

# The cost of public sector pensions in Scotland



Prepared for the Auditor General for Scotland and the Accounts Commission  
February 2011

# Auditor General for Scotland

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- Scottish Water
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- following up issues of concern identified through the audit, to ensure satisfactory resolutions
- carrying out national performance studies to improve economy, efficiency and effectiveness in local government
- issuing an annual direction to local authorities which sets out the range of performance information they are required to publish.

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# Summary

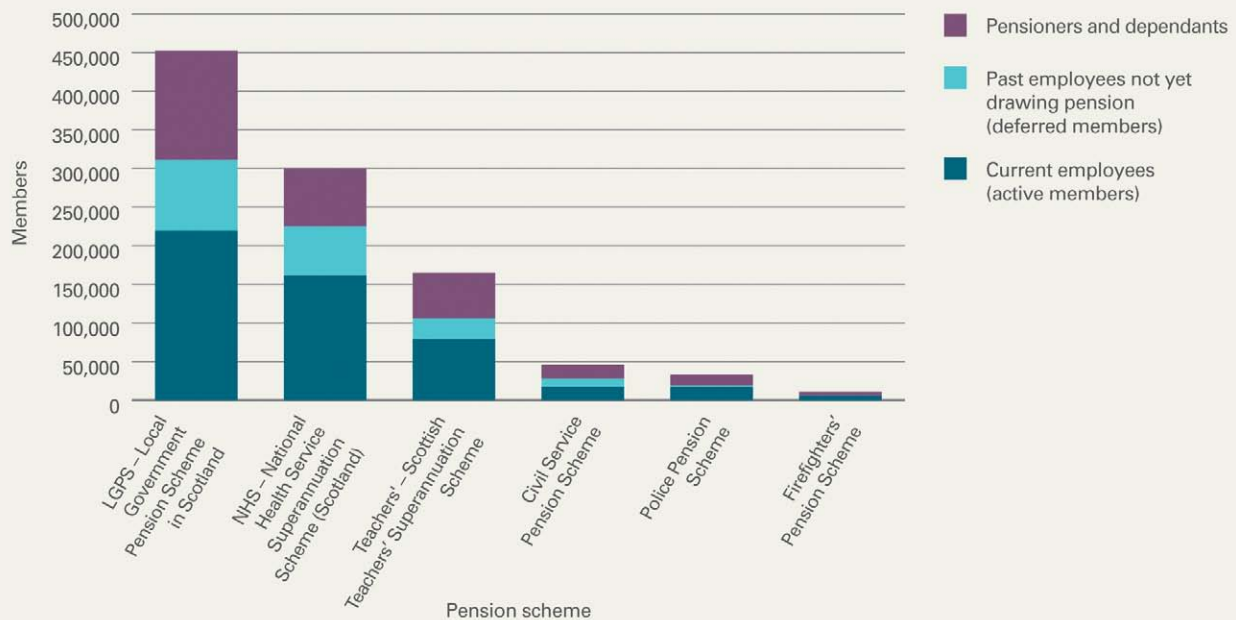
## The context for public sector pensions

1. Occupational pensions are an important part of public sector workforce reward, recruitment and retention. They can also serve to provide adequate income when people stop working. Around one million people in Scotland currently have a direct interest in one of the six main public sector pension schemes, either as members or as pensioners and dependants ([Exhibit 1](#)).

### Exhibit 1

Membership of the six main public sector pension schemes in Scotland 2010

The local government, NHS and teachers' schemes account for more than 90 per cent of total membership.



Source: Audit Scotland survey of pension schemes

2. In 2009/10, the six schemes paid out £2.8 billion to pensioners while public bodies contributed £2.2 billion and employees paid £814 million to meet their expected long-term costs. Because of the effect of these costs on the Scottish budget and the budgets of individual public bodies it is important the schemes are well managed and controlled.
3. Occupational pension policy is a reserved matter. Although the UK government has primary responsibility for policy, the Scottish Government has some influence on how UK changes are implemented in Scotland. This includes the ability to make secondary legislation, though the degree of change is limited by a mixture of UK government legislative and financial controls.
4. The main difference among the six schemes is that only the Local Government Pension Scheme (LGPS) is a funded scheme. (Pensions jargon can sometimes be complicated – we explain terms as they are used and

there is a brief glossary of common pension terms at [Appendix 1](#)). As a funded scheme, the LGPS uses current pension contributions both to pay current pensions and to invest in assets and earn a return to help meet the long-term cost of pensions. Eleven lead councils are responsible for how the LGPS is controlled, financed and operated, within a policy and guidance framework set by Scottish ministers.

5. The other five schemes, which cover teachers, the NHS, the civil service in Scotland and police and firefighters' are unfunded (also known as a 'pay-as-you-go' pension schemes – no fund is built up to help cover future pension payments). Employers and employees contribute as if the schemes were funded – the contributions are calculated using assumptions set by HM Treasury – and these contributions are used to pay current pensioners and dependants.
6. In June 2006, we published *Public sector pension schemes in Scotland*. This short report looked at the financial pressures the schemes were then facing. In particular, pension liabilities were increasing because the number of pensioners had been increasing and people were living longer than previously forecast. These pressures remain, while changes in the economic environment have led to a significant increase in the reported value of pension liabilities, linked to changes in the assumptions about interest rates.
7. The UK government has set up an Independent Public Services Pensions Commission (the Commission), chaired by a former Work and Pensions Secretary, Lord Hutton, to review fundamentally the way public sector pensions are provided. The Commission published an interim report in October 2010. It concluded that the case for pension reform is clear and that “the current public service pensions system has been unable to respond flexibly to changes in life expectancy”.<sup>1</sup>
8. The UK spending review in October 2010 accepted the Commission's interim findings.<sup>2</sup> The Commission will publish its final report, looking at options for long-term, structural reform, in time for the 2011 UK budget due in March 2011. The Commission's final report will have major implications for pensions policy and the reform of pensions, which the Scottish Government has already committed to consider. The recommendations in our report are concerned with areas that are outside the scope of the Commission's review.

## About this report

9. This report sets out information on the costs of the six main public sector pension schemes in Scotland. It is intended to supplement the Independent Public Services Pensions Commission's review and provide clarity, transparency and understanding on the costs and key features of the main schemes that operate in Scotland. It sets out how the schemes operate within the UK framework, how costs are controlled and the governance arrangements for the schemes. Our report is in four parts:
  - **Part 1** highlights the key features of the six main pension schemes in Scotland, including how they are paid for and the benefits they provide to members.

<sup>1</sup> *Interim Report*, Independent Public Service Pensions Commission, October 2010.

<sup>2</sup> *2010 Spending Review*, HM Treasury, October 2010.

- **Part 2** looks at what has been happening in recent years in the pension schemes, including the reasons for and the impact of reforms between 2006 and 2009, current developments, the role of the Scottish Government and the further challenges ahead.
- **Part 3** examines the costs and governance of the five main unfunded schemes.
- **Part 4** examines the costs and governance of the funded LGPS in Scotland.

10. In examining these schemes we drew on a wide range of information and reports provided by each of the six schemes, including the latest accounts for each scheme as at 31 March 2010, supplemented with a data request to all the schemes. We also interviewed relevant people in the pensions sector and established a project advisory group to provide independent advice and feedback at key stages of the project ([Appendix 2](#)).

11. Our report does not look at smaller schemes such as judicial pensions, the Scottish Parliament pension scheme or the independent schemes for the Scottish Legal Aid Board and the enterprise agencies.<sup>3</sup> Nor does it cover private sector pensions or independent bodies that receive public funds such as universities or wider matters reserved to the UK government (including the state pension scheme, the tax consequences of public sector pensions or their impact on the benefit system).

## Key messages

- Public service pension schemes have a long history and reflect the different needs of their employers and members. Employers currently pay contribution rates of between 11.5 and almost 25 per cent of pay to meet the expected long-term cost of the schemes. Employees' contributions vary but on average are around a third of those of employers. To some extent, higher contributions reflect higher levels of benefit agreed at UK level. But there is no clear rationale for some of the variation in contributions between schemes.
- Pensions are earned according to pay and length of service, so there is significant variation in how much individual pensioners are paid, both across and within different schemes. Many pensions are low, reflecting relatively short service, low pay or a combination of both. Currently the average pension for women is about half that for men.
- In March 2010, there were 172,300 pensioners and dependants in the five main unfunded schemes, 13 per cent more than in 2005. The number of pensioners in the funded LGPS increased by 11 per cent to 141,400 over the same period. These increases are due to the earlier growth in public sector employment and because pensioners are living longer than previously forecast.

<sup>3</sup> These smaller schemes account for about one per cent of all public sector pensions in Scotland.

- Direct spending on pensions does not immediately or directly affect the spending power of the Scottish budget but changes in employers' pension contributions do. The £2.2 billion cost of these contributions in 2009/10 is 19 per cent more in real terms than five years ago but this is mainly due to underlying increases in public sector employment and pay. Despite growing financial pressures on all the schemes, employers' contributions for the three largest unfunded schemes have remained relatively constant at between 3.4 and 3.7 per cent of the Scottish budget.
- Significant cost pressures have built up in all of the schemes as a result of people living longer than previously forecast while long-term interest rate changes have increased the schemes' reported liabilities. Reforms between 2006 and 2009 should help contain employers' spending in all the schemes. In addition, in the teachers', NHS and civil service pension schemes there is an agreement to share any future increases in pension contribution rates with employees. However, there is no similar arrangement for adjusting the share of costs for the police or firefighters' pension schemes and the timetable for implementing this in the LGPS has slipped by one year to March 2011.
- Recent decisions by the UK government should help to alleviate further the potential for increases in employers' contribution rates. However, the precise effect of these decisions and existing pressures on pension costs – and ultimately on the spending power of the Scottish budget – will not become apparent until later in 2011 or 2012.

## Recommendations

In considering how to respond to the findings of the Independent Public Services Pensions Commission, the Scottish Government should:

- provide a clear statement of the aims and objectives of the public sector pension schemes in Scotland
- ensure that it is meeting these aims and objectives by putting in place arrangements to scrutinise pension provision across the public sector in Scotland, within the context of other aspects of public sector pay and conditions; and as part of this, consider increasing the role of experts to strengthen scrutiny and decision-making
- consider whether differences among schemes in areas such as contribution rates and level of benefits are necessary to realise the objectives of each scheme
- within the legal and financial constraints which apply, decide how best to incorporate changes made at a UK level into the equivalent Scottish schemes to meet its objectives for public sector pension schemes in Scotland
- with councils, decide on the extent and pace of further reform of the LGPS. As part of this, they should have a clear policy on whether to set a cap on the level of future employers' contributions as a percentage of pay.

# Part 1. Key features and benefits of the six schemes

## Key messages

- Pension schemes have a long history and reflect the different needs of their employers and members. Employers currently pay contribution rates of between 11.5 and almost 25 per cent of pay to meet the expected long-term cost of the schemes. Employees' contributions vary but on average are around one third of those of the employer. To some extent, higher contributions reflect higher levels of benefit agreed at UK level. But there is no clear rationale for some of the variation in contributions among schemes.
- Pensions are earned according to pay and length of service, and many pensions are low, reflecting relatively short service, low pay or a combination of both. For example, the £4,754 average pension in the LGPS is less than half of the £10,220 average in the teacher's scheme.<sup>4</sup> There are also some differences in entitlement among the schemes.
- The average pension for women in the six schemes is about half that for men. This is because current women pensioners had shorter lengths of service than men and were paid less. For example, in the teachers' scheme the £9,600 average pension for recently retired women is below the £13,700 average for men. Around half of the difference is due to shorter service, the rest reflects lower pay.
- Final salary schemes better reward employees with higher pay progression compared to those on low pay with less pay progression. While currently only two per cent of pensioners receive £30,000 a year or more, their pensions represent around 11 per cent of all payments. Some of this difference is the result of longer service and higher pension contributions.

## Overview of the six schemes

**12.** Employers provide pensions to their employees as part of their remuneration package. The six main public sector pension schemes in Scotland have a long history and have developed different features to meet the needs of their employers and members. The features also vary to some extent according to when each member joined each scheme. However their common features include:

- Though it is not compulsory for public sector employees to join any pension scheme, all new employees are automatically enrolled into the relevant scheme unless they decide to opt out. Around 500,000 current employees are active members of one of the six main schemes in Scotland, which is around 85 per cent of the public sector workforce. This compares to about 35 per cent of UK private sector employees with employer-sponsored pensions. (The Pension Act 2008 due to come into effect in 2012

<sup>4</sup> All figures for annual pension income exclude any lump sum payments – see paragraph 25.



will require employers to automatically enrol most employees into a qualifying pension scheme. The new requirements will be staged over a four-year period depending on the size of the employer and to help both employers and individuals adjust to the additional costs gradually.)

- Employees must make contributions as a percentage of pay in return for a pension. The share varies from scheme to scheme but on average employees contribute around a quarter of total costs with the rest paid by employers.
- The age at which employees may retire and get a pension varies. Many current employees may retire at age 60. But improvements in life expectancy have created pressure for change and employees entering the schemes since the most recent reforms cannot now normally retire before age 65 (except for the police and firefighters' schemes).

**13.** All pensions are based on paying sufficient resources in the present to provide an income in the future. Inevitably assumptions about the future must be made. The timescale involved is long, up to sixty years or more over a working life and a retirement. Consequently there is an unavoidable element of risk involved in the whole pension provision process. Risks are allocated differently according to the type of scheme:

- In the case of a defined benefit scheme the employer is wholly responsible for pensions earned by an employee and guarantees the future retirement income ie all risks fall on the employer.
- In a defined contribution scheme the employer provides for certain payments to be made for pension provision. But the employee is responsible for reviewing the provision over time as circumstances change and for any action to maintain its adequacy.

**14.** All public sector pension schemes in Scotland provide a defined benefit pension. Private sector organisations also have defined benefit schemes but in recent years have moved more to defined contribution schemes.

**15.** The LGPS is the only one of the main public sector pension schemes that is funded. This means it uses pension contributions from employers and employees to invest in assets to earn a return to help meet the long-term cost of pensions. It is also the largest of the six main schemes accounting for 45 per cent of membership in Scotland (**Exhibit 1 on page 2**). It comprises 11 individual pension funds, administered by 11 lead councils but covering all council employees in Scotland. In addition to council staff, LGPS members include non-uniformed staff in the police and fire services. Staff in colleges, valuation boards, the voluntary sector and other employers including contractors associated with local government may also be eligible for membership through admitted bodies.<sup>5</sup>

**16.** The other main public sector schemes are unfunded – no fund is built up to cover future pension payments. Employers and employees contribute as if the schemes were funded, although the contribution is based on a calculation using assumptions set by HM Treasury. Contributions are used to pay current pensioners and dependants.<sup>6</sup> The NHS and the teachers' schemes have 30 per cent and 16 per cent respectively of the total

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<sup>5</sup> Audit Scotland staff are eligible for membership of the LGPS.

<sup>6</sup> For the unfunded schemes any difference between contributions received and pensions paid out in any year provide savings for, or must be met from, current government spending. Part 3 provides further information.

membership of the six schemes and are the largest unfunded schemes. The civil service, police and firefighters' schemes are smaller, together making up nine per cent of the combined pension scheme membership ([Exhibit 1, page 2](#)).<sup>7</sup>

17. The Scottish Government implements legislation and policy for the five main Scottish schemes, excluding the civil service scheme. Regulations are prepared and administered by the Scottish Public Pensions Agency (SPPA). The SPPA is an executive agency, created in 1993. It is also responsible for administering the NHS and teachers' pension schemes.

18. [Appendix 3](#) provides a summary of the main features of each of the six main schemes.

## Contribution rates vary among schemes

19. Providing pensions is a long-term undertaking; today's employees could be receiving pensions in 2070 and beyond. Because of the risks involved in making commitments over such a long period, good financial planning and a good understanding of future cash flows and cost pressures are essential. Over time, assumptions need to be reviewed and adjustments made. Government policy and legislation therefore requires actuaries to regularly evaluate the long-term cost of meeting pension commitments and recommend the overall level of contributions required to meet them. For the LGPS, this advice takes account of the expected returns from pension fund investments.<sup>8</sup> There is a four year-actuarial valuation cycle for the NHS, teachers' and civil service schemes and three years for the LGPS. The next actuarial valuations for these four schemes are due in 2012.<sup>9</sup> After the valuations, contribution rates may be revised with changes due to take effect from April 2012.

20. All schemes need to ensure that contributions are sufficient to meet the long-term cost of pensions. Until recently, although some police and fire boards have had actuarial advice to forecast their liabilities and likely pension costs, full actuarial valuations of police and fire pension schemes have been rare. This should change, as the Scottish Government has introduced a new financial system from April 2010 that requires regular actuarial valuations. However, until 2010/11, police and fire boards paid pensions directly from their operating budgets and their contributions were set by the difference between the cost of pension payments and employees' contributions, which resulted in very high employers' contribution rates equivalent to up to 45 per cent of pay. The employers' contribution rates for police and fire boards are currently based on rates for England and Wales and the Scottish Government will meet the difference between contributions received and pensions paid. The contribution rate may be revised once the valuations now required have been completed.

21. Pensions form part of the overall terms and conditions of employment and need to be considered in this context. The relative share of contributions between employers and employees reflects the history and

<sup>7</sup> For the civil service there is a GB-wide pension scheme. We have estimated all figures for the civil service in this report based on members who work in the Scottish Administration being three per cent of the GB-wide total.

<sup>8</sup> For unfunded schemes, HM Treasury has approved a special methodology (SCAPE - Superannuation Contributions Adjusted for Past Experience) to set employers' contribution rates. It is intended to mirror the operation of a funded scheme by keeping track of a notional pension account, which includes a notional investment fund.

<sup>9</sup> The effective date of each valuation will be 31 March 2011 but the valuations are not expected to be completed until 2012.

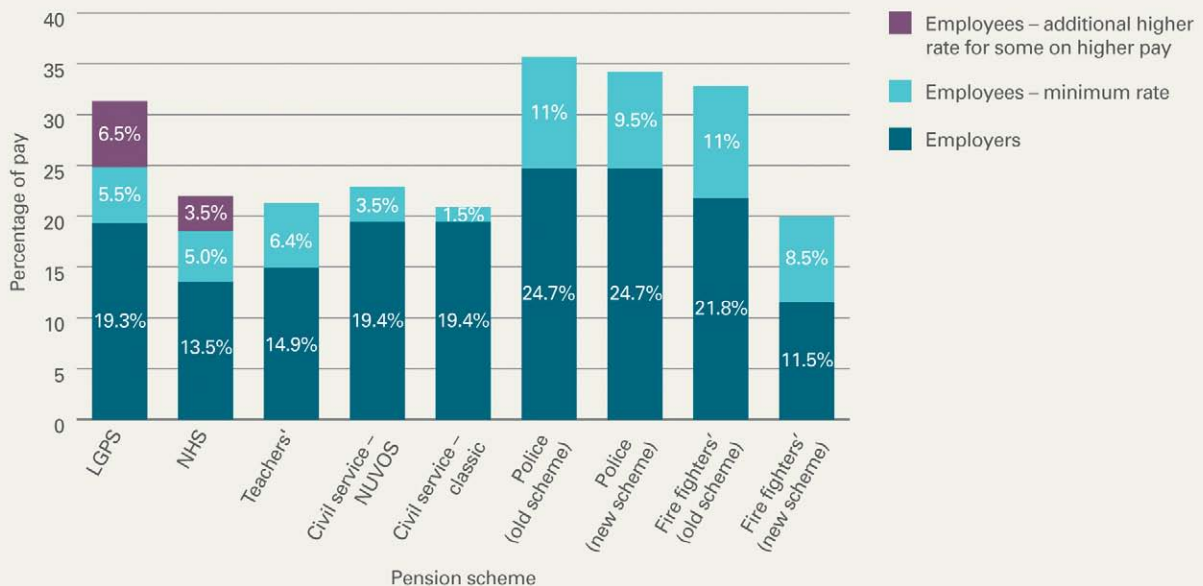
circumstances of each scheme and the employees it was designed to serve. For example, police officers have a lower retirement age, which means that pension costs are higher with higher employers' and employees' contribution rates as a result. The lower retirement age for police officers reflects operational considerations including how far it is desirable for them to work for more than 30 years.

22. Employers' contribution rates currently vary from 11.5 to 24.7 per cent, while employees' rates vary from 1.5 to 11 per cent (Exhibit 2). The overall contribution rates for the three biggest unfunded schemes – NHS, teachers' and civil service – are similar although the relative contribution of employers and employees varies.

**Exhibit 2**

Employers' and employees' contribution rates

There is considerable variation in employers' and employees' contribution rates.



Note: For the LGPS, the employers' rate is the median rate for all 11 funds. For the LGPS and the NHS pension schemes, employee rates are tiered and higher paid members must pay a higher contribution rate. The average employee contribution rate in the LGPS is 6.3 per cent and in the NHS it is 6.5 per cent.  
Source: Audit Scotland

23. Although the higher contribution rates of the police and firefighters' schemes reflect higher costs, other differences in scheme contribution rates reflect their individual history and remuneration policies rather than any particular rationale. The Independent Public Services Pensions Commission concluded that the development of public sector pension schemes has not been a planned and fully coherent process and that there is a plethora of complex provisions. It has indicated that it is important to bring together information about the overall position on schemes in a way that explains differences between them including contribution rates.<sup>10</sup>

<sup>10</sup> Interim Report, Independent Public Services Pensions Commission, October 2010.

## Individual pensions vary significantly across schemes and according to individual circumstances

24. Pensions are generally based on individuals' length of service and final salary. On average, pensioners in the police and firefighters' schemes receive higher pensions while in all schemes men generally receive higher pensions than women (Exhibit 3). This variation reflects differences in pay and reward and in the proportion of employees working reduced hours within each occupation and sector. It also reflects the shorter average working lives of women in recent years and any previous pay inequality.<sup>11</sup>

### Exhibit 3

The average annual pension received by men and women in each scheme

On average pensioners in the police and fire schemes receive the most, while in all schemes men generally receive higher annual pensions than women.

Scheme	Average annual pension		
	Overall (£)	Men (£)	Women (£)
Civil service	4,222	not available	not available
LGPS	4,754	6,771	3,255
NHS	7,057	13,351	5,098
Teachers	10,220	12,841	8,937
Firefighters	13,291	14,634	5,817
Police	15,674	17,730	8,999

Note: These figures are averages for all current pensioners and dependants in each scheme, excluding lump sums. On retirement, pensioners may opt to exchange up to a quarter of their annual pension for a higher lump sum. The averages shown above reflect pensions paid after any reduction to pay for any higher lump sum.

Source: Audit Scotland

25. In addition to the annual pension, pensioners also receive a one-off, tax-free lump sum payable on retirement. The amount of lump sum depends on the length of service and final salary. It used to be an automatic amount according to individual scheme rules. However, following the Pensions Act 2006, there is now more flexibility and most scheme members now have the right to swap up to a quarter of their annual pension for a lump sum, a process known as commutation.<sup>12</sup> The take-up rate and amounts of lump sum vary significantly (we show in Parts 3 and 4 that there has been higher spending on lump sums in all schemes in recent years).

<sup>11</sup> Although women generally receive lower pensions, on average they receive them for longer than men. For example, the Office for National Statistics' current forecast for the life expectancy of men and women in Scotland aged 60 in 2010 is 24.1 years and 27.2 years respectively.

<sup>12</sup> For example, in the LGPS any pension built up before April 2009 is calculated at an accrual rate of 1/80th of salary for each year of service with an automatic lump sum of three times pension. Pension built up from 1 April 2009 is calculated at a better 1/60<sup>th</sup> accrual rate, though with no automatic lump sum. However, there is an option to take additional lump sum in exchange for some pension, at the rate of £12 of lump sum for every £1 of annual pension given up.

26. The average pensions include employees who retired many years ago and therefore may not be representative of employees who are retiring now. We therefore obtained and analysed information from the LGPS and teachers', firefighters' and police schemes about the pensions paid to employees who have retired over the past two years (five years for teachers).<sup>13</sup> This is likely to be more representative of the benefits available to pensioners retiring now and in the near future. It shows that pensions vary considerably among schemes and that length of service significantly affects the level of pension received (**Exhibit 4, overleaf**).
27. As previously stated, pensions are only part of the overall terms and conditions for staff. The charts in **Exhibit 4** are not therefore intended to compare the fairness of each pension scheme. Variations in pension received are a result of underlying differences in the type of work and careers of the members of each scheme. In particular:
- The teachers', police and fire schemes provide for jobs where employees tend to remain in service throughout their careers. In the police and firefighters' schemes, most officers may earn pension twice as fast after 20 years' service, which provides a big incentive to remain in the service (and over 95 per cent do so for more than 20 years). Although this feature was withdrawn from 2006 for new entrants to the scheme, it remains for most officers who joined before then.
  - Employees in the teachers' pension scheme also have long service, with over 70 per cent of teachers having more than 20 years' service at retirement.
  - Employees in the LGPS (and the NHS and civil service schemes) tend to have a wider variety of jobs, shorter service and lower pay compared to teachers, police officers and firefighters in the other schemes. For example, 60 per cent of LGPS pensioners had worked for less than 20 years and a higher proportion of employees, particularly women, had worked part time.
28. Differences in length of service also partly account for differences in pension between men and women. In the teachers' scheme the £9,600 average pension for recently retired women is less than the £13,700 average for men. Around half of the difference is because retired women teachers' average length of service (24 years) was shorter than male colleagues (29 years) with the rest due to differences in salary.
29. In the police scheme, differences in the pensions of recently retired men and women are lower than indicated in **Exhibit 3** and are because women have shorter service and not because of pay differences.<sup>14</sup> There were too few female pensioners within the fire service to reach any conclusions.

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<sup>13</sup> We were unable to undertake a similar analysis for the NHS and civil service schemes as information on length of service is not included on the pension record of retired employees.

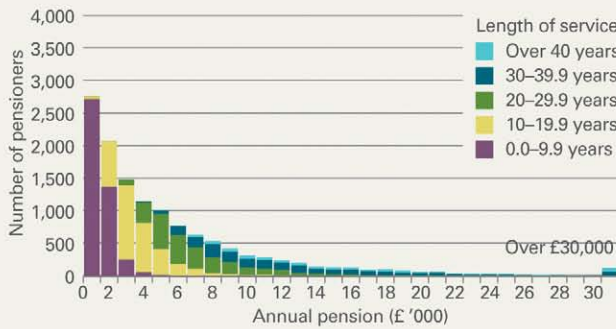
<sup>14</sup> In the police scheme the pension for recently retired women is £17,800 compared to £20,116 for men.

**Exhibit 4**

**Annual pension income and length of service in four of the pension schemes**

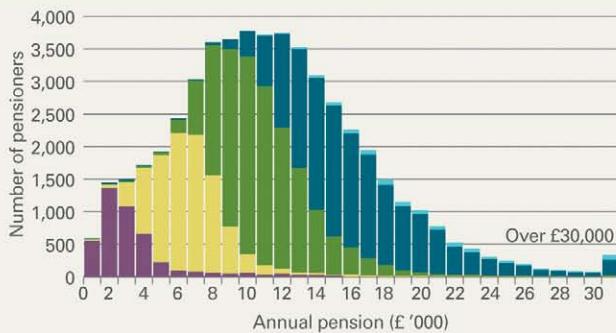
There is significant variation in how much annual pension income individuals receive, both across and within different schemes. Length of service has a significant effect on the amount of pension received.

Each chart shows the value of annual pension, in bands of £1,000, for recently retired members of each scheme. The colours indicate how long pensioners worked to receive their pension.



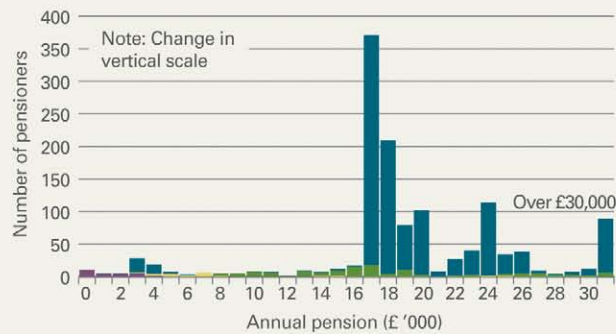
**In the LGPS (left)**

- Many employees with short lengths of service and/or lower pay has led to many low pensions.
- Employees with less than ten years' service tend to retire with pensions of £2,000 a year or less.
- Most retired employees with pensions of over £10,000 a year had long service of over 20 years.
- Retired employees with pensions of over £30,000 account for around one per cent of pensioners and six per cent of the total pensions paid out.



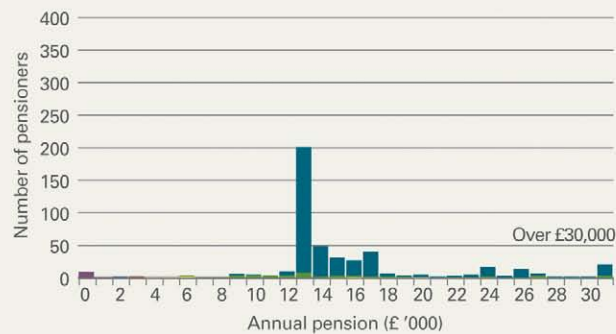
**In the teachers' scheme (left)**

- Over 70 per cent of pensioners had over 20 years of service.
- Only ten per cent had less than ten years' service.
- Retired employees with pensions of over £30,000 account for around half a per cent of pensioners and two per cent of the total pensions paid out.



**In the police scheme (left)**

- Over 90 per cent of retired officers had 30 years' service or more.
- Pensions are higher because of this pattern of long service with a clear peak at £17,000-£18,000 pension a year.
- Retired employees with pensions of over £30,000 account for around seven per cent of pensioners and 12 per cent of the total pensions paid out.



**In the firefighters' scheme (left)**

- Over 90 per cent of retired officers had 30 years' service or more.
- Pensions are higher because of this pattern of long service with a clear peak at £13,000 pension a year.
- Retired employees with pensions of over £30,000 account for around five per cent of pensioners and 11 per cent of the total pensions paid out.

Note: On retirement, pensioners may opt to exchange up to a quarter of their annual pension for a lump sum. The annual pension values shown in the charts are the pensions paid after any reduction to pay for any higher lump sum.

Source: Audit Scotland survey of pension schemes

## Final salary schemes reward employees with higher pay progression

30. Final salary schemes reward employees with higher pay progression compared to those with less pay progression (**Exhibit 5**). For each pound of pension contribution they make, some employees can receive almost twice as much in pension payments than others.<sup>15</sup> On average, across the five schemes where we have data only two per cent of staff receive pensions of £30,000 a year or more. However, annual payments to these pensioners represent around 11 per cent of all pension payments (**Exhibit 4, previous page**).<sup>16</sup> Some of this difference is the result of longer service and higher pension contributions.

### Exhibit 5

How final salary schemes benefit employees with faster pay progression

Consider two employees who work for 40 years in a pension scheme that provides a pension of 1/80th of final salary a year of service. In real terms:

- Aileen's salary starts at £10,000 a year and she is promoted every five years receiving a salary increase of £5,000 each time, (and paying increased pension contributions with each promotion) to end at £50,000 a year.
- Bruce is not promoted and his salary remains at £10,000 a year.

Aileen's pension will be £25,000 a year, Bruce's £5,000 a year. Some difference is to be expected – Aileen had a more successful career. But Aileen's pension is worth over 90 per cent of her average salary over her career, while Bruce's pension is just half of his average salary. This is because Aileen's pension is based on her final salary of £50,000, although for most of her career she earned less than this.

Source: Adapted from the Independent Public Service Pensions Commission interim report October 2010

31. Pensions are based on final salary for all but one scheme. As a result of the most recent reforms, the civil service has introduced the nuvos scheme, in which pensions are based on average pay for the whole period of service (uprated for inflation) rather than final pay. This scheme is known as a CARE scheme (Career Average Revalued Earnings). Both the NHS and local government schemes include tiered employees' contribution rates designed to reflect difference in pay levels; this reduces, but does not remove, the higher effective benefit rates for those with higher pay progression.

<sup>15</sup> 'Should Defined Benefit Pension Schemes be Career Average or Final Salary', Sutcliffe C, The ICMA Centre, University of Reading, Discussion Papers in Finance, DP 2007-6, 2007.

<sup>16</sup> The majority of pensioners (60 per cent) earning over £30,000 per year are members of the NHS pension scheme; they are not shown in Exhibit 4 because information on length of service is not available for NHS pensioners.

## Part 2. Pension reform

### Key messages

- Pension reforms implemented between 2006 and 2009 to help deal with rising costs included increases in retirement ages and in employees' contribution rates for some schemes, changes to lump sums and changes to accrual rates.<sup>17</sup> Many of the reforms only affect new members of schemes, or are being phased in gradually. Savings will be limited in the short term and will be fully realised only after existing scheme members retire in 30 to 40 years.
- A system known as 'cap and share' was introduced in the teachers', NHS and civil service schemes to help limit employers' costs. However, there is no such arrangement for the police and firefighters' schemes. For the LGPS the timetable for agreeing a system for cost-sharing (without a cap) has slipped one year to March 2011.
- The present UK government is pursuing further pension reform. The Scottish Government has some influence on the way in which UK changes to pensions are implemented in Scotland, although this is limited by UK government legislative and financial constraints and varies for each scheme. Key issues for the Scottish Government to address include deciding how best to incorporate changes made at a UK level into the equivalent Scottish schemes; working with councils to decide on the extent and pace of further reform in the LGPS; and considering whether differences between schemes remain justifiable, fair and affordable.

### All the pension schemes were reformed between 2006 and 2009 because of rising costs

- 32.** The Independent Public Service Pensions Commission has highlighted the main reasons for pension reform, in particular the need to deal with increasing costs. It reported that between 1999/2000 and 2009/10 the amount of benefits paid from the UK's largest public service pension schemes increased by 32 per cent in real terms. It attributed this increase in costs mainly to an increase in the number of pensioners as a result of the expansion of the public service workforce over the last four decades, longer life expectancy and the extension of pension rights for early leavers and women.<sup>18</sup>
- 33.** The Commission reported that life expectancy had increased significantly. For example, women who worked in the NHS who retire at age 60 can now expect to live an additional 32 years, compared to an additional 20 years in 1955. Consequently people are spending more of their lives in retirement and receiving pensions

<sup>17</sup> The accrual rate is the rate at which members earn their pension benefits. For every year of service a proportion of salary is earned as pension.

<sup>18</sup> *Interim Report*, Independent Public Service Pensions Commission, October 2010.



for a lot longer than was expected when the pension schemes were set up. This has led to significant increases in pension costs and calls to make public sector pension schemes more affordable.

34. Life expectancy is continuing to rise.<sup>19</sup> For example, in the Strathclyde pension fund, the life expectancy at age 65 for pensioners increased by one year between 2005 and 2008, from 19.3 years to 20.3 years for men and from 22.3 years to 23.2 years for women.
35. There is an unavoidable element of risk involved in the whole pension provision process as forecasts must be made over 60 years or so. Whilst errors in forecasting are therefore inevitable, there is also evidence that life expectancy has been systematically underestimated in actuarial assessments in recent years.<sup>20</sup>
36. Changes to the population age structure will also affect the long-term affordability of pensions. Projected changes in Scotland's population mean that the ratio of pensioners to working people is predicted to rise from one in four of the population to one in three by 2050. This means that there may be a smaller proportion of working age people to support pensions in future.
37. In 2004, the Turner Commission report *Pensions: Challenges and Choices* set out the challenges for pensions, including increasing life expectancy and decreasing savings rates for retirement. It called for a number of changes, including increasing the retirement age and reform of the state pension.<sup>21</sup> Following this review and others, the UK government initiated reforms to make public sector pension schemes more affordable. These reforms, implemented between 2006 and 2009, increased the retirement age for most employees and revised benefits to help control costs and make the schemes fairer (Appendix 3). They included:
- an increase in the normal pension age (NPA) from 60 to 65 for new entrants into the civil service, NHS and teachers' schemes (existing members of the schemes keep an NPA of 60) and an increase in NPA from 55 to 60 for new entrants to the firefighters' scheme (but existing members keep an NPA of 55)
  - changes in employees' contribution rates in most schemes and higher entitlements relative to length of service, with costs offset by removing automatic lump sums
  - new agreements for cost-sharing between employers and employees in the civil service, NHS and teachers' schemes
  - the phasing out of early retirement under the 'rule of 85' in the LGPS, so that by 2020 the NPA for all LGPS members will be 65.<sup>22</sup>
38. Each of the reforms involved negotiation and agreement between employers' bodies, trade unions and the Scottish Government. The National Audit Office has recently estimated that, for the whole UK, £59 billion

<sup>19</sup> *Life Expectancy*, Office for National Statistics, October 2009.

<sup>20</sup> *Interim Report*, Independent Public Service Pensions Commission, October 2010.

<sup>21</sup> *Pensions: Challenges and Choices, The First Report of the Pensions Commission*, TSO, 2004.

<sup>22</sup> The NPA is already 65; however, until 2020 the rule of 85 allows employees aged 60 or more, with protected rights, who have a combined age and length of service of 85 years to retire with unreduced pension.

savings would be made over 50 years from the changes for the civil service, NHS and teachers' schemes and that by 2059/60 the changes will reduce the projected cost to taxpayers by 14 per cent.<sup>23</sup>

## The reforms led to some convergence between schemes

39. We compared the benefits of each scheme before and after reform by measuring the pension an employee earning £25,000 a year would receive on retiring after 30 years' service. This comparison is illustrative and does not take into account the complexities of an actuarial valuation (**Exhibit 6**).

### Exhibit 6

The relative value of pensions in the six schemes

We compared the benefits of the schemes by measuring the pension that an employee earning £25,000 a year would receive on retiring at normal pension age after 30 years' service in each scheme. The total pension payments reflect the fact that lump sums are no longer automatically available in most of the reformed schemes.

Scheme and member	Normal pension age (NPA)	Employees' contribution as percentage of salary	Annual pension (retiring at NPA after 30 years with final salary of £25,000) (£)	Years of life expected after retirement (assuming a life expectancy of 85 years)	Total pension payments (not discounted, including lump sums) (£)
<b>Before 2006–09 reforms</b>					
NHS scheme, eg charge nurse	60	6.4%	9,375	25	262,500
Teachers' scheme	60	6.4%	9,375	25	262,500
Civil service (classic)	60	1.5%	9,375	25	262,500
LGPS, eg Social worker	65	6.0%	9,375	20	215,625
Firefighter	55	11.0%	16,667	30	500,000
Police officer	55	11.0%	16,667	30	500,000
<b>After 2006–09 reforms</b>					
NHS scheme, eg charge nurse	65	6.5%	12,500	20	250,000
Teachers' scheme	65	6.4%	12,500	20	250,000
LGPS, eg social worker	65	6.1%	12,500	20	250,000
Firefighter	60	8.5%	12,500	25	312,500
Police officer	55	9.5%	10,714 <sup>1</sup>	30	364,286

Notes:

1. In the new scheme police officers receive a lump sum of four times their annual pension, all or part of which can be converted to increase their pension, the pension figure quoted here is the minimum figure.
2. These figures have been prepared solely for the purpose of comparing the relative value of the schemes indicated.
3. The newest civil service scheme (nuvos) is excluded from this analysis as it is a career average scheme and not directly comparable with the final salary schemes.

Source: Audit Scotland

40. Using our comparison, in the reformed schemes all staff would receive an annual pension of £12,500, except for police officers where the annual pension is lower. However, unlike the other reformed schemes, where

<sup>23</sup> *The impact of the 2007/08 changes to public sector pensions*, National Audit Office, December 2010.

automatic lump sums are no longer available, a lump sum of four times annual pension was introduced for police officers. If this lump sum is converted to an annual pension it would make the pension broadly equivalent to that in the other schemes. Because police and firefighters retire earlier, their total pension value is higher because it may be received for longer. However, police officers and firefighters pay significantly more for their pensions, their contribution rates being higher both before and after the reforms.

## Savings from recent reforms will only be fully realised in the long term and the impact of ‘cap and share’ schemes is untested

41. Many of the biggest cost-saving measures only affect new members of schemes, or can only be phased in gradually. Consequently, savings will be limited in the short-term and will only be fully realised after the members of the old schemes retire in 30 to 40 years.
42. As part of the reforms, a system known as ‘cap and share’ was introduced in the teachers’, NHS and civil service pension schemes. Under this, employers and employees share any increases or decreases in overall contribution rates after an actuarial valuation until a cap in employers’ contributions is reached. When the cap is reached, increases or reductions in contribution rates fall on employees, either by changing contribution rates or by negotiating changes to benefits. The National Audit Office estimated that across the UK cap and share will contribute to 60 per cent of the savings from the recent reforms in these schemes over the period 2009/10 to 2059/60.<sup>24</sup>
43. However, not all cost pressures are included within the cap and share arrangements. For example, changes in life expectancy are included within the arrangement but changes to financial assumptions used to value pension liabilities are not. Because the arrangements have not been tested it is difficult, at this stage, to assess the overall impact of cap and share on controlling employers’ costs.
44. At present there is no cap and share system for police and firefighters’ pension schemes and the timetable for agreeing a system for cost-sharing in local government has slipped one year to March 2011.<sup>25</sup> This could put pressure on local government employers at a time when they already have to make savings. Given the potential impact of cost-sharing, it is important that the Scottish Government and councils seek to reach an agreement on cost-sharing in time for the implementation of new employer rates following the next actuarial valuation.
45. The impact of recent reforms on contributions will not be quantified until the next round of actuarial valuations, which were intended to be completed in time for resultant changes to be introduced in April 2011 (police and firefighters) and April 2012 (NHS and teachers). They will also reflect more recent proposals from the UK government to alleviate cost pressures within all of the schemes. The valuations are not expected to be completed until 2012.

<sup>24</sup> *The impact of the 2007/08 changes to public service pensions*, National Audit Office, December 2010.

<sup>25</sup> The 2008 agreement for the reformed LGPS in Scotland included a commitment “that allows future changes in scheme costs to be shared equitably between employers and scheme members. Such a mechanism will be developed by 31 March 2010”.

## The UK government is further reforming pensions to reduce costs

46. In June 2010, the UK government asked a former Work and Pensions Secretary, Lord Hutton, to chair an Independent Public Service Pensions Commission. The Commission's remit is to conduct a fundamental structural review of public service pension provision and to make recommendations in time for the 2011 UK budget.
47. In its interim report in October 2010, the Commission concluded that there is a case for long-term structural reform.<sup>26</sup> It identified options to provide savings in the short-term and is now considering a range of alternative structures for the long-term, including moving to career average as an alternative to final salary schemes, and increasing retirement age.
48. The UK government has accepted the findings of the Commission's interim report and is committed to continue with a form of defined benefit pension. In the spending review in October 2010, it announced increases in employees' pension contributions aimed at achieving savings across the UK, rising from £1.1 billion a year in 2012/13 to £2.8 billion by 2014/15. These savings include savings from 'cap and share'.<sup>27</sup> This is broadly equivalent to a three per cent increase in the employees' contribution rate.
49. The UK government also announced that it will change the index used to increase pensions each year from the Retail Price Index (RPI) to the Consumer Prices Index (CPI).<sup>28</sup> Because the CPI usually increases at a lower rate than the RPI, over time this change is expected to reduce the value of a pension by around 15 per cent on average. It could also reduce public service pension expenditure by over ten per cent by 2030 and by 20 per cent by 2060.<sup>29</sup>

## The Scottish Government can influence pension scheme reform

50. The UK government is primarily responsible for setting policy for public sector pensions. Within this, responsibility for some policy aspects of five of the six main schemes in Scotland (all but the civil service), including aspects of scheme design, lies with Scottish ministers, or with Scottish ministers and HM Treasury ministers jointly. The SPPA advises the Scottish Government and ministers on these matters.
51. The Scottish Government has varying levels of discretion in modifying the changes to each pension scheme in Scotland:
- The **LGPS in Scotland** is separate from the equivalent schemes in England and Wales. The Scottish Government determines changes to the scheme in Scotland independently of the UK government, after negotiations with employers and trade unions. However, it is important that overall the benefits and the costs of the LGPS are reasonably consistent across the UK. For example, to facilitate workforce moves

<sup>26</sup> *Interim Report*, Independent Public Service Pensions Commission, October 2010.

<sup>27</sup> *2010 Spending Review*, HM Treasury, October 2010.

<sup>28</sup> The CPI excludes items such as mortgage repayments, TV licences, vehicle excise duty, trade union subscriptions and council tax.

<sup>29</sup> *Interim Report*, Independent Public Service Pensions Commission, October 2010.

the Scottish Government has regard to contribution rates in England and Wales when setting rates for the LGPS in Scotland. Differences between the Scottish scheme and those in England and Wales include a different system of tiered employees' contribution rates and the introduction of cost-sharing arrangements (but no cap) in Scotland. Scottish ministers also adopted a different timescale for phasing out early retirement in the LGPS under the 'rule of 85'.

- The **NHS and teachers' schemes in Scotland** are separate from the equivalent schemes in England and Wales. However, as with the LGPS it is important that overall costs and benefits are in line with the rest of the UK. Ultimately HM Treasury ministers and Scottish ministers must both approve changes to these schemes in Scotland. The SPPA, on behalf of the Scottish Government, is an observer at the negotiations for England and Wales. Changes made at the UK level are taken forward in Scotland through separate negotiations between the Scottish Government, employers and trade unions. However, the UK government has an ultimate veto over decisions taken in Scotland, should it choose to exercise it.
- The **police and firefighters' schemes** are UK-wide but administered at a local level. For any changes to them, the Scottish Government contributes to UK-level negotiations. The SPPA and Scottish Government Justice Directorate represent the Scottish Government at these negotiations.
- The **civil service scheme** operates at a UK level, although the Northern Ireland Assembly has a legally separate scheme. The Cabinet Office has overall management responsibility for its operation. The Scottish Government has no role in the operation of this scheme, although it must pay employers' contributions for its 17,500 employees who are members of the scheme.

52. The scale of the public sector in Scotland and the long-term cost of public sector pensions mean that the Scottish Government will need to consider how the UK government-led reform process can be implemented in Scotland.

## Recommendations

In considering how to respond to the findings of the Independent Public Services Pensions Commission, the Scottish Government should:

- provide a clear statement of the aims and objectives of the public pension schemes in Scotland
- ensure that it is meeting these aims and objectives by putting in place arrangements to scrutinise pension provision across the public sector in Scotland, within the context of other aspects of public sector pay and conditions; as part of this, consider increasing the role of experts to strengthen scrutiny and decision-making
- consider whether differences among schemes in areas such as contribution rates and level of benefits are necessary to realise the objectives of each scheme
- within the legal and financial constraints which apply, decide how best to incorporate changes made at a UK level into the equivalent Scottish schemes to meet its objectives for public pension schemes in Scotland.

# Part 3. The costs and governance of the five main unfunded schemes

## Key messages

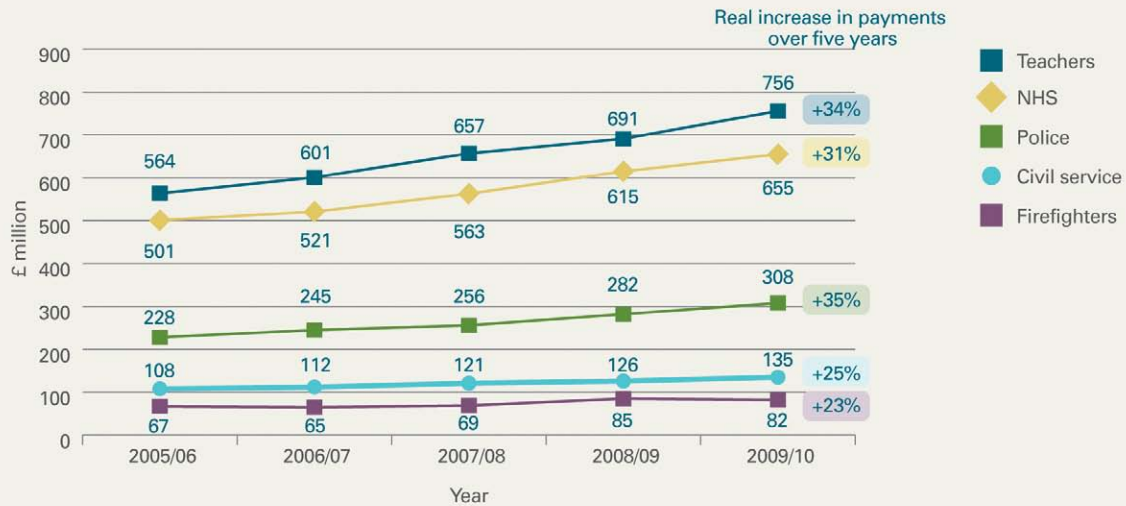
- In March 2010, there were 172,300 pensioners and dependants in the five main unfunded schemes, 13 per cent more than in 2005. Payments to pensioners and their dependants from the unfunded schemes have increased by 32 per cent in real terms over the past five years from £1,468 million to £1,936 million. This increase in pension payments reflects the increase in the numbers of pensioners combined with the underlying growth in pay over time.
- Employers' contributions in the unfunded schemes have increased by 15 per cent in real terms over the past five years, from £1,167 million to £1,338 million. However, the increase reflects underlying growth in employment and pay in the public sector. The cost of pension contributions for the three largest schemes has remained relatively constant at between 3.4 and 3.7 per cent of the Scottish budget.
- The SPPA has indicated that contribution rates for the largest unfunded schemes (teachers and NHS) may need to increase by two to four per cent of pay. Under the cap and share agreement this could lead to significant increases in employees' contributions. Recent decisions by the UK government should help to alleviate further the potential for increases in employers' contribution rates. However, the precise effect of these decisions and existing pressures on pension costs - and ultimately on the spending power of the Scottish budget - will not become apparent until later in 2011 or 2012.
- The governance arrangements for the unfunded schemes could be improved. Responsibilities are divided between many different bodies and it is unclear currently who is accountable and responsible for the overall effectiveness of the schemes.

## Pension payments are rising because there are more pensioners

- 53.** Payments to pensioners and their dependants for the unfunded schemes have increased by 32 per cent in real terms over the past five years from £1,468 million to £1,936 million (**Exhibit 7**). This increase in pension payments reflects an increase in the numbers of people reaching retirement combined with underlying pay growth over time.
- 54.** In March 2010, there were 172,300 pensioners and dependants in the five main unfunded schemes, 13 per cent more than in 2005. This increase is due to the earlier growth in public sector employment and because pensioners are living longer than had been forecast. In addition, the average payment to pensioners is increasing because newly retired pensioners have higher pensions reflecting earlier increases in pay. This is the result of long-term demographic change and decisions on public spending over many years and needs to be considered in this context.

**Exhibit 7**

Unfunded pension schemes – payments to pensioners and their dependants 2005–10 (real terms)  
 Payments have increased in all unfunded schemes by 32 per cent on average.



Note: Payments include pensions and lump sums. All figures adjusted to constant 2009/10 prices using the RPI.  
 Source: Audit Scotland

- 55. Spending on pensions includes both recurring expenditure on the annual pension and spending on one-off tax-free lump sums payable on retirement.<sup>30</sup> For all the unfunded schemes, lump sums have increased from around 20 per cent of total pension payments in 2005/06 to around 25 per cent in 2009/10. Spending on lump sums varies from around 21 per cent of the total in the NHS and teachers’ schemes to around 28 per cent in police and firefighters’. This may reflect differences in commutation rates. In the NHS, teachers’ and new firefighters’ schemes pensioners get £12 added to their lump sum for every pound of pension they give up, while in the old police and firefighters’ schemes this is around £17 because they retire earlier and are in effect giving up more pension.
- 56. For the NHS, teachers’ and civil service schemes, staff taking part of their pension as a lump sum represents a cost saving to the schemes as the cost is on average less than the expected amount of pension exchanged. In the police and firefighters’ schemes, the lump sum is calculated to be cost neutral.
- 57. The cost of pensions being paid will continue to rise. The SPPA estimates that total payments to pensioners for the NHS and teachers’ schemes will exceed employers’ and employees’ contributions after 2010/11. This gap is projected to rise to £489 million by 2014/15 (Exhibit 8, next page). There is also a risk that pension costs will increase further if the rate of inflation rises because pensions are increased annually by the rate of inflation.
- 58. The £1,936 million a year now spent on paying pensions of the five main unfunded schemes is a large public spending commitment. However, its impact on the spending power of the Scottish Government is affected by

<sup>30</sup> As noted in Part 1, under recent reforms of the schemes and following the Pensions Act 2006, pensioners have the right to swap up to a quarter of their annual pension for a lump sum.

the different budget arrangements for paying pensions for each scheme. HM Treasury pays the pensions of the (UK-wide) civil service scheme. Pensions for the remaining four unfunded schemes are paid from different parts of the Scottish budget. The Scottish budget is split into Annually Managed Expenditure (AME) and Departmental Expenditure Limits (DEL):

- Spending on **teachers' and NHS pension payments** is part of AME. AME accounts for around 15 per cent of the Scottish budget and contains those elements of expenditure that are not readily predictable. Under UK government funding policy, the Scottish Government is not normally required to find offsetting savings from elsewhere within its budgets to cover increases in AME.<sup>31</sup> Increased spending on teachers' and NHS pensions in the short term does not therefore immediately affect the Scottish Government's discretionary spending power.
- **Police and firefighters' pensions** are paid for out of DEL, which forms about 85 per cent of the Scottish Government's budget and include revenue and capital expenditure. DEL is included in the Barnett Formula and UK government spending decisions therefore determine the total DEL allocation.<sup>32</sup> The Scottish Government decides how to spend DEL. However, it has to fund any increased spending on police and firefighters' pensions, which directly affects its spending power.

### Exhibit 8

Projections of pension payments and contributions in the NHS, teachers' and civil service pension schemes  
The gap between contributions and pension payments is forecast to get bigger.



Source: SPPA projections to 2014/15 for the costs and cash flows of the Scottish teachers' and NHS pension schemes, HM Treasury projections for civil service scheme

<sup>31</sup> *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly Statement of Funding Policy*, HM Treasury, 2010.

<sup>32</sup> The Barnett Formula allocates Scotland a population share of changes in comparable spending programmes in England. For comparable expenditure, Scotland gets exactly the same £s per head increase as in England. Comparability is the extent to which services delivered by Whitehall departments correspond to services delivered by the devolved administrations. Barnett only applies to expenditure classified within DEL.



59. Classifying any spending between AME and DEL is not permanent and in the past spending has been switched between them. The effect of switching NHS and teachers' pension payments from AME to DEL would have a significant impact on the Scottish Government's spending power, although there are no plans to do so.

## Employers' pension contributions have increased in line with underlying employment costs

60. As noted in Part 1, employers and employees participating in each pension scheme must pay annual contributions to reflect the estimated long-term cost. For all five unfunded schemes, the employers' contributions fall directly on the Scottish budget (within DEL).
61. Total employers' contributions for the unfunded schemes increased by 15 per cent in real terms between 2005/06 and 2009/10, from £1,167 million to £1,388 million. Employees' contributions increased by 16 per cent in real terms from £469 million to £544 million over the same period. This reflects general pay growth and higher employment in the Scottish public sector. Total public sector pay costs for the Scottish Government and Scottish local government grew by ten per cent in real terms between 2005/06 and 2008/09.<sup>33</sup> Employment in the sector grew 3.3 per cent between 2005 and 2009, from 412,900 to 425,100 employees.<sup>34</sup>
62. When considering the overall affordability of public sector pensions it is important to put the increase in payments and contribution rates into the context of the general increase in Scottish Government expenditure over recent years. Pension payments to retired employees have risen from 8.4 per cent to 9.2 per cent of the Scottish budget over the past five years while employers' contributions for the three largest unfunded schemes fell from 3.7 per cent to 3.4 per cent. This is mainly because employers' contribution rates have remained relatively stable in the NHS and teachers' schemes.<sup>35</sup> Therefore the changes in pensions spending have been driven by employee numbers and pay trends, which have been increasing in line with the general growth in public spending.

## The reported liabilities of the five unfunded schemes have increased significantly over the last five years

63. In accounting for pensions cost, the principle is that an organisation should account for retirement benefits at the point at which it commits to paying them, even if actual payment will be made in future years.<sup>36</sup> For annual accounts purposes therefore, each scheme prepares an estimate of the long-term cost of meeting its pension undertakings.

<sup>33</sup> *Budget Cuts and Public Sector Pay in Scotland*, paper by Professor David Bell, May 2010.

<sup>34</sup> Public sector employment in Scotland, Scottish Government, June 2010.

<sup>35</sup> Employers' contributions in the teachers' scheme increased from 12.5 per cent to 13.5 per cent from 1 April 2007 and fell in the NHS scheme from 14 per cent to 13.5 per cent from 1 April 2009.

<sup>36</sup> The relevant accounting standards are International Accounting Standard 19 (Employee Benefits) for employers and International Accounting Standard 26 for pension schemes.

64. The reported pension liabilities for the five main unfunded schemes have increased significantly in real terms since 2006 (**Exhibit 9**). Some of this increase is a result of absolute changes in the liabilities – such as having to pay more because of increases in the numbers of members; increases in pay; and because of members living longer as a result of improving life expectancy. However, the main reason for recent increases has been changes in the financial assumptions that are used for the estimates. In particular, volatility in interest rates influence the discount rate that is used to estimate the reported pension liabilities each year.<sup>37</sup> Consequently, historically low interest rates have had the effect of sharply increasing pension liabilities reported in accounts over the past year.

### Exhibit 9

Changes in the reported pension liabilities of the five main unfunded schemes between 2006 and 2010 (real terms)

The reported liabilities of the five main schemes have increased by 45 per cent since 2006.

Scheme	Reported liabilities	
	as at 31 March 2006 (£ billion) <sup>1</sup>	as at 31 March 2010 (£ billion)
NHS	18.1	28.2
Teachers	16.3	24.4
Police	7.9	9.3
Firefighters	1.9	2.5
Civil service	3.4	4.6
<b>Total</b>	<b>47.6</b>	<b>69.0</b>

Notes:

1. Figures for 31 March 2006 adjusted to 31 March 2010 prices using the RPI.

2. The information was derived from the audited accounts of police and fire boards and from the pension scheme accounts for the NHS, teachers' and civil service schemes.

3. The main reason for the increases in liabilities has been changes in the financial assumptions that are used for the estimates.

4. The proposed change of basis for uprating pension payments from RPI to CPI (UK budget June 2010) is expected to reduce pension liabilities by between seven and ten per cent.

Source: Audit Scotland

65. Despite the increase in the reported liabilities of the unfunded schemes, the contribution rate set for them has remained largely constant. This reflects the fact that in setting contribution rates for these schemes actuaries must follow guidance from HM Treasury. This guidance prescribes the discount rate of 3.5 per cent a year in real terms and this rate has remained unchanged over the past five years. This rate is higher than the rate that is currently used for valuing pension liabilities in annual accounts, which for the 2009/10 accounts was typically 1.6–1.9 per cent a year in real terms.

<sup>37</sup> Like an interest rate, a discount rate is set as a percentage per year. It is applied when discounting future financial payments to a present value. A lower discount rate will therefore have the effect of increasing the reported value of future pension liabilities, although the liabilities themselves may remain the same.

66. If the discount rate set by HM Treasury for the unfunded schemes falls, the overall pension contribution rate will need to increase. The UK government has accepted the recommendation of the interim report of the Independent Public Service Pensions Commission to review the use of the current discount rate. This review is now under way and is expected to conclude in March 2011. The Commission estimated that reducing the discount rate by 0.5 per cent a year could increase overall pension contribution rates by about three per cent.

## The unfunded schemes are subject to continuing cost pressures

67. The latest actuarial reviews of pension schemes are due to be completed in 2012.<sup>38</sup> Although there is pressure to increase overall contribution rates, recent decisions by the UK government and other changes in policy will or may reduce any increase in costs for employers. In summary:

- In evidence to the Independent Public Service Pensions Commission, the SPPA indicated that demographic effects, including longer life expectancy, could increase overall contribution rates in Scotland by between two and four per cent of pay.
- In addition, there will be further pressure if changes are made to how actuaries evaluate the long-term cost of pensions (discount rates) as the Commission has suggested is necessary. This could increase required contributions by a further three per cent of pay.
- However, the UK government proposals in 2010 to change the index used to increase pensions every year from RPI to CPI and to raise employees' contributions by around three per cent will ease pressure on employers' contributions.

68. An increase in pension contribution rates for the unfunded schemes could bring the cap and share scheme into operation for NHS and teachers' pension schemes. The cap on employers' contributions is 14 per cent of pay for teachers, 15 per cent for NHS employees and 20 per cent for the civil service pension scheme.<sup>39</sup> Both employers' and employees' pension contributions may rise, although any rise to employers' contributions in the teachers' and NHS schemes is likely to be small (0.5 per cent or less) and may be partially limited by the cap. The bulk of any increase in contributions may therefore fall on employees. However, because the cap has not been tested it is difficult to assess the overall effect.

## Responsibility for pension decisions is shared between the UK and Scottish governments

69. Responsibility for public sector pensions in the UK is shared between the UK and devolved administrations. The UK government sets overall pensions policy, while in Scotland the Scottish Government, supported by

<sup>38</sup> Because of the changes in UK government policy in 2010 and the potential for further changes following the Independent Public Service Pension Commission's review, these valuations are no currently on hold.

<sup>39</sup> The caps for the NHS and teachers' schemes are linked to the employer rates in their counterpart schemes in England and Wales under HM Treasury-approved requirements.

the SPPA, has some influence on pension scheme design and reform, though its influence varies among the schemes.<sup>40</sup>

70. The SPPA directly administers the day-to-day operation of the two biggest unfunded schemes, for the NHS and teachers, by maintaining records of all members of these schemes, collecting contributions and paying pensions as they become due. It prepares accounts for each scheme it administers, which Scottish ministers must present to the Scottish Parliament. Lead councils administer most of the police and firefighters' schemes and will prepare separate accounts for the first time in 2010/11. The Cabinet Office administers the civil service scheme (**Exhibit 10**).

### Exhibit 10

Administration arrangements for unfunded pension schemes

The administration arrangements for unfunded pension schemes vary.

Scheme	Employers	Scheme administered by	Contribution rate set by	Pension paid by	Scheme accounts
NHS	NHS bodies	SPPA	Scottish ministers (with Treasury approval)	Scottish budget (AME)	Presented to the Scottish Parliament
Teachers	Councils				
Civil service	Scottish Government	Cabinet Office	UK Treasury	UK Treasury	UK accounts only
Police	Police boards	Seven administering councils and one police board <sup>1</sup>	Scottish ministers	Scottish budget (DEL)	A separate pensions account within the accounts of police and fire authorities
Firefighters	Fire boards	Eight administering councils			

Note: 1. Lothian and Borders Police Board administers its own scheme.  
Source: Audit Scotland

71. Separate to these policy and administration responsibilities, employers are responsible for certain local decisions, such as granting early and ill-health retirements. As employers, the Scottish Government, councils, NHS, fire and police boards bear the additional costs that arise if they allow staff to take early retirement. Scheme administrators calculate these costs, which are in addition to the normal contributions that employers must pay to meet the estimated cost of each scheme. This ensures that local managers take full financial responsibility for their pension decisions.
72. Responsibilities are also complicated because public sector pensions cannot be isolated from other aspects of pay and conditions for the workforce. They are subject to the natural differences in recruitment, reward and retention approaches that may arise between different jobs, employers and sectors.

<sup>40</sup> See paragraph 51 above.

73. Despite the complexity of these arrangements and the division of responsibilities there is no clear strategic framework in place to scrutinise pension provision across the whole public sector in Scotland. The level of spending across the Scottish budget is significant and, in principle, Scottish ministers are ultimately responsible. However, there is no single high-level forum of officials charged with specific responsibility for advising Scottish ministers on the effectiveness of the whole public sector pensions system or future strategic policy.
74. The SPPA's framework document indicates it has a relatively limited role in this respect.<sup>41</sup> It states: "Occupational pension policy is a reserved matter and HM Treasury directly fund most of the public service pension scheme costs. Therefore the role of Scottish ministers is to produce the detailed public service pension scheme regulations in the light of advice from the SPPA. This generally only extends to ensuring that scheme regulations are consistent with Scottish administrative and legal requirements whilst remaining in line with UK government pensions policy."
75. The SPPA supported the Scottish Government during the pension reforms that were completed in 2009. Further significant reforms will be made to the funding and administration of public sector pensions, which will affect the SPPA's workload.
76. The SPPA has an external management board. Its four members are externally appointed and the Scottish Government's Director General – Finance nominates its chair. The board advises the Chief Executive of the SPPA on the overall direction of the agency and seeks to support effective governance. For example, in 2010 it examined the SPPA's approach to benchmarking its work and improving efficiency. However, the board has no remit to examine questions about the wider effectiveness of pensions administration and governance in Scotland.
77. At the UK level, the Independent Public Sector Pensions Commission has highlighted the importance of clearly defining responsibility for pensions decisions. It will consider whether there is a case to introduce greater independent scrutiny and regular independent review of public sector pensions in its final report.

## SPPA governance is generally sound

78. The pension schemes that the SPPA administers or regulates are set out in statute and its work and responsibilities are summarised in its framework document as an agency. In addition, for each of the main schemes, the SPPA has established individual consultative advisory bodies with representatives from employers and trade unions affected. These act as a sounding board or may take a lead role concerning changes or potential changes to the main schemes.
79. The SPPA prepares and presents to the Scottish Parliament the annual accounts for the teachers' and NHS schemes and similarly prepares and presents its own accounts as an agency. These accounts are subject to annual audit by Audit Scotland on behalf of the Auditor General for Scotland.

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<sup>41</sup> *Framework Document 2008-11*, SPPA, May 2008.

- 80.** Audit Scotland's 2009/10 audit of the SPPA resulted in a clear audit certificate and concluded that its internal governance arrangements were generally satisfactory. However, while overall key controls were operating effectively there were some areas of the SPPA's activities with room for improvement. The auditor made recommendations about areas where control or governance should be improved. These included:
- The need to improve and provide greater assurance about data quality for pensions administration. There were issues including adjustments for missing records, multiple contracts and deferred members entitlement to refunds.
  - Currently there is no qualified actuary on the board of the SPPA. The auditor highlighted the complexities of revaluation and pension administration, the imminent revaluations of both the teachers' and NHS schemes and proposed reforms. The auditor recommended that the SPPA consider including an actuary in the next round of appointments to its board or seek actuarial expertise in another way.
- 81.** The SPPA regularly benchmarks the cost of its operations against other similar organisations. In 2008 it compared the pensions administration cost of the SPPA with other pension schemes and found that the SPPA administration costs, at £12.99 a member a year, were lower than those of similar schemes in local government and the private sector.

# Part 4. The costs and governance of the LGPS

## Key messages

- Local audits indicate that the 11 funds that make up the LGPS in Scotland are generally well administered, with the larger funds being examples of good governance. Governance in the smaller schemes is adequate but sometimes less well developed and risks occur where funds rely on a small number of staff. The Scottish Government is currently funding a COSLA project looking at the case for reducing the current funds to (potentially) two or three.
- In 2009/10 there were 141,400 LGPS pensioners, 11 per cent more than in 2005/06. Payments to LGPS pensioners and their dependants increased by 26 per cent in real terms over the last five years, from £667 million to £840 million a year. These higher costs do not represent an immediate demand on council budgets but do represent a significant underlying cost pressure.
- Over the last five years, employers' contributions to the 11 LGPS pension funds increased 25 per cent in real terms, from £667 million to £836 million a year. This reflects an increase of ten per cent in scheme members and general increases in pay, but there were also increases in the employers' contribution rates to the LGPS. The higher contribution rates reflect the need to meet higher than expected costs arising from people living longer than expected and poorer than expected pension fund investment performance in recent years.
- Further increases in employer contributions may be required from April 2012 to respond to cost pressures. Much depends on decisions to be made after the 2011 actuarial valuations, which are due to be completed early in 2012, and the possible effects of UK government policy decisions.

## The LGPS operates within a well-established governance system

**82.** Operating within a framework set out by the Scottish Government, responsibility for the management and investment of each LGPS fund rests with councillors sitting on a pensions committee in each of the 11 lead councils responsible. The responsibilities of each committee are considerable:

- The value of the investment assets in each fund individually ranges from £138 million to £10 billion.
- All investment activity carries risk. All the funds are advised by actuaries and other experts. Under pension scheme regulations set by the Scottish Government, each fund prepares and maintains a funding strategy statement and a statement of investment principles. They also prepare and publish triennial fund valuation reports and have a target of being 100% funded. From September 2011 they are also required to prepare governance compliance statements, indicating how they achieve good governance requirements. All of these requirements are intended to support the effective operations of each fund.

83. The Scottish Government makes the regulations for the LGPS based on regulations for the equivalent scheme within England and Wales. However, the SPPA does not act as a regulator as it has no oversight of pension administration or the management of pension funds in the 11 administering authorities.
84. Each of the 11 member funds that make up the LGPS in Scotland has been established for many years. Each fund administers its own day-to-day operations in areas such as maintaining members' records, collecting contributions and paying pensions once due. The LGPS:
- is the largest single public sector pension scheme in Scotland with currently more than 450,000 current pensioners and past and current employee members
  - provides pensions and related services to all 32 councils in Scotland and some 600 other employing organisations that under legislation may participate in it
  - has assets in management of more than £21 billion, including £5.5 billion invested in UK equities.
85. The funds are subject to internal and external audit. Before 2010/11, the activity of each fund was treated, for financial reporting and auditing purposes, as part of the lead council that administered it. However, from 2010/11, the Scottish Government requires that separate pension fund accounts will be published and subject to separate external audit and reporting. This will increase the transparency and accountability of the funds.
86. The financial audits of the 11 lead councils for the LGPS indicate that they are generally well managed. In particular, the larger Lothian and Strathclyde funds are examples of good practice. For example, both the Lothian and Strathclyde funds have won national pension fund of the year awards in UK-wide polls, which include funds of all sizes in both public and private sectors. Where audit issues do arise they tend to be in the smaller funds, in particular risks associated with succession planning where funds rely on a small number of staff.
87. The pension fund conveners interviewed during our fieldwork were experienced councillors and the pension fund committees operated in a non-partisan way. Fund conveners see good member training as essential to good pension fund management and all have taken steps to ensure that members are adequately trained.

## Payments to LGPS pensioners have been increasing

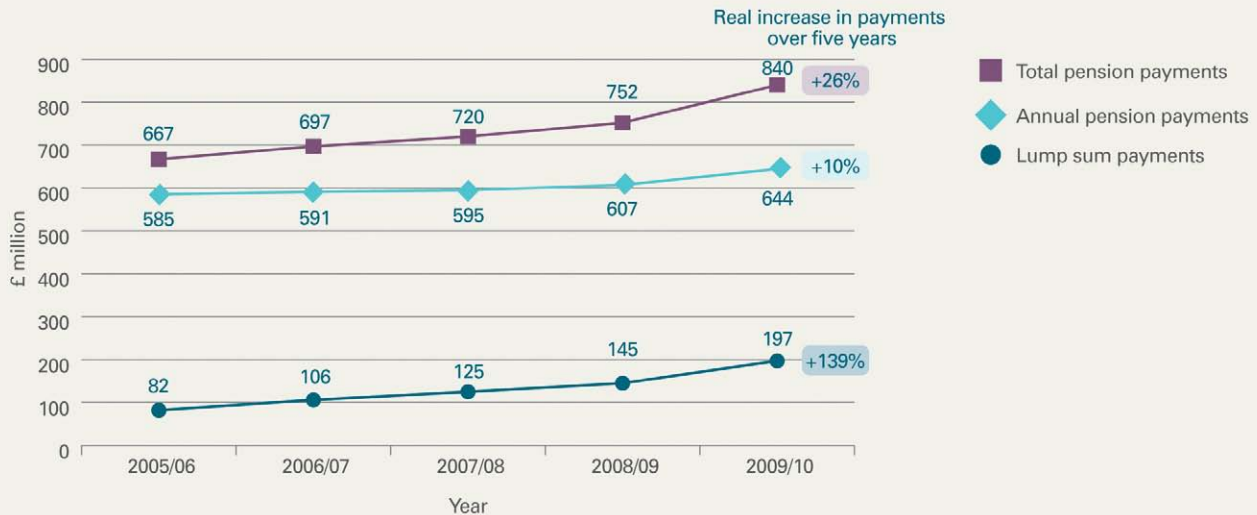
88. Between 2005/06 and 2009/10, payments to LGPS pensioners and their dependants increased by 26 per cent in real terms, from £667 million to £840 million (**Exhibit 11**). Over the same period the number of LGPS pensioners increased 11 per cent from 127,000 to 141,400. The increase in pension payments reflects a combination of demographic factors and growth in public sector employment and pay over time. This is broadly the same effect as for the unfunded schemes (Part 3).



**Exhibit 11**

Payments to LGPS pensioners and dependants 2005/06–2009/10 (real terms)

Total pension payments increased by 26 per cent over five years. Increasingly over the period, pensioners have exercised their right to swap some of their annual pension for lump sums.



Note: All figures adjusted to constant 2009/10 prices using the RPI.  
Source Audit Scotland survey of councils

89. The increased spending on LGPS pensions also reflects higher spending on one-off tax-free lump sums payable when employees retire. Pensioners have exercised their right to swap some of their annual pension for lump sums, introduced from 2006. Over the past five years the cost of these lump sums to the LGPS increased in real terms from £82 million to £197 million (139 per cent) while payments for annual pensions increased from £585 million to £644 million (ten per cent). Similar to the unfunded schemes, higher lump sums lead to more spending in the short term, but in the long term they may provide a cost saving to the LGPS as the cost is, on average, less than the expected amount of pension exchanged.
90. The LGPS as a funded scheme meets its pension payments from employers' and employees' contributions and investment returns. It currently achieves a cash surplus each year, which it retains and invests to help meet future pension costs. Because the LGPS is financed in this way, increasing payments to LGPS pensioners in any year do not represent a demand on the council budgets or on the Scottish or UK budgets. However, higher pension payments may reflect a longer-term cost pressure, which can result – and in the case of the LGPS has resulted – in increased costs for employers.

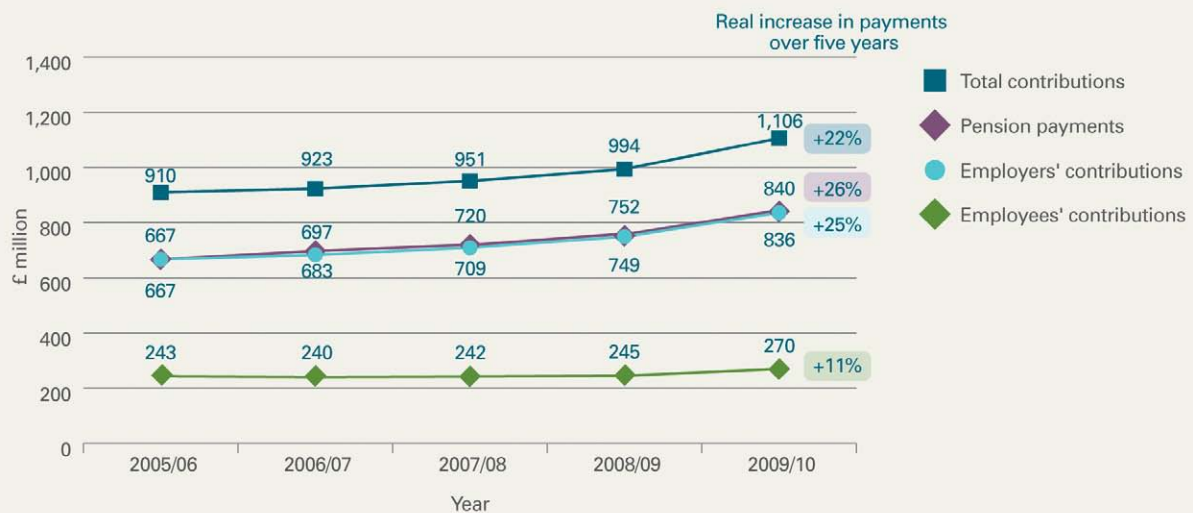
## Employers' contributions to the LGPS have increased by a quarter in the last five years

91. Employers and employees participating in the LGPS must pay annual contributions to meet its estimated long-term cost. These contributions have increased in recent years. Between 2005/06 and 2009/10 the total employers' contributions to the LGPS increased 25 per cent in real terms, from £667 million to £836 million. In the same period, employees' contributions also increased, by 11 per cent in real terms, from £243 million to £270 million. Total LGPS contributions comfortably exceeded pension payments (**Exhibit 12, next page**).

## Exhibit 12

Pension payments from and contributions to the LGPS 2005/06–2009/10 (real terms)

Growth in contributions has matched growth in pension payments.



### Notes:

1. All figures adjusted to constant 2009/10 prices using the RPI.

2. The level of pension payments each year is, coincidentally, almost exactly the same as the level of employers' contributions. However, there is no direct relationship between the two figures.

Source: Audit Scotland

## The LGPS has increased its employers' contribution rates

- 92.** The increase in contributions partly reflects an increase in the number of people employed in the sector and underlying pay growth over the period. In addition, however, the LGPS has increased contribution rates for employers. The median employer contribution rate increased from 16.2 per cent to 19.3 per cent of pay between 2002/03 and 2008/09.<sup>42</sup> The increase in rates reflects actuarial advice that higher charges were necessary to meet future costs in particular increasing liabilities. In broad terms, these higher charges are needed because people are living longer than previously forecast and to make up for poorer than expected pension fund investment performance. There was also recognition that in the 1990s the level of employers' contributions had been historically low and increases were needed to achieve a more sustainable rate.
- 93.** The cost of the contributions required by the LGPS fall on the operating budgets of each council. Increasing employers' contributions to the LGPS therefore represents a direct increase in costs for councils' budgets and for those of other employers within the LGPS.
- 94.** One of the aims of the reform of the LGPS was to secure a long-term reduction in employers' contribution to around 12–14 per cent of pay, excluding contributions to make good any funding shortfall. The reformed scheme is designed to achieve an employers' contribution rate of 13.3%. However, when and if this may be

<sup>42</sup> The 11 separate funds within the LGPS each set their own contribution rates for participating employers.

achieved is uncertain as some of the measures will only have an impact in the long term and cost pressures in the LGPS have been more severe than expected when the reforms were devised.

## The LGPS is subject to continuing cost pressures

- 95.** The next actuarial review of the LGPS funds is due to take place during 2011 and will set contribution rates for councils from April 2012. As with the unfunded schemes (Part 3), there is pressure to increase contribution rates for the LGPS. These cost pressures include demographic change. In addition, for the LGPS, fund actuaries may need to recommend higher rates to adjust for recent investment performance, if this has been lower than allowed for in previous reviews.
- 96.** The LGPS funds aim to deliver a long-term return on assets sufficient to meet the cost of future pensions. Their net cash flow is positive, for example the total pension contributions exceeded pension payments by £266 million in 2009/10 (**Exhibit 12**). Each LGPS fund invests the current surplus of contributions over pension payments to meet their future pension liabilities. The positive cash flow in the LGPS is expected to continue for some time into the future. The funds can therefore take a long-term view of investments and match the term and risk profile of their investments to their long-term liabilities.
- 97.** LGPS investments reduced in value as a result of the general and significant falls in stock markets in 2008/09, falling from £19.8 billion in March 2008 to £15.5 billion in March 2009. However, markets have recovered and the value of their assets was £21.5 billion at March 2010. General reductions in interest rates have affected the value of the liabilities of the LGPS that are reported in councils' accounts. Interest rates – in particular, the return on high-quality corporate bonds and government bonds – influence the discount rate that is used to estimate the reported pension liabilities each year.<sup>43</sup> Consequently, historically low interest rates have had the effect of sharply increasing liabilities in the LGPS that are reported in councils' accounts. In 2009/10, the estimated value of these liabilities had increased to almost £26 billion, significantly above the almost £17 billion estimated asset value. (**Exhibit 13, next page**).
- 98.** For the purposes of LGPS actuarial valuations and setting contribution rates, however, actuaries take a different approach to discounting that has a significant effect on the outcome. In particular, for these valuations actuaries apply a discount rate that reflects the expected rate of return on investments in each LGPS fund.<sup>44</sup> This results in the use of a higher discount rate than the one that is used for the purposes of valuing liabilities in the councils' annual accounts. Consequently, the liabilities have been estimated as having a lower value in the LGPS actuarial valuations than in the accounts. For example, Lothian Pension Fund's 2008 actuarial valuation assessed its funding level (the ratio of its total assets to total liabilities) at 85 per cent taking account of expected returns on investment. But the funding level based on the discount rate for the annual accounts would have been 64 per cent.

<sup>43</sup> Like an interest rate, a discount rate is set as a percentage per year. It is applied when discounting future financial payments to a present value. A lower discount rate will have the effect of increasing the reported value of future pension liabilities.

<sup>44</sup> Actuaries are required to take a prudent longer-term view when assessing the expected rate of return on each LGPS fund.

### Exhibit 13

#### LGPS reported assets and liabilities (councils only)

Fund assets have recovered significantly over the past year but reported liabilities have increased more because of changes in interest and discount rates.

	2007/08	2008/09	2009/10
Reported fund assets (£ billion)	15.1	12.3	16.9
Reported fund liabilities (£ billion)	16.5	15.5	25.8
Aggregate deficit (£ billion)	1.3	3.1	8.9
Funding level (ratio of assets to liabilities)	92%	79%	66%

Note: The difference between the assets reported in this table and in paragraph 97 is that the table covers only 32 councils and not the 600 or so admitted bodies. We have limited our analysis in this way because summary information about the pension liabilities of the admitted bodies is not readily available.

Source: Council accounts 2009/10

- 99.** The volatility in the level of reported assets and liabilities of the LGPS funds illustrated by **Exhibit 13** underlines the unavoidable yet substantial element of uncertainty and risk associated with pension provision in the long term. Significant swings in value can and have produced significant changes in the funding level, which in turn may affect the required contributions in the long term. This reinforces the importance of having thorough financial knowledge and expertise available to assist each fund in its operations and decisions.
- 100.** The pressures to increase contributions as a result of factors such as poorer investment performance and greater longevity will be offset to some extent by recent UK government decisions. These include changing the index used to increase pensions every year from RPI to CPI, which will reduce pension liabilities. The decision to raise employees' contributions by around three per cent will, of course, reduce the potential cost for employers.
- 101.** On the other hand, making up pension fund deficits will be more difficult if the expected five per cent real reduction in funding support to councils in 2011/12 translates into a similar reduction in councils' employees.<sup>45</sup> Although a reduction in workforce may reduce the total level of contributions for current service, the sum required to make up the existing pension fund shortfall would remain the same but would be shared across a smaller payroll, which will increase employers' contributions as a percentage of pay.
- 102.** The combined effect of these factors on the relative contributions to be paid by employers and employees in future is uncertain. To summarise:
- People living longer will lead to pressures to increase contributions rates by two to four per cent and any reductions in the workforce will increase contribution rates required to make up pension fund deficits.
  - The three per cent increase in employees' contributions announced by the UK government will alleviate these pressures for employers.

<sup>45</sup> *Scottish Spending Plans and Draft Budget 2011/12*, Scottish Government, November 2012.

- The change from RPI to CPI for the indexing of pensions will lead to reductions in benefits to scheme members of 15 per cent on average, but in doing so will also alleviate cost pressures for employers and employees.
- Uncertainties include pension fund investment performance, the detail of the cost-sharing agreement due to be implemented in March 2011 and the details of further pension reform to be announced before the UK budget.

## The pension pathfinder project suggests that the LGPS could be managed more efficiently

- 103.** The pension pathfinder project is looking at the rationalisation of the 11 pension funds that make up the LGPS in Scotland. The project arose from a partnership arrangement between the City of Edinburgh, Fife and Scottish Borders councils, funded by the Scottish Government under the Efficient Government agenda. Its aim was to consider opportunities to improve the management of the LGPS. This quickly developed to include potential opportunities across Scotland. A first phase high-level options appraisal completed in November 2009 found that there were “*strong arguments for creating larger pools of assets... through either a merger of funds or by creating a common investment fund*”.<sup>46</sup> **Exhibit 14 (next page)** shows the arguments for and against rationalisation of the LGPS.
- 104.** The main arguments for rationalising the LGPS relate to reducing the cost of professional investment advice and to risk and governance. In purely financial terms, the pathfinder suggested that administrative savings of some £11-13 million a year might be achieved from merging the funds. These arise from savings in both benefits administration (potential savings of £3 million a year compared to current costs across 11 funds of £11 million a year) and in investment management and administration expenses (potential savings of £8-10 million a year compared to current costs across 11 funds of £53 million a year). In addition, the risks identified by auditors of smaller funds relying on a small number of staff would be lessened.
- 105.** We discussed the scope for pension fund rationalisation with council members and officers during our fieldwork. Although some felt that the risks and transitional costs could outweigh the potential long-term benefits, others felt that there were considerable benefits in rationalisation of the funds.

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<sup>46</sup> *LGPS Pathfinder Project Options Appraisal*, Hymans Robertson, November 2009.

### Exhibit 14

#### Pensions pathfinder – arguments for and against LGPS rationalisation

The table outlines the high-level findings of phase one of the project. The second phase of detailed research will examine governance requirements and include detailed financial modelling.

Advantages identified by the review	Disadvantages identified by the review
Leave things as they are	
<ul style="list-style-type: none"> <li>✓ The systems for administering the LGPS are well established in Scotland.</li> <li>✓ The LGPS funds are on a good base and have good-quality investment management.</li> </ul>	<ul style="list-style-type: none"> <li>✗ Potential economies of scale are lost, contrary to the shared services agenda and the need for savings.</li> <li>✗ Some pensions funds are so small that there are significant key person risks, and training and development opportunities are limited.</li> <li>✗ Pensions investment is becoming more complex and the status quo may not support effective investment management in future.</li> </ul>
Full merger into two or three Scotland-wide local government pension funds	
<ul style="list-style-type: none"> <li>✓ The potential for councils to achieve savings through economies of scale in administration and savings in fund management fees.</li> <li>✓ The potential to reduce workload (as members move within Scotland it would not be necessary for them to leave one fund and join another with all the associated administration).</li> <li>✓ A consistent level of service across Scotland.</li> <li>✓ Clear separation of activity between pension fund and non-pension fund work.</li> <li>✓ Opportunities for specialisation of employees.</li> </ul>	<ul style="list-style-type: none"> <li>✗ Short-term set-up and transition costs for the new arrangements.</li> <li>✗ Implications for local governance – most lead councils would give up direct responsibility for managing the performance of their fund. A new system would need to identify what future governance and oversight should look like in practice.</li> </ul>
Centralise pension administration but leave pension fund investment as it is	
<ul style="list-style-type: none"> <li>✓ The potential for councils to achieve savings through economies of scale in administration.</li> <li>✓ Builds on existing and established local governance and oversight arrangements.</li> </ul>	<ul style="list-style-type: none"> <li>✗ Short-term set-up and transition costs for the new arrangements.</li> </ul>

Source: Audit Scotland, from pathfinder options appraisal report

- 106.** Following the initial research, COSLA is leading a second phase of detailed research to look at the most effective service delivery model for fund administration and to investigate what changes in fund governance would be required if fund administration was changed. The Scottish Government funds this project, which is being managed by the Improvement Service with participation from council and Scottish Government representatives. It is expected to report in early summer 2011.
- 107.** Any recommendation for change in the management of the LGPS made and approved following the second phase of research will take time to plan and implement. This will require the continued commitment and support of councils as well as the Scottish Government.

## Recommendation

In considering how to respond to the findings of the Independent Public Services Pensions Commission, the Scottish Government and councils should decide on the extent and pace of further reform of the LGPS. As part of this, they should have a clear policy on whether to set a cap on the level of future employers' contributions as a percentage of pay.

## Appendix 1. Glossary of pension and other technical terms

**Accrual rate** – the rate at which members earn their pension benefits in a **defined benefit** scheme. For every year worked a proportion of pay is earned as pension. For example, in a final salary pension scheme with an accrual rate of 60ths, someone retiring after 20 years would get a pension of one-third (20/60ths of their final salary).

**Actuarial valuation** – an assessment done by an actuary, usually every three or four years. The actuary will work out whether enough money is being paid into a pension scheme to pay pensions when due and assess whether **employees' and employers' contributions** are sufficient.

**Actuary** – an expert on pension scheme assets and liabilities, life expectancy and probabilities (the likelihood of things happening) for insurance purposes.

**Commutation** – a process by which pension scheme members swap some of their annual pension for a lump sum.

**Defined benefit pension** – an **occupational pension** where employee benefits are paid based on a formula using factors such as pay and length of employment. Investment risk falls on the employer.

**Defined contribution pension** (also called a money purchase scheme) – a certain amount or percentage of pay is set aside each year by an employer and employee and invested for the benefit of the employee. The amount contributed is fixed, but the benefit is not. There is no way to predict how much the pension will be worth upon retiring; therefore investment risk falls on the employee.

**Discounting** – a mathematical process that reduces amounts of money due to be paid or received at future dates to a present equivalent value expressed as a single sum. This reflects the fact that in general people value £1 received today more highly than £1 received at a future date (for example, because they could invest £1 received today to receive more than £1 in the future). Pension liabilities are valued using a set **discount rate** to estimate their future worth.

**Discount rate** – like an interest rate, a discount rate is set as a percentage per year. It is applied when **discounting** future financial payments to a present value. For example, at a discount rate of three per cent a year, £1 received in one year would be valued now at 97p. A lower discount rate will increase the reported value of future pension liabilities, although the liabilities themselves may remain the same.

**Employees' and employers' contributions** – money contributed by the employee and employer respectively to pay for pensions. **Contribution rates** are usually expressed as a percentage of the employees' pay.

**Funded pension scheme** – a scheme set up by an employer including a **pension fund**. Money that employees and employers provide in the form of contributions is set aside in a fund and invested to provide a return to help meet future pension liabilities.

**Lump sum** – a one-off payment of all or (more usually) part of an occupational pension. Lump sums usually form part of the retirement package, are paid on retirement and are tax-free.

**Occupational pension** – a pension created by an employer for the benefit of employees.

**Pension** – an arrangement to provide people with an income when they are no longer receiving a regular income from employment, usually when they have retired.

**Pension fund** – money set aside and invested so that money is available to pay future **pension liabilities**.

**Pension liability** – the obligation to pay current and retired members of a pension scheme their defined benefits from the date of retirement until death. A total liability at any given time is valued using the set **discount rate**.

**Pension shortfall** is where an employer offering a **defined benefit** pension does not have enough money in the **pension fund** to meet the pension obligations to employees who will retire in the future. This happens when investments such as equities perform poorly or where estimated **pension liabilities** increase more than expected. This shortfall is usually met by an increase in **employees' and employers' contribution rates**.

**Real terms** – figures that have been adjusted for changes in inflation, the effect of inflation has been removed to allow any underlying changes to be shown clearly.

**Unfunded pension scheme** – one where pension liabilities are paid for from the current **employees' and employers' contributions**, or from government funding. No money is put aside in a pension fund. Also known as a pay-as-you-go pension scheme.



## Appendix 2. Project advisory group

Audit Scotland would like to thank members of the project advisory group for their input and advice throughout the audit:

Professor Andrew Cairns, Professor of Financial Mathematics, Heriot-Watt University

Mr Chad Dawtry, Director of Policy, Strategy and Development, Scottish Public Pensions Agency

Mr David Dorward, Treasurer and Chief Executive, Dundee City Council (SOLACE)

Ms Sarah Fortune, Policy Manager (Finance), COSLA

Mr David Henderson, Scottish Government

Mr Richard McIndoe, Head of Pensions, Strathclyde Pension Fund, City of Glasgow Council

Ms Christine McLaughlin, Scottish Government

Ms Alison Murray, Chief Actuary, Glasgow Office, Government Actuaries Department

Ms Marjory Stewart, Director of Finance, Dundee City Council (CIPFA)

Mr John Wright, Head of Local Government, Hymans Robertson Actuaries

Note: Members of the project advisory group sat in an advisory capacity only. The content and conclusions of this report are the sole responsibility of Audit Scotland.

## Appendix 3. The six main public sector pension schemes in Scotland

Each of the six main schemes is established and regulated under separate legislation. All six schemes have been subject to reform in recent years. The arrows (→) indicate the direction of changes that have resulted

Scheme	Scheme type and negotiation arrangements			Recent pension reforms			
	Type of scheme	Employer	Terms & conditions negotiation	Year of last reform	Cap and share? (and cap per cent)	Accrual rate	Normal pension age
LGPS <sup>1</sup>	Funded, defined benefit	Councils (and 600 or so admitted bodies)	Scotland (COSLA, trade unions and Scottish Government)	April 2009	No	80 <sup>th</sup> plus lump sum → 60 <sup>th</sup>	65 (and rule of 85 phasing out) <sup>2</sup>
NHS	Unfunded, defined benefit	NHS (Scotland)	Scotland (but follow UK scheme)	April 2008	Yes 15%	80 <sup>th</sup> plus lump sum → 60 <sup>th</sup>	60 → 65
Teachers	Unfunded, defined benefit	Councils	Scotland (but follow UK scheme)	April 2007	Yes 14%	80 <sup>th</sup> plus lump sum → 60 <sup>th</sup>	60 → 65
Civil service <sup>3</sup>	Unfunded, defined benefit	UK civil service	UK-wide	July 2007	Yes, 20%	80 <sup>th</sup> plus lump sum → 60 <sup>th</sup> or 43 <sup>rd</sup>	60 → 65
Police	Unfunded, defined benefit	Police forces	UK-wide	April 2006	No	60 <sup>th</sup> plus lump sum → 70 <sup>th</sup>	50 <sup>4</sup> & 55 → 55
Firefighters	Unfunded, defined benefit	Fire and rescue services	UK-wide	April 2006	No	60 <sup>th</sup>	55 → 60

### Notes

1. The eleven LGPS funds are: Aberdeen; Borders; Dumfries & Galloway; Falkirk; Fife; Highland; Lothian; Shetland; Orkney; Strathclyde; and Tayside.

2. The normal pension age for the LGPS is 65; however until 2020 the rule of 85 allows employees aged 60 or more, with protected rights, who have a combined age and length of service of 85 years to retire with unreduced pension.

3. For the civil service there is a GB-wide pension scheme. We have estimated all figures for the civil service in this report based on members who work in the Scottish Administration being three per cent of the GB-wide total.

4. For the main police scheme officers may retire after 30 years with full pension. The minimum qualifying age for this is 48½ years.

5. For the police and firefighters' schemes, the employer contributions have been calculated as their pension payments minus employee contributions. This arrangement is changing for 2010/2011.

Scheme	Scheme membership at March 2010			Contribution rates		Scheme cost 2009/10 (£ millions)				
	Number of active members	Number of deferred members	Number of pensioners and dependants	Employers	Employees	Annual employees' contributions	Annual employer contributions	Total contributions	Pension payments (including lump sums)	Net cash flow (Total contributions less Pension payments)
LGPS	219,585	91,399	141,448	Typically 18-22%	6 → 5.5 - 12% (tiered by salary band)	£270m	£836m	£1,106m	£840m	£266m
NHS	161,600	63,504	75,353	13.5%	6 → 5 - 8.5% (tiered by salary band)	£299m	£581m	£879m	£655m	£222m
Teachers	78,765	27,083	59,153	14.9%	6.4%	£155m	£360m	£516m	£756m	-£240m
Civil service <sup>3</sup>	17,500	10,518	18,049	18.9%	1.5 → 3.5%	£12m	£85m	£97m	£135m	-£38m
Police	16,963	1,942	14,487	24.7%	11 → 9.5%	£63m	£245m <sup>5</sup>	£308m	£308m	0
Firefighters'	5,398	354	5,225	21.8% (old scheme) 11.5% (new scheme)	11 → 8.5%	£15m	£67m <sup>5</sup>	£82m	£82m	0
All schemes	499,811	194,800	313,715	-	-	£814m	£2,174m	£2,988m	£2,778m	£210m

# The cost of public sector pensions in Scotland

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ISBN 978 1 907916 14 4      AGS/2011/3

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