LIGHTHOUSEGROUP

LighthouseGroup
26 Throgmorton Street
London
EC2N 2AN

T: 0870 1977 400
F: 0870 1977 499
www.lighthousegroup.plc.uk

FEATURE ARTICLE

Date: **28th June 2011**

Issued by: **Andrew Gadd, Head of Research - Lighthouse Group**

The Hutton Report

Following the Government commissioned Report from the Independent Public Services Pension Commission, led by former Labour minister John Hutton on the subject of the future of final salary pension schemes, if you are a member of a Public Service pension scheme, such as the NHS Pension Scheme or Teacher's Scheme you can expect to see massive changes to your pension by 2015.
It must be noted however that at present the Hutton Report only represents recommendations and there aren't any final plans on the table yet but the report has set out a number of broad principles in relation to Public Sector Schemes that the Government has accepted.

In essence the biggest change proposed is that pensions should be calculated as a proportion of average salary over a career, rather than final salary. In addition the report also advocates that public sector workers pay more in and potentially work longer before receiving their pension.

It must however be noted that years of service already accumulated under existing terms are secure and cannot be withdrawn. Likewise, those who have retired will not see pensions cut. However, teachers and the broader public sector will see future rises in their pensions linked to the Consumer Prices Index not the Retail Prices Index.

How will Public Service pension schemes changes under Hutton's proposals?
Hutton's proposed changes are expected to come in by the end of the current Parliament i.e. 2015. As I have already said the biggest shift proposed by Hutton is a move from Public Sector pensions being final salary schemes (which pay a percentage of your final salary based on your years of service) to career average schemes (which are based on average pay across your career). (And at this stage Lord Hutton has not recommended the exact shape of the future career average schemes, he has left that up to the government.)

This proposed change will have the biggest impact on those who start off as low earners and work their way up to be high earners across their career (this has already been implemented for anyone

who joined the civil service after 2007). Lower-paid employees, and those whose salary stays relatively constant across their career, won't feel much impact.
In addition to reflect rising longevity Hutton has proposed that the public sector retirement age should rise in line with the state pension age. If implemented this will mean that by 2020, most public sector staff (excluding the police, members of the armed forces and fire fighters) will retire at 66.

Finally Hutton has also proposed ways to cap the cost of public sector pensions with “automatic stabilisers”. These would mean that as longevity in general increases, the pension age should either go up, or employee contributions should rise, or the accrual rate (how quickly you build up pension rights) should slow.

Why are public sector pensions being reformed?
The simple answer is that Public Service schemes are what are called “unfunded” schemes. This means that current contributions pay the pensions of current pensioners rather than being invested to provide pensions in the future.

This might not be a problem if it weren’t for the fact that currently over 10 million people in the UK are over 65 years old and the latest projections are for 5••• million more elderly people in 20 years time and the number will have nearly doubled to around 19 million by 2050. This means that in 2008 there were 3.2 people of working age for every person of pensionable age. This ratio is projected to fall to 2.8 by 2033. Which means that for many the cost of “unfunded” public sector pensions paid for by current taxpayers is unsustainable going forward.

Although some analysts argue that the cost is sustainable and to support this they refer to a graph in the Hutton Report that shows the cost of public sector pensions actually falling as a proportion of GDP over the next 50 years - see p23 of the Report. Costs peak around about now at around 2% of GDP (£32 billion a year), and then falls, even on the worst-case scenario, to closer to 1.4% of GDP. This reduction isn't however primarily due to the Hutton reforms but is, in fact, due to two other major reforms set to be put in place.

The first is a shift to higher employee contributions. The average public sector worker will have to start increasing their contributions by 3 percentage points (e.g. from 6% to 9%) on average by 2014/15, but this will vary across the board – this it is estimated will save around £2.8 billion a year.

The other reform is moving from using the Retail Price Index (RPI) to the Consumer Price Index (CPI) for future pension increases. Both track the changing cost of a basket of goods and services, from **3** food to travel fares, over the course of a year. The key difference between them is that RPI includes housing costs such as council tax and mortgage repayments. This means that CPI is typically lower than RPI in the figures that are produced monthly by the Office for National Statistics.

RPI, which started in 1947, has historically been the favoured measure of inflation used by Governments when calculating increases in pensions and various benefits each year. However, since its first “emergency” budget in June 2010 the Coalition Government has been introducing CPI as its favoured inflation measure. It claims CPI, which the Bank of England uses for its inflation target, better reflects the costs incurred by the typical household.

As I write this article CPI inflation is currently 4.0 per cent while RPI is 5.3 per cent and these are expected to fall to 2.5 per cent and 3.6 per cent from next year. But the difference between the two measures is expected to increase as interest rates rise. By 2015 RPI is forecast to be at 3.8 per cent which is forecast to be almost double the CPI rate of 2 per cent. The change from RPI to CPI is estimated to save £6 billion a year.

What is the effect on me as an individual who is a member of a Public Scheme?
That will really depend on your individual circumstances but a key point to note, as I said at the beginning of this article, is that these changes aren't proposed to be retrospective. All entitlements already accrued under your “old” scheme remain. So the closer someone is to retirement now, the less affected they'll be.

What should I do?
For individual advice I would recommend speaking to an Independent Financial Adviser to explore your options. It is important to remember that your retirement planning does not have to be solely through a pension scheme. It might, for example, be appropriate to use an Individual Saving Account (ISA) as part of your retirement strategy but ultimately please don’t put your head in the sand and simply hope that everything will be alright – do take some action to ensure that your retirement

Whilst Lighthouse Financial Advice has taken every effort to ensure that the above research is accurate, we cannot accept liability for any errors or omissions. In addition, it should be noted that the research does not constitute advice to invest, or not invest, in any product referred to above. This research is provided in order to assist our advisers to provide their clients with sufficient information on which to make an informed investment decision. The past performance of an investment provides no guarantee as to the future performance of the new funds. The value of unit prices can fall as well as rise and the return of your capital is not guarantee.

Lighthouse Financial Advice is a wholly owned subsidiary of Lighthouse Group Plc, the AIM listed largest autonomous IFA and wealth management group in the UK. Full details of Lighthouse Financial Advice, including regulatory authorisations, can be found at http://www.lighthousefa.co.uk, or by contacting:

General enquiries phone number: 08000 85 85 90

General enquiries email address: enquiries@lighthousefa.co.uk