment of Exchequer costs to 20% of payroll costs, rather than a reduction in this level – the wider review of public sector pensions to be undertaken at another time would need to address whether this is an appropriate longer-term cost.
 - There remain considerable economies of scale that are offered by larger collective DB arrangements in terms of both administration and investment. As a result, DC arrangements can be around 40% more inefficient in terms of proceeds delivered by equivalent contributions. A DB scheme for a number of reasons, including the pooling of assets rather than requiring individual investment accounts to be maintained for each member as under a DC scheme, has inherently greater operating efficiency (source: 2008 National Institute on Retirement Security report, *A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans*, August 2008).
 - As we have indicated earlier, there needs to be a much wider debate about public sector pension policy, including the PCPF, which is unlikely to occur until after a General Election. This should include a full debate on risk sharing arrangements as these might apply in the public and private sectors, rather than a simple DB/DC debate. Until then, we recommend that the SSRB looks at changes within the current PCPF structure, rather than it pre-empt the outcome of such a wider debate.
 - Again, given this need for a wider review of public sector pensions, we do not think the time is opportune for the PCPF to be integrated into another funded scheme or that the scheme be transformed into an unfunded arrangement (such as the civil service scheme).

We feel that each of these options is too significant a change to be considered outside of a wider review of public sector pensions, taking account of the look-across to private sector pensions.

In particular, we feel there would be considerable public and private sector disquiet to a reform that would weaken the funding basis of the scheme (why should the PCPF scheme benefit from a generous taxpayer-backed covenant, not available to private sector funded schemes?). This would look like preferential treatment for MPs at a time when the public already has very serious concerns about the 'privileges' of MPs.

A move to an unfunded arrangement would raise similar concerns given the current UK Government practice of arguably understating the cost of public sector pensions, thereby distorting reporting between unfunded and funded pension schemes. At present, the use of a long term discount rate rather than market-based interest rates arguably distorts the timing of meeting the cost of the liabilities falling on present and future taxpayers compared to funding requirements in the private sector.

6. Our specific proposals for the SSRB to consider in framing its recommendations by the end of 2009 are as follows:

- **The scheme should move to a career average structure:** whilst this is unlikely to have a significant impact in the short-term, given the recent trend of increases in MPs pay, it does provide protection if at some future stage the pay levels of MPs are re-aligned. This is needed in the event that there is no wider review of parliamentary or other public sector pensions ahead of such a pay re-alignment.

Such a structure could also integrate the current arrangements for Office Holders.

Revaluation to reflect inflation should be capped as in the private sector to up to 2.5%.

- **Adjustments in the 'normal retirement age' should be used as the primary cost containment measure:** after each triennial valuation, the benefits to be accrued for the following 3-years should be referenced to a normal retirement age, which enables the Exchequer contribution to be capped at 20% of payroll.

Over time, this would result in multiple tranches of benefits payable from different retirement ages.

On actual retirement, early (or late) retirement adjustments would apply to the individual tranches to provide an equivalent pension at the actual date of retirement.

An alternative approach would be to set the accrual rate for the 3-year period to meet the cost requirements.

We suggest a cautious approach to calculations be taken to reduce the risk of further deficits arising. If this results in future surplus, additional revaluation or pension increases could be granted.

- **The ‘rule of 80’ early retirement provisions should be abandoned as out-dated.**
- The 2009 pension tax changes for those on higher incomes will inevitably impact on a considerable number of MPs with income over and above their Parliamentary salaries, rendering contributions into the PCPF scheme tax inefficient. **The opportunity could be taken in this review to offer MPs the option of a cash alternative equivalent to the value of the Exchequer contribution.**
- **The proposed changes should apply to the future service of all MPs as well as new entrants from the next General Election:** we believe that it would be divisive and invidious to have different pension arrangements for MPs future service. This would also add complexity to the pension arrangement, when simplification needs to be the order of the day across all types of pension arrangements.

These proposals represent about the limit of genuine risk sharing currently available, whilst retaining a DB approach. We detail below a summary of the ACA’s recommendations on how wider risk sharing, requiring changes in current legislation (which presently restricts its application), could be implemented. These reforms could provide additional flexibility in the running of both private and public sector funded schemes, like the PCPF.

Risk sharing

7. Over the last 5-years the ACA sought actively to promote legal reforms to allow for greater design freedom to be enacted so that we move away from a situation where employers largely meet 100% of pension risks (as with defined benefit/usually final salary schemes) or members largely meet 100% of those risks (as with defined contribution/money purchase schemes). In the event that the SSRB is tempted by the argument to move quickly towards a defined contribution 'solution', we attach an appendix that illustrates the volatility associated with this type of arrangement over the last decade or so.
8. The ACA is continuing to advocate changes in legislation that would permit wider risk sharing, in particular:
 - **The ability to adjust revaluation/pension increases to reflect funding levels (both for future benefit accruals and for past benefits accrued in the new arrangements).**
 - **The ability to adjust normal retirement age retrospectively for service in the new arrangements, if required, to restore funding levels.**

There would be safeguards for members including no retrospective change to retirement age for individuals within, say, 10-years of current retirement age. There would also be re-instatement of 'lost' revaluation/pension increases if funding levels return to surplus.

These reforms could be applied equally to funded public and private sector schemes but, because of the legislative changes needed, these must be seen as part of a longer-term review.

Conclusion

9. The ACA believes that the proposals detailed above provide a realistic way of capping the costs of the PCPF scheme so it can meet the constraints placed on the scheme by the Exchequer in the shorter-term.
10. We believe longer-term changes may be appropriate to the PCPF and other public sector schemes, but that these require a wider review of public sector pensions as a whole, that goes beyond the remit of the SSRB, taking into account the trends in private sector pensions, and the equity of public sector arrangements in respect of the cost falling on present and future taxpayers.

Appendix: the volatility of defined contribution pensions

Of key importance is the volatility and unpredictability in pension outcomes that is associated with defined contribution, which to a large degree is absent from defined benefit schemes. The following table graphically shows the degree of volatility in pension outcomes (a 70% reduction in the pension outcome over a ten year period for the same per pound savings) arising from defined contribution:

Based on a man contributing £200 per month for 20 years in an average with profits policy (the picture remains much the same if mixed (managed) funds are used instead of with-profits). Single life annuity at age 65, escalating by 3% per annum.

Maturity Date	Fund value at retirement	Annuity rate per £1,000	Pension annuity amount (pa)
January 1996	£287,413	£79.14	£22,706
January 1998	£263,716	£66.16	£17,407
January 2000	£242,842	£59.47	£14,402
January 2002	£206,501	£56.70	£11,669
January 2004	£148,725	£44.60	£6,593
January 2006	£121,452	£41.20	£4,964
January 2008	£112,942	£44.90	£5,073
July 2008	£107,984	£47.20	£5,097

Source: Watson Wyatt Worldwide and the annual survey of with-profit pensions published by *Money Management* magazine.

Produced by:

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