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CIPFA Scottish Workshop

Public sector pensions: a deal made to last for 25 years?

John Wright

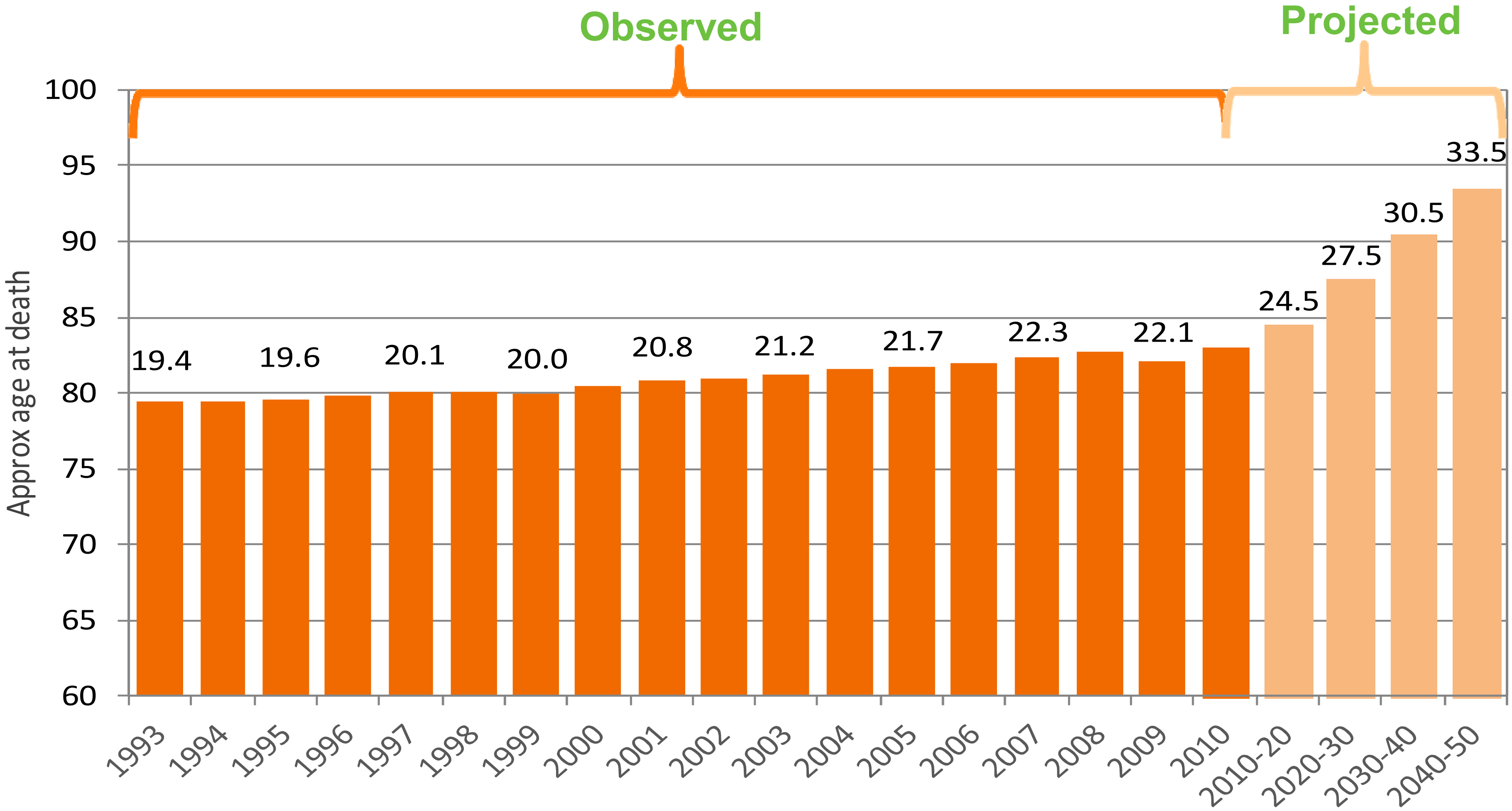
19 September 2012

Public sector pensions reform update

- Recap:
  - Why reform?
  - The story so far
- A good deal for members?
- A good deal for taxpayers?
- Will these reforms last 25 years?
- Public Service Pension Bill
- What will happen in Scotland?

The case for reform

Life expectancy increasing



Current schemes not designed to pay this long

Based on observed longevity from 1993 to 2009 for men sourced from Club VITA, and assuming 3 years per decade improvements from 2010. Figures shown are life expectancy from age 60.

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The reform story so far...

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The story so far...

June 2010 CPI + Oct 2010 Contribution Increases

March 2011: Hutton, endorsed at Budget

Early Nov 2011: govt “improved offer”, cost ceiling

End Nov 2011: union day of action

March 2012: “negotiations concluded”, Budget

April 2012: CPI, contribution increases start

Sept 2012: Public Service Pensions Bill

Scheme design process (E&W)

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Reference Scheme
CARE, 1/60th, NAE, 3.2% on eee conts

Cost ceiling
20.4% with 3.2% increase in eee conts

Scheme design

Final agreement
CARE, 1/49th, CPI
(cost ceiling 19.5%, no contribution increase)

Similar process in Scotland?

New scheme designs

Reference Scheme
CARE
SPA
1/60 + ave earnings
3.2% on contributions

Civil Service	NHS	Teachers	LGPS
1/43	1/54	1/57	1/49
CPI	CPI + 1.5% pa	CPI + 1.6% pa	CPI
Option to pay extra to retire 3 years before SPA	Same plus one-off "choice" for protected members	Same plus higher conts for higher accrual	No rise in average conts, new "50/50" option

Uniformity sacrificed?

A good deal for members?

Union reaction to reforms

True or false?

Pay more, work longer, get less?

Pay more	• Protection for low paid: £15k pa or less – no change • Overall contribution income remains unchanged in LGPS • Better paid pay more (& live longer)
Work longer	• Within 10 years of retirement, no change • More than 10 years from retirement: - Accrued rights protected (take pension at original NRA) - Not forced to retire later – choose when to retire
Get less	• Within 10 years of retirement, no change • More than 10 years from retirement: - Accrued rights protected (final salary link) - CARE, better accrual rate, revaluation = winners & losers • Could get less if take post 2015 benefits early • Could get more pension if work to SPA

It depends!

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How much pension is enough?

Good design?

Chart based on CARE scheme with 1/60th accrual and allows for Basic State Pension of £140 per week. Assumes the member has a full public service career (45 years in this example) and remains in the scheme throughout. Sources: Hymans Robertson (2011) and Turner (2004)

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A good deal for taxpayers?

Points of view

- *"This is a fair deal for public service workers, an affordable deal for the taxpayer and a good deal for the country."* – *Rt Hon Danny Alexander MP*

- *"The uncontested analysis shows public sector pensions are affordable now and in the future."* – Mark Serwotka, PCS union

- *"If the objective is to save money, then this latest set of reforms do not meet that objective."* – Carl Emerson, Institute for Fiscal Studies

Financial effect - unfunded schemes (% of GDP)

When?	Net cashflow (benefits less member conts) (% of GDP)	Explanation
Current	c2.0%	Current schemes
2061-62	c1.5%	No CPI, no Hutton, no contribution increase Effect of GDP growth, 2005-08 schemes (retire at 65) and cap and share
2061-62	c1.1%	As above except introduce CPI link
2061-62	c1.0%	As above except + increase in employee contributions
20612-62	c0.9%	As above except + Hutton from 2015 (CARE, SPA, etc)

Pay as you go schemes only. Figures represent pension benefits net of employee contributions as % GDP

Source: OBR, Fiscal sustainability report (July 2012)

Financial impact in the LGPS

Taken in isolation and ignoring changes in market conditions and payroll etc..

- No impact on existing deficits (past service)
  - Accrued rights to 2014 are protected
- Modest savings on new benefits (future service)
  - c1.5%-2% of pay across whole fund
- Savings will vary by employer:
  - Depends on member profile, member conts, 50/50 option
- Measures to containing future cost increases
  - SPA link and “cost management” (cap and collar)

Unlikely to see employer contributions reduce

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What happens next?

Assessment of E&W reforms

Positives	Negatives
Retaining defined benefits	50% increase in member contributions
No levelling down	Benefits don't need at a price members cannot afford?
Retirement age change to control costs	Member dissatisfaction, despite very good benefits
Career average scheme fairer especially low paid/women	Risk of opt outs
Protection of accrued rights	Lack of uniformity, complexity
10 year protection	Lack of portability
	Lack of choice
	Consultation process
	Design: high accrual rate

What might you do differently?

Public Sector Pensions Bill

- Covers LGPS & unfunded (all parts of the UK)
- Design changes common to all schemes
  - CARE (no future Final Salary DB), SPA link
- Enables “Cost control”
  - Cap and collar on employer contributions
- Stronger governance and arms’ length oversight:
  - “Pension Board” (Pension Committee for LGPS)
  - Pension Regulator (oversight, codes of practice, powers to intervene)
  - For LGPS (E&W), DCLG oversight of funding plans - independent review of scheme valuations to be published including remedial action taken
- High regulatory hurdle to prevent further reform within 25 yrs
- Implement by 2015 (2014 for LGPS in E&W)

Scheme specific details in secondary legislation

What about Scotland...

- Requirements of Bill also cover Scotland
- Still to go through a consultation exercise
- Approval of Scottish Parliament needed
- Opportunity for Scotland-specific LGPS scheme
  - Separate design, contributions, cost ceiling
  - Cost management
  - Governance arrangements
- Subject to overall April 2015 deadline
- Process for implementing new scheme

.....still a very challenging timescale!

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Thank you

Any questions?

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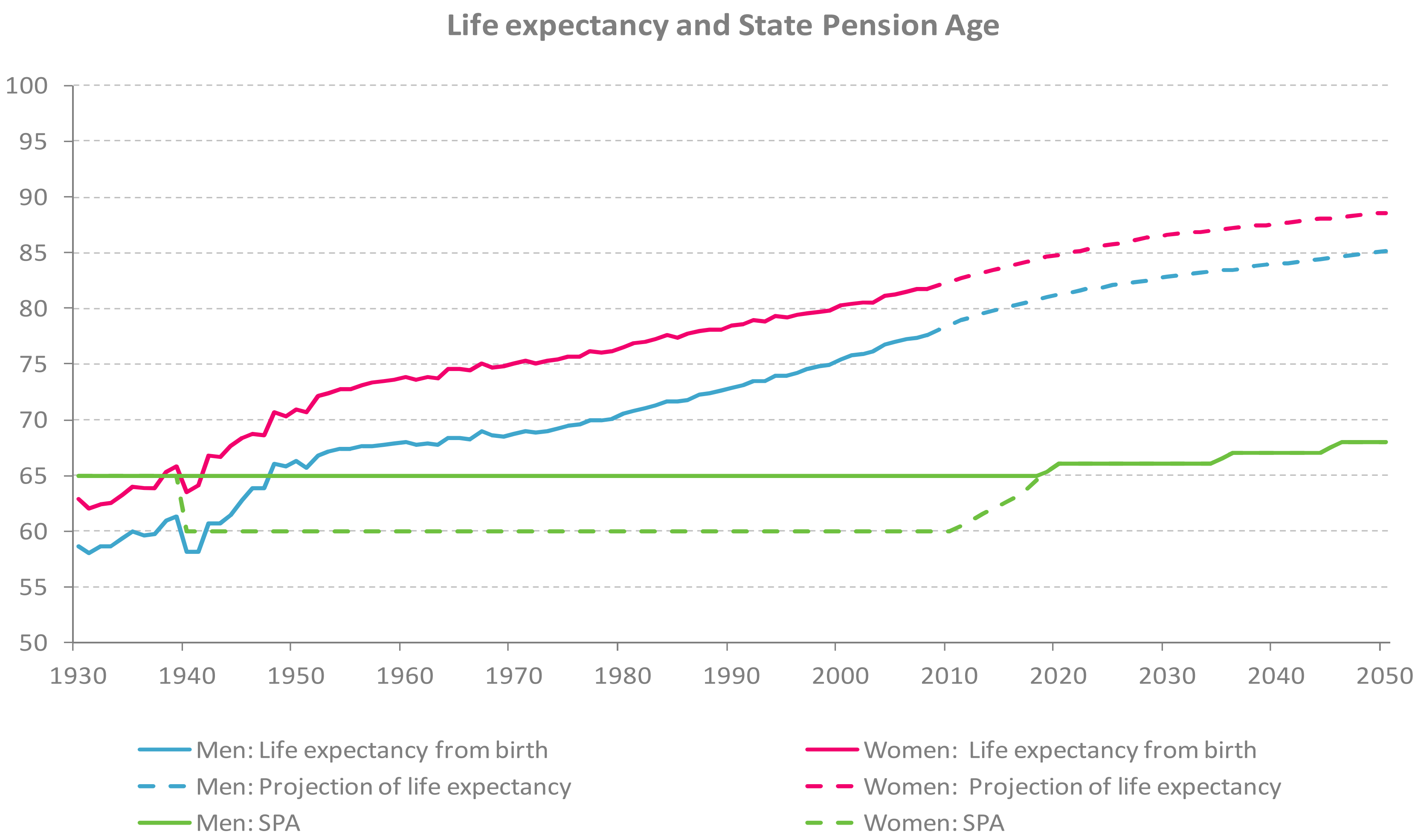
Working longer



Life expectancies are based upon historic data from the Office for National Statistics and the Human Mortality Database (www.mortality.org). Projected life expectancies use the 2008-based ONS principal projections. All life expectancies are period life expectancies (are based on longevity at the date of retirement and do not capture changes in longevity that will occur in subsequent years). State Pension Ages shown are based upon our understanding of the State Pension Age changes proposed in 2010 Spending review.

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Linking SPA to longevity automatically*

Age today	Current plan for SPA	Future SPA with auto link**?
56	66 (2022)	66y 7m (2022)
50	67 (2029)	67y 10m (2030)
30	68 (2050)	70y 7m (2053)
0	68 (2080)	74y (2086)

State Pension at 68 if age 50 or under?

*Announced at March 2012 Budget. **Club Vita analysis based on government projections of life expectancy (ONS)

Efficiency and governance in the LGPS: Fund merger and alternative approaches

Linda Selman,

September 2012

LGPS governance and efficiency – Fund mergers and alternatives?

- What are you trying to achieve?
- Investments
- Administration
- Governance arrangements
- Alternative ways of achieving same objectives?

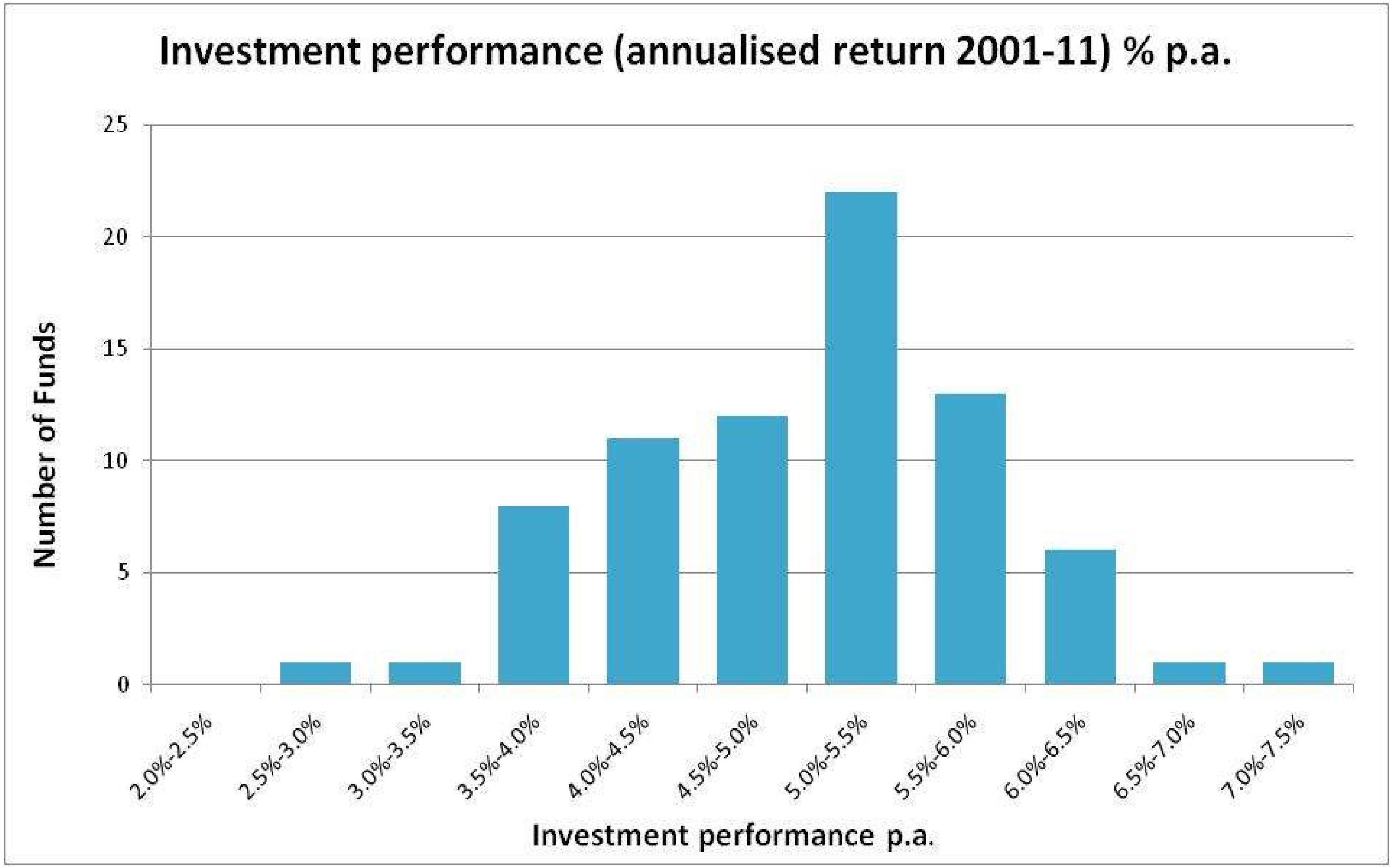
What are you trying to achieve?

- Save money?
- Improve performance?
- Reduce risk?
- Pool resources?
- Retain local decision making?
- Invest in broader asset classes
- Reduce deficits?

Worthwhile goals - can all of this be achieved?

Investments

Investment returns across LGPS Funds



Active management one reason for range

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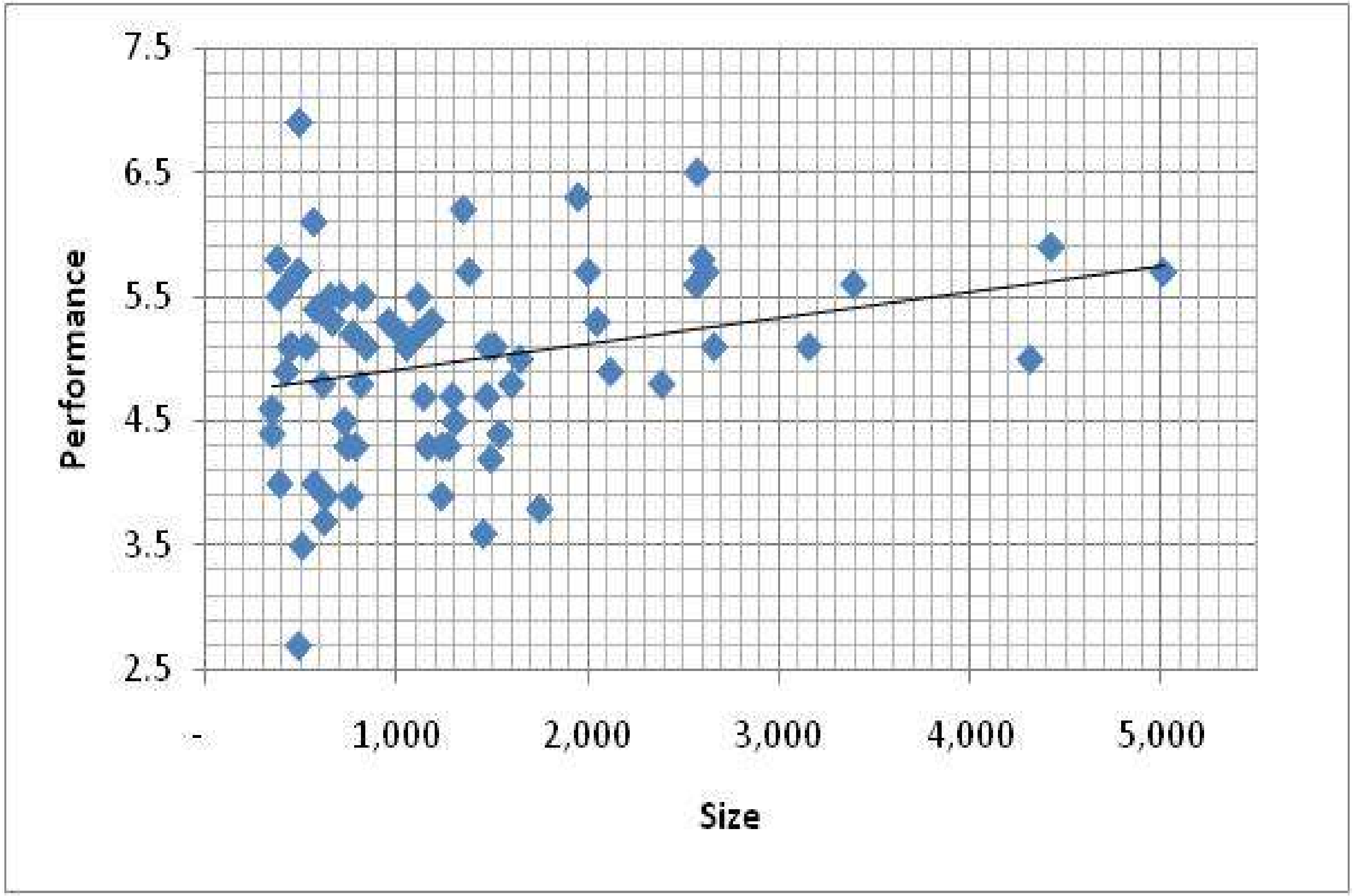
Do larger LGPS Funds do better?



Size doesn't guarantee success but helps?

Larger investment Funds – what's the benefit?

Advantages include

- More internal / professional resource?
- More internal / hands on management?
- Better diversification – asset classes, managers
- More bargaining power on fees?

Diversification and fee advantage?

	Small	Medium	Large Fund
Size	500m	2bn	10-20bn
Number of managers	2 – 8?	10?	10-20 + some internal
Fees e.g. active global equity	60bps	45bps	35bps?

What price for asset management?

Asset class	Annual fees
Alternatives	300-400bps?
Property	90bps
Bonds and cash	22bps
Active equity (International)	35bps
Active equity (UK)	25bps
Passive – bonds	10bps
Passive – equity	5-8bps

Total fees*

*Illustrative example. Not based on any actual Fund

What does this tell us?

- Getting value from active management?
  - “closet” trackers vs differentiated / exotic
- Greater use of passive?
  - big fee saving, little impact on performance
  - concentrate on management by sector / region
- Are all investment mgt expenses measured?
  - e.g. Fund of Funds
- More collectivisation
  - pool resources for alternatives?
  - strip out a layer of cost?

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Is fund merger the only way to get investment scale benefits?

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Financial benefits of scale – other options?

- Re-negotiate fees of existing managers?
- LGPS asset pools / collectivisation
  - passive, alternatives, property?
  - negotiated scale fees

Scale benefits without merger

Operational benefits of scale – other options?

- Share services for investment functions?
  - pool resources, strengthen governance
  - Centralised monitoring
- Centralised / shared procurement?
  - one jointly procured UK equity tracker
  - pool assets for alternatives eg infrastructure investment

Other costs?

Administration costs

	Cost per member (£)
Highest	£38
Lowest	£15
Average UK	£20-£23
Outsourced	£18
Survey of large schemes (40,000 +)	£36

Comparing apples and oranges

Concentrate on big ticket items?

	Small Fund 500m	Larger Fund 2-10bn	Nature
Investment management	40-60bps	30-40bps	Speculative?
Administration	5-10bps	4-8bps	Necessity
Advisers and custody	2-3bps	<1-3bps	Risk management

Small saving on investment management, covers a large proportion of other costs

Can scale benefits only be achieved by merger?

Consider

- Shared services?
- Joint procurement?
- LGPS asset pools / collectivisation?
- Re-negotiate fees with existing managers?

Concentrate on big ticket items

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Thank you

Any questions?

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How big are LGPS Funds?

How big are LGPS Funds?

	UK	Europe (c.500)	World (c.1000)
Largest	BT Group (Euro 39.6bn)	Norway Govt (Euro 376.9bn)	Japan Govt (Euro 920.8bn)
Strathclyde (Euro 12.2bn)	15th	64th	203rd
Greater Manchester (Euro 11.3bn)	18th	69th	219th
Median (Euro 1.1bn)	209th	583rd	Not available
London Borough (Euro 0.9bn)	231st	661st	Not available
Combined LGPS (Approx Euro 170bn)	1st	3rd	12th

Large compared with many UK private sector schemes, small by international standards

Governance and operational arrangements

Governance & investment decision making

Scheme	Size	Decision making	Investment resource
LGPS	£500m	Elected Member Committee	1 FTE?
LGPS	>£4bn	Elected Member Committee + Investment Sub	4-5 FTE?
USS	c£30bn	Supervisory board, Investment Sub, 7 other committees, CEO, CIO	N/A
BP	c£17bn	Supervisory Board sets policy, CEO with delegated authority	20+
Ontario Teachers	c£70bn	Board of Directors sets strategy, Executive management team with has authority for tactical asset allocation, currency management, manager selection	10+

Would larger schemes require a different governance and operational model?

Alternative governance/operational models?

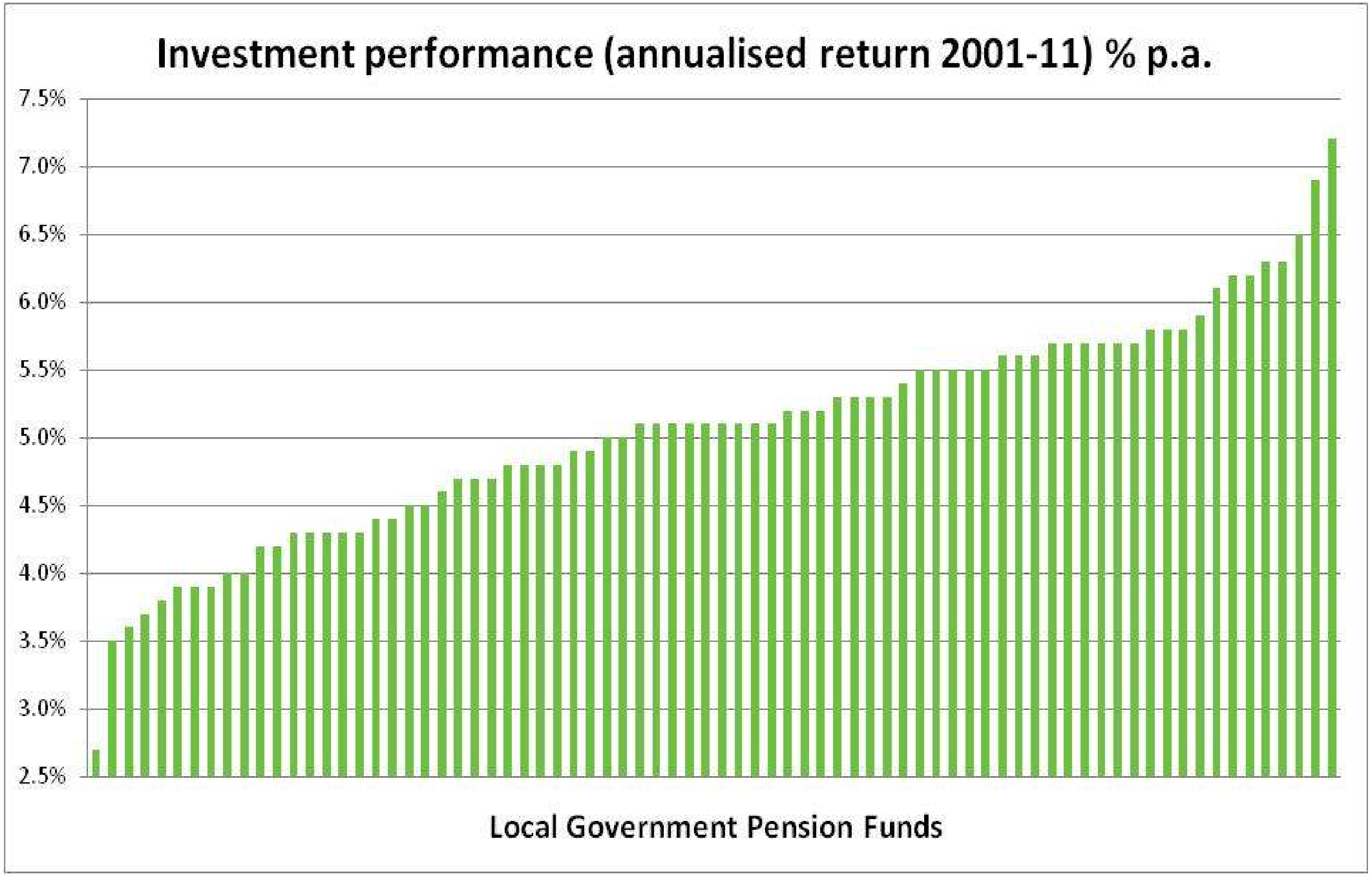
- More internal, professional resource
- Supervisory Board: agree strategy, monitor, hold Executive to account
- Executive team: delegated authority (execution, tactical decisions, etc)
- Decision making less tied to timing of committee meetings?
- But loss of local accountability and decision making?

Hutton and LGPS rationalisation

- 6.23 “Commission does not propose rationalising governance and administration of locally administered schemes through moving to wholly national arrangements, **instead** advocating greater co-ordination and collaboration”
- 6.25 “there is a case supplementing local pension boards with a national pensions board .. separate from individual local authorities”
- 6.72 “desirable for LGPS Funds to have incentives to obtain performance improvements, including merging the investment of assets or even the underlying Funds where appropriate”

Praise for shared service and procurement initiatives

Investment returns across LGPS Funds



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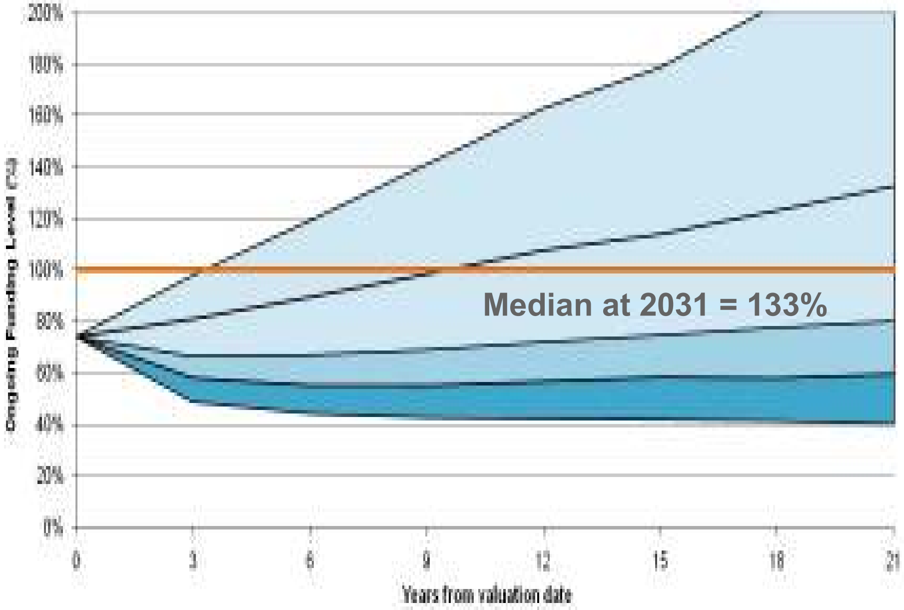
CIPFA Scotland meeting

- Catherine McFadyen, Actuary
- David Walker, Investment consultant
- 19 September 2012

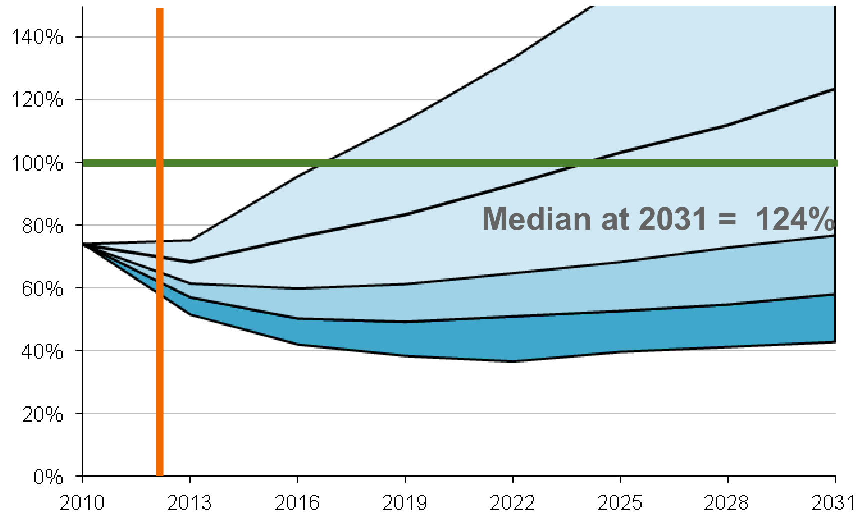
LGPS Median Fund England and Wales

Positive Outlook – 2010 and 2012



2010

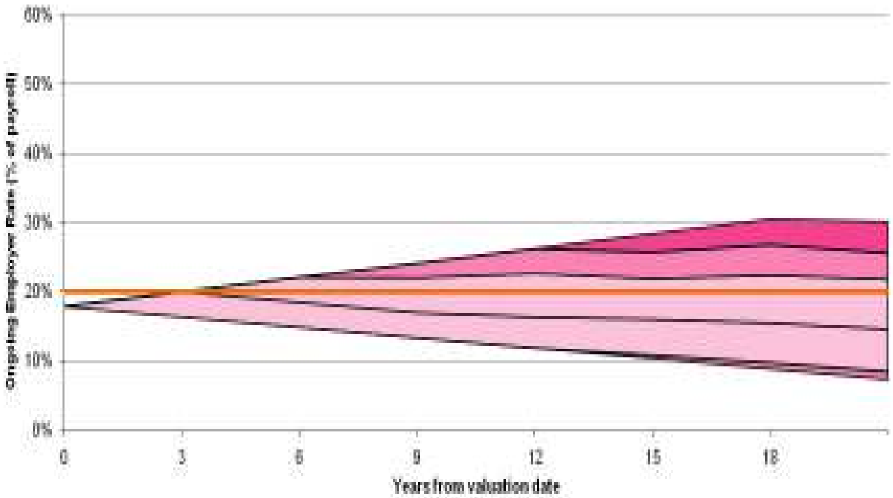
- 80% funded at 2010
- Stabilisation rule - + 1% / -0.5%
- Median funding level is 133%



2012

- 70% funded at 2012
- Stabilisation rule - + 1% / -0.5%
- Median funding level is 124%

Positive Outlook – 2010 and 2012

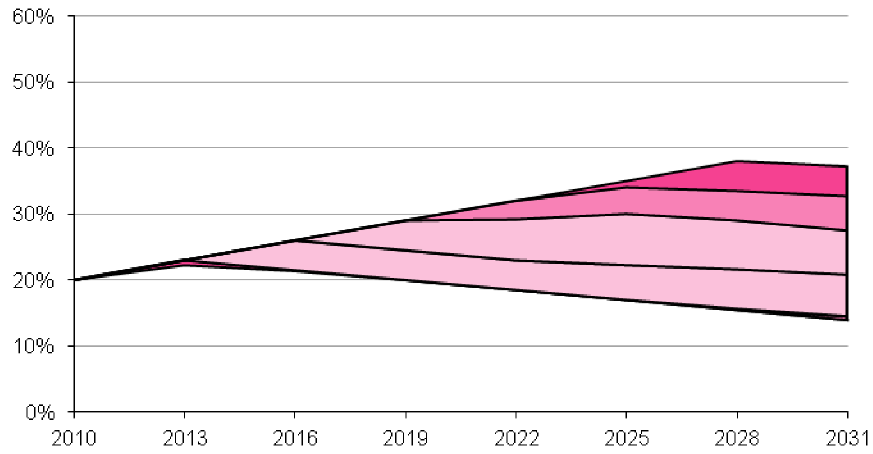


2010

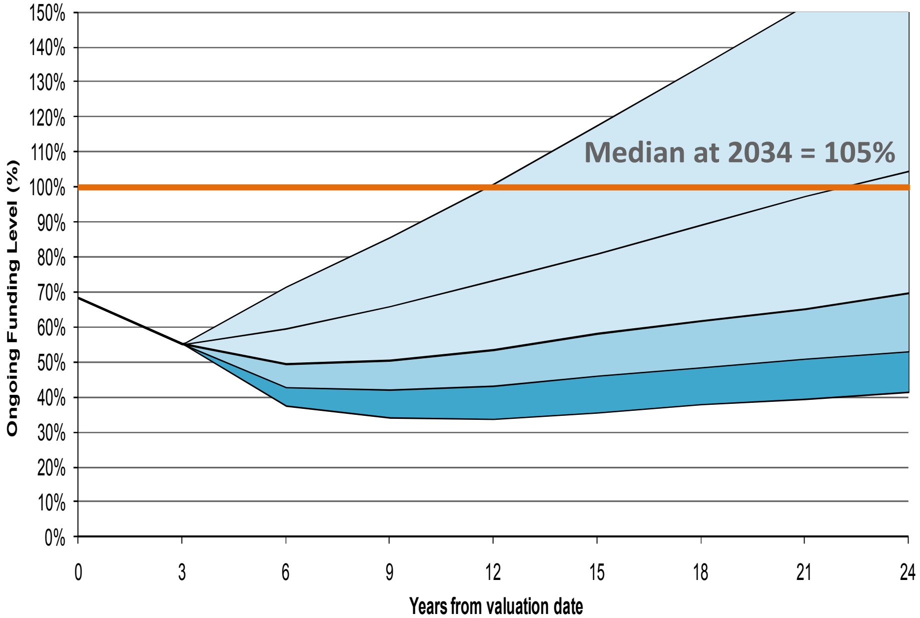
- Median contribution rate is 12%

2012

- Median contribution rate is 21%



Below the Average – 2010 and 2012

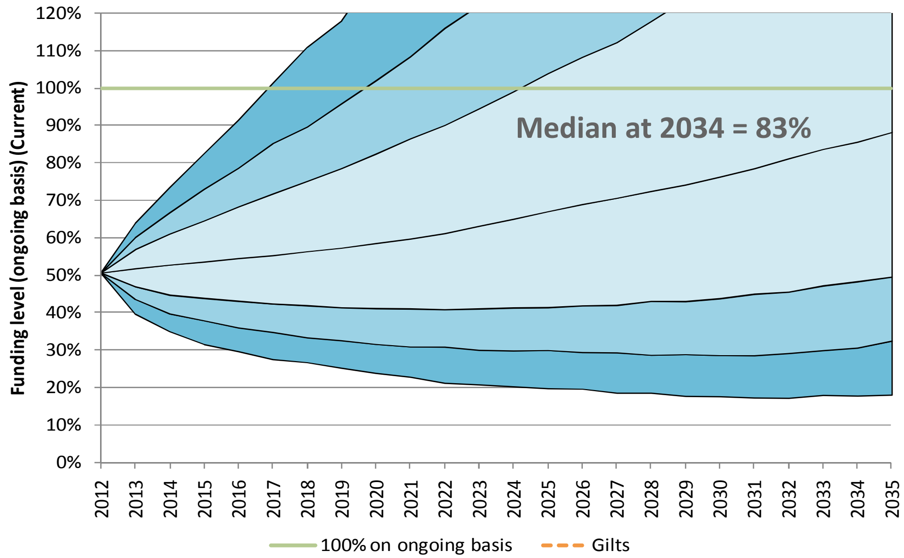


2010

- 61% funded at 2010
- Stabilisation rule - Fixed until 2011, then +1% / -1%
- Median funding level is 105%

2012

- 50% funded at 2010
- Stabilisation rule - + 1% / - 1%
- Median funding level is 83%



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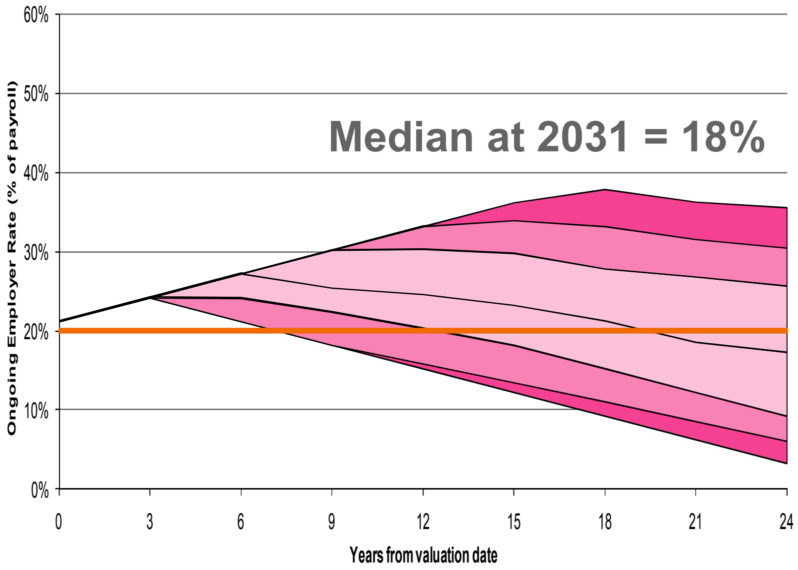
Affordability – 2010 and 2012

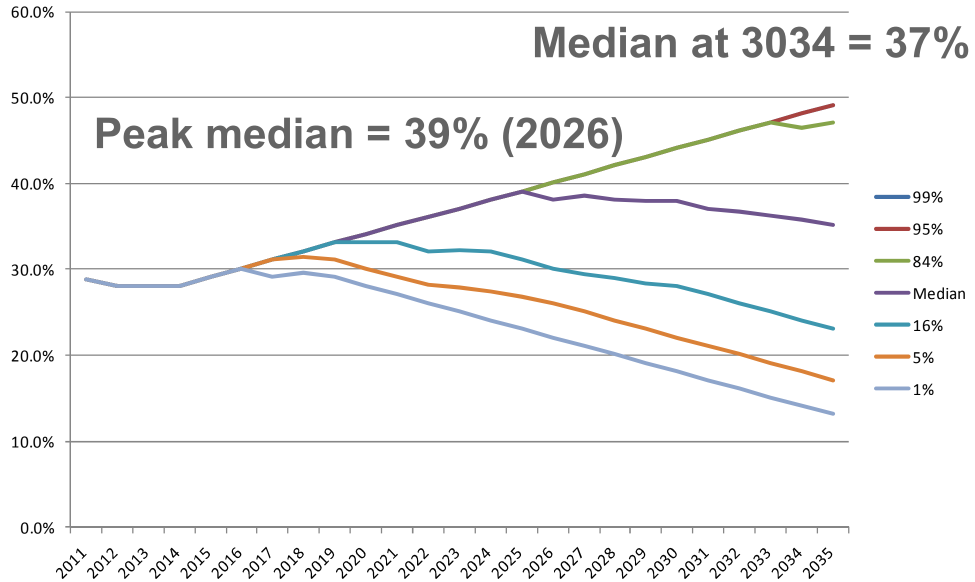


2010

- Median contribution rate is 18%

2012

- Median contribution rate is 37%



Benefits of risk management

- Risk management framework
  - Capture market opportunities
  - Reduce funding and contribution volatility
  - Capture attractive return sources (capitalise on illiquidity premium)

Dynamic risk management

Unintended risk (typically liability related)

- Interest rate risk: interest rates ↓ PV of liabilities ↑
- Inflation risk: inflation ↑ PV of liabilities ↑

Intended risks (typically asset related)

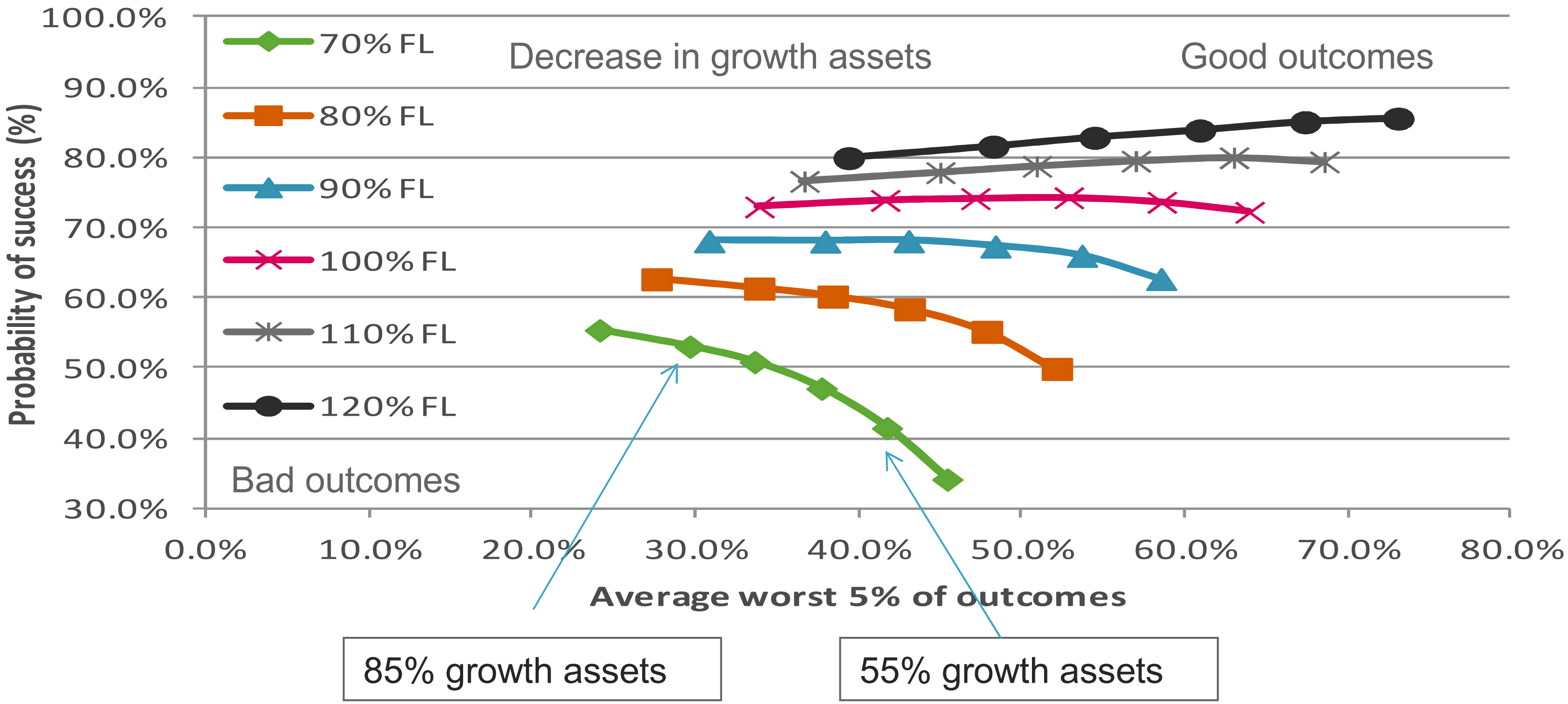
- Equity risk (market) – 'beta'
- Manager risk (skill) – 'alpha'

Unavoidable risk

- Longevity

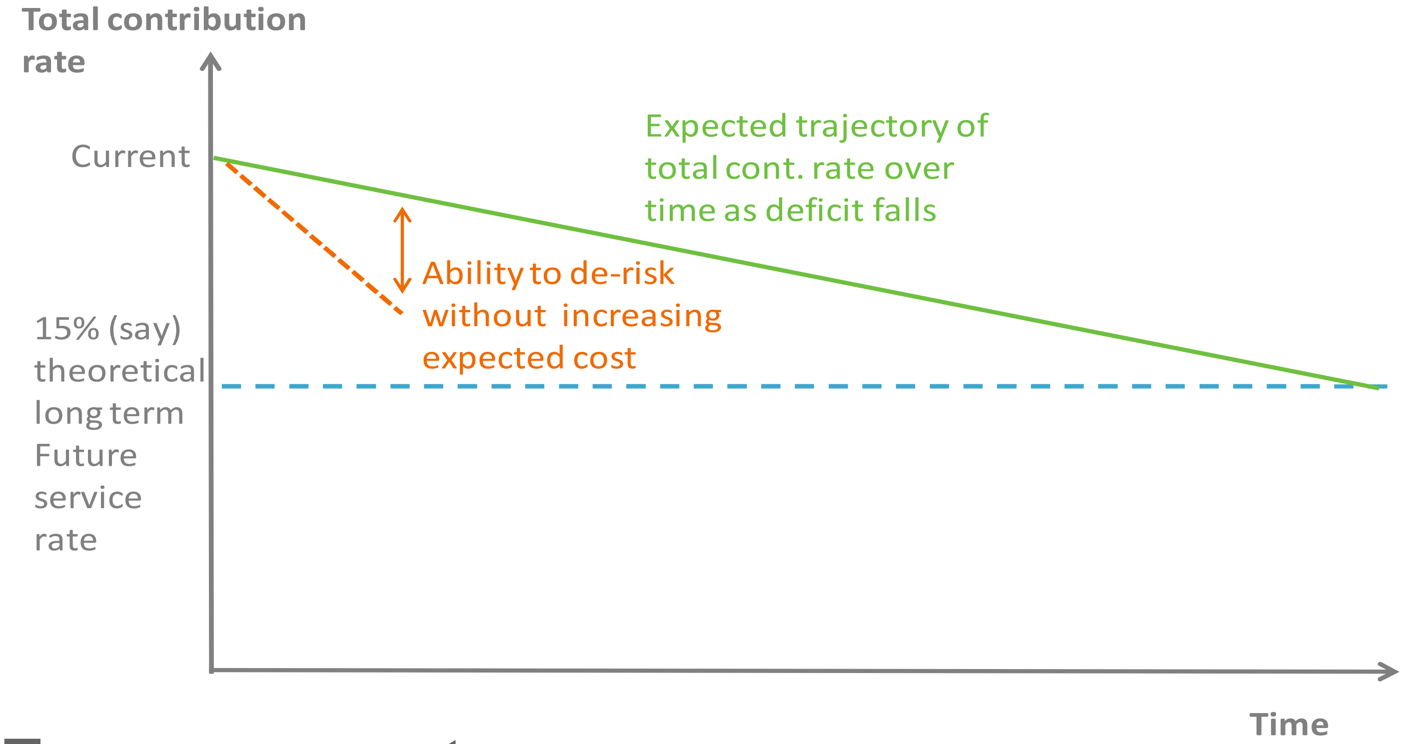
- Need to determine which risks are important and how to manage these risks

Risk management in practice



- Understand your fund's tolerance to risk
  - When we need to take risk
  - When to protect the fund – risk not rewarded
- Example fund – agree to de-risk at 110% funded

Other ways of looking at risk management



- Focus on costs
  - reduce risk when ahead of expectations
  - Control volatility around a long term affordable level on contributions

Summary

- LGPS not immune to mark to market risk
  - Some funds still well positioned
  - Others need significant contributions to get back on track
- Delicate balance between need for risk and protecting the fund
- Practical steps are possible to plan for the future
- Capture opportunities when you can
  - Agree what you are trying to achieve
  - Put in place a strategy that reflects your objectives

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Thank you

Any questions?