The cost of public sector pensions in Scotland

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Summary

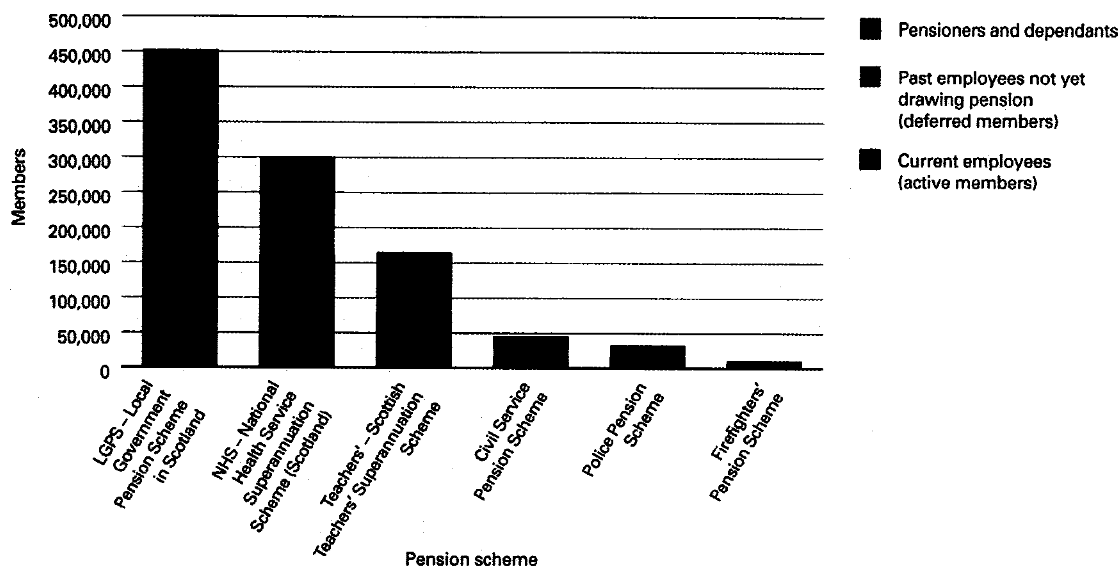
The context for public sector pensions

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".[1]

8. The UK spending review in October 2010 accepted the Commission's interim findings.[2] 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.

1 *Interim Report,* Independent Public Service Pensions Commission, October 2010.
2 *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.[3] 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.

3 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 put 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.[4] 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

[4] All figures for annual pension income exclude any lump sum payments – see paragraph 25.

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.

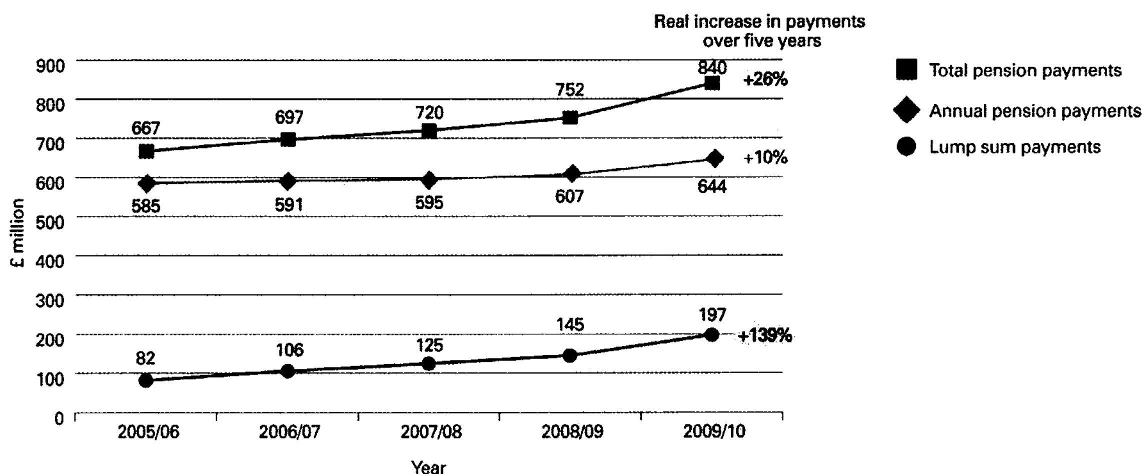
Payments to LGPS pensioners have been increasing

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

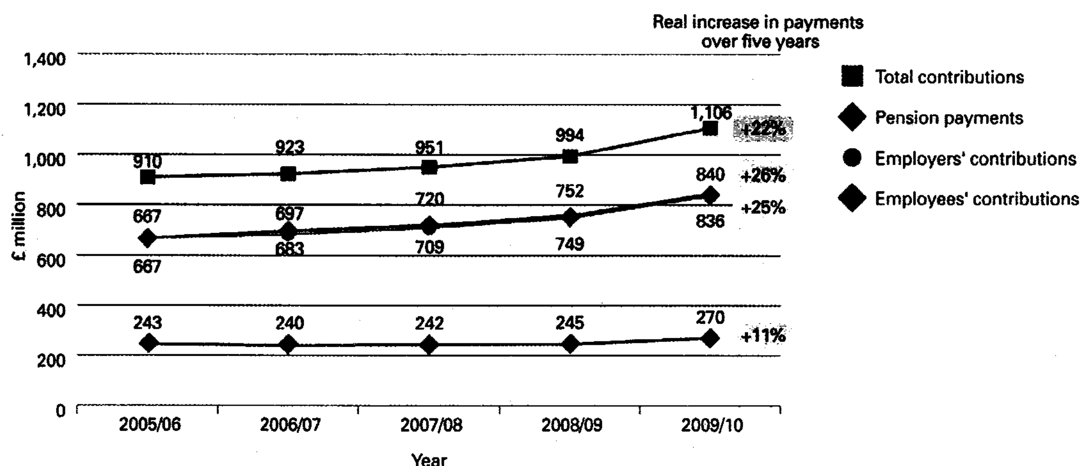
89. The increased spending on LGPS pensions also reflects higher spending on one-off tax-free lump sums payable when employees retire. Pensioners have exercised their right to swap some of their annual pension for lump sums, introduced from 2006. Over the past five years the cost of these lump sums to 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.[42] 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

[42] 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.[43] 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.[44] 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.

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[43] 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.

[44] 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
[illegible]	[illegible]	[illegible]	[illegible]
Reported fund liabilities (£ billion)	16.5	15.5	25.8
[illegible]	[illegible]	[illegible]	[illegible]
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.[45] 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.

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[45] *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*".[46] **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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[46] *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
[illegible]	
✓ The systems for administering the LGPS are well established in Scotland. ✓ The LGPS funds are on a good base and have good-quality investment management.	✗ Potential economies of scale are lost, contrary to the shared services agenda and the need for savings. ✗ Some pensions funds are so small that there are significant key person risks, and training and development opportunities are limited. ✗ Pensions investment is becoming more complex and the status quo may not support effective investment management in future.
[illegible]	
✓ The potential for councils to achieve savings through economies of scale in administration and savings in fund management fees. ✓ 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). ✓ A consistent level of service across Scotland. ✓ Clear separation of activity between pension fund and non-pension fund work. ✓ Opportunities for specialisation of employees.	✗ Short-term set-up and transition costs for the new arrangements. ✗ 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.
[illegible]	
✓ The potential for councils to achieve savings through economies of scale in administration. ✓ Builds on existing and established local governance and oversight arrangements.	✗ Short-term set-up and transition costs for the new arrangements.

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.