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Dear Terry

Local Government Pension Scheme reform

On behalf of CIPFA and the Panel, thank you again for the opportunity to meet with Bob Holloway and yourself over the course of the last few weeks to discuss in more detail the DCLG proposals for raising the 3.2% short-term savings as required by government and the longer-term scheme reform design principles.

Clearly events have moved on apace since the consultation on contribution rates was launched on 7 October and, as we have discussed previously, this issue and that of the longer term reform of the LGPS have reached the point at which it is perhaps more appropriate to look at both elements in the round.

Therefore rather respond to your 7 October letter on a point by point basis, I have set out below the broad principles which CIPFA believes should guide the decision-making process.

1. Any solution should seek to minimise the increase in employee contributions

In our previous submissions to the Hutton Commission and to DCLG, CIPFA has highlighted the potential impact that an increase in employee contribution rates may have on employee participation in the public sector pension schemes and the implications of any fall in membership on both the long term and short term public finances.

In the policy costings that accompanied the 2010 spending review, the Treasury took the view that "it is possible that a small number of individuals will choose to leave their pension scheme as a result of these changes, though given the generosity of the schemes there is little economic rationale to do so, and policy will be designed to mitigate these impacts." Consequently the costings assumed that opt-out rates would increase "equal to one per cent of total paybill".

In isolation, this assumption may well have held. However, in view of the other pressures on personal incomes in the public sector (pay restraint, benefit reductions, inflation at over 5% and tax increases), many public sector employees may already be considering whether they can afford pension scheme membership at current contribution rates. Notwithstanding the strong "economic rationale" for members to remain in the scheme and the protection being offered to the lower paid, the "affordability" issue singles out employee contribution increases as the one factor most likely to prompt members to consider opting out of the LGPS.

Whilst the options put forward by DCLG recognise this to an extent (insofar as the proposed contributions increases do not go as far as those proposed for the Teachers, NHS and PCSP schemes), experience on the ground in local government, trade union surveys and a weight of anecdotal evidence points to potential large scale opt-outs in response to the 1.5% increase proposed by DCLG.

Declining membership of the scheme has potential consequences for both the short-to medium term financing of the LGPS, as well as longer term consequences for the wider public finances.

Experience from the private sector strongly suggests that in recent years as employees have left occupational pension arrangements (such as where defined benefits schemes have been closed to future accrual) those members no longer accruing benefits have failed to opt into alternative pensions savings (see below).

Figure 1: Occupational and personal pension scheme trends

Source: ONS Occupational Pensions Schemes Annual Report (2009) and HMRC data(2001-02 to 2009-10)

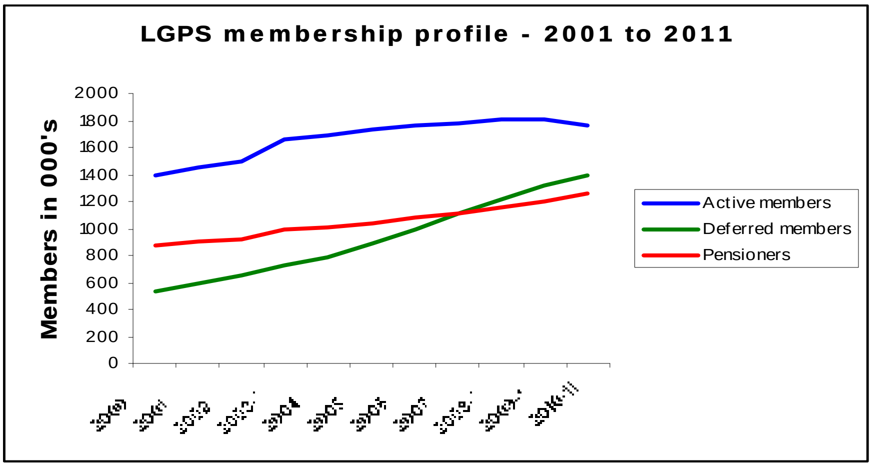
In fact personal pension savings has been in decline in cash terms since 2007-08, reducing at the rate of around £1 billion per annum, as the effects of the downturn on personal incomes has taken hold. There is therefore no particularly strong reason to believe that an LGPS member opting-out of the scheme would make alternative pension arrangements, particularly if the reason for opting out was on the basis of cost. This assertion is supported by the recent findings of the Strategic Society Centre[1] who found that most pension saving among employees is done through occupational schemes rather than personal pensions. About half of employees save into an occupational pension, while just over 7% save to a personal pension. Whilst auto-enrolment may address this decline, there remains considerable doubt as to how effective it will be in addressing the long-term decline in pension saving.

[1] Strategic Society Centre, *"Who saves for retirement"* – December 2011

In the longer term this failure to make adequate provision for income in retirement will result in far greater numbers falling back on state benefits in retirement, which might not have been the case had they remained in an occupational pension scheme. This is particularly apt in the case of the local government workforce which consists of a large percentage of low-paid/low earning employees, who are as such unlikely to have or undertake any form of significant additional pensions savings outside of the LGPS.

More immediately however, a decline in LGPS membership in response to a contributions increase would have a marked effect on scheme funding. It is already the case that the number of contributing members in the scheme has begun to decline, as the effect of the 145,000 jobs lost in local government in the last financial year takes hold. There is also evidence to suggest that, job losses apart, an increasing number of members are responding to a decline in real incomes (which the IFS forecasts will reach 7.4% for the 3 year period ending in March 2013) by boosting their disposable incomes through saving on pension contributions.

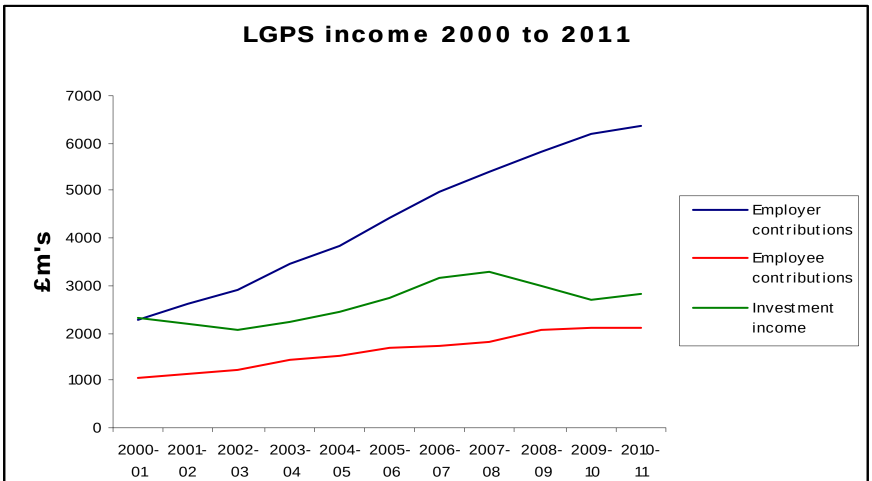
Figure 2



Source: DCLG SF3 data (England and Wales)

The effect of this changing profile is reflected in the financial position of pension funds across the country. Employee contributions peaked in 2009-10 at around £2bn and actually fell back slightly in 2010-11 (and have continued to fall throughout 2011).

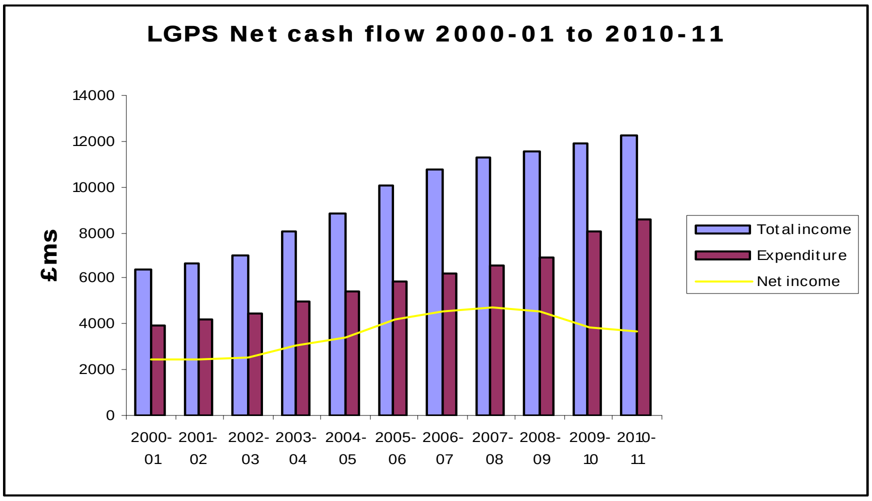
Figure 3



Source: DCLG SF3 data (England and Wales)

This fall in the overall contributions yield from employees has contributed to the decline in the net cash flow of the Local Government Pension Scheme.

Figure 4



Source: DCLG SF3 data (England and Wales)

Overall the positive net cash flow into the LGPS has fallen by 20% in the last two years and research by undertaken by CIPFA shows that this trend is likely to continue, and accelerate, into 2011-12.

Based on information supplied by local government pension funds across the country, employee contributions fell on average by 6.3% for the period April to September 2011 when compared with the same period in 2010, with gross employer contributions also falling by 3.4% (this despite an average 0.3% increase in the rate payable by employers and a significant increase in deficit recovery contributions following the last valuation in 2010). Overall the total contributions income in the LGPS is forecast to fall by around 4.2% in 2011-12.

With expenditure on existing pension benefits increasing by over 3% and retirements increasing as a consequence of workforce reductions, the positive net cash flow of the LGPS is set to fall below £3 billion in 2011-12.

With the Office for Budgetary Responsibility estimating that workforce reductions will now be 70% higher by 2016-17 than previously forecast, this downward trend is likely to continue at the same rate if not faster. Therefore within the space of 4-5 years, the average fund could be in negative cash flow, with some funds reaching this point even sooner.

At the point where income from contributions and investments is no longer sufficient to meet outgoings, the difference must be met from asset sales. As assets become a source for making pension payments, funds will be increasingly averse to investment strategies that put capital at risk and will move from higher risk, return-seeking investments (such as equities and hedge funds) to those which better match the funds liabilities and present lower risk (such as bonds and property). This in turn impacts upon the investment income the fund may hope to generate as the overall return on equity investments generally outperforms that on bonds. It also changes the assumptions that actuaries will use in determining employer contribution rates, as the assumed return on investments falls into line with bonds rather than equities (at the last valuation in 2010, this “equity outperformance” assumption added around 1.5% to the investment return assumption). A lower investment return assumption subsequently pushes up the amount employers will need to find to fund the scheme.

Given the current downward trend in fund income from contributions, opt-outs on the scale imagined by, for example, the GMB union (whose most recent survey of 1000 LGPS members suggested that up to 55% could opt-out of the scheme due to the cost pressures caused by increased contributions) would dramatically accelerate the decline in contributions. However it would take far fewer than this to opt-out to cause a net decrease in contributions. At around a 20% opt-out rate (spread evenly across the current membership), the additional contributions generated by a 1.5% increase would be out-weighed by the contributions lost through opt-out.

Contributions are already forecast to fall by 13% by March 2015 as a consequence of local government job losses as councils seek to live within the funding settlement set down in the spending review. Further falls due to increased opt-out rates will only serve to worsen the net cash flow position, bringing forward the point at which expenditure exceeds income and the scenario set out above begins to materialise.

Given HM Treasury’s acceptance that the funded nature of the LGPS allows for some latitude in the way in which the required savings can be delivered, we would therefore urge DCLG to consider carefully the potential impact of increasing employee contributions at this time and would recommend that, if an increase is necessary, other cost-saving options should be considered in order to minimise the level of the increase. A scenario which might achieve this is set out in Annex A.

2. Adequate implementation time should be allowed for any changes

As we have discussed previously and outlined in our letter of 2 November (copied at Annex B for ease of reference), the Panel is concerned at the short timescale envisaged for making potential changes to the contributions regime, potentially from 1 April 2012.

Based on the proposals as they stand, fund employers and scheme administrators would be faced with making significant system changes to accommodate both the new rates and expanded tiers (from 7 to 11) in a very short period of time. Whilst the transition from dual tier to salary-based, multiple tier contributions as part of the 2008 scheme changes was implemented effectively by LGPS administrators and scheme employers, this was achieved with the benefit of a full 12 months lead-in time. This allowed administrators and employers to plan, develop, test and implement the necessary changes to pensions administration and payroll systems.

The technical implications of updating and testing payroll software to be compliant with a new range of tiered contributions for the many thousands of LGPS employers and admitted bodies within such a short-timescale should not be underestimated. Undertaking this work at such short notice and not necessarily in tandem with other, routine software updating may command a premium from suppliers and present employers with unexpected costs at a time when local government resources are already considerably stretched.

In addition to the cost issues, the less time that is allowed for communicating the necessary changes to employers and for them to subsequently brief payroll providers to carry out the necessary changes, the greater the risk of error. In addition to the financial impact of potential under or over-payment of contributions, the risk that a 1 April 2012 implementation date presents will no doubt be factored into the auditors’

2012-13 risk assessment. Funds will be obliged to undertake significant assurance work to verify that the correct level of contributions has been received. It may also result in additional audit fees if additional audit work is also required.

We would suggest therefore that suggest that, should contribution changes be necessary in 2012, the implementation date be put back to at least 1 October 2012 to allow adequate time for the required changes to be made. We have incorporated this suggestion into the scenario at Annex A.

3. CLG should aim to minimise the number of scheme change "events"

As noted above, the issues of how the LGPS might raise the £900 million required by government and that of the longer term reform of the public sector pension schemes have reached the point at which it is perhaps more appropriate to look at both elements in the round.

This provides DCLG with the opportunity to consider the necessary changes as one package of measures that can be enacted at the same time. Such an approach would have a number of advantages over staging changes over a period of years. These are outlined below:

Communications

A single change event would simplify the necessary communications exercise that fund administrators will need to engage in to ensure that scheme employers and scheme members are properly informed of changes to the scheme. The meaning and consequences of a series of stepped changes may prove difficult to communicate effectively to scheme members at a time when there is a great deal of concern at member level over what these changes may mean to them individually.

Administrative changes

Co-ordinating the necessary system changes at both the employer and fund administrator end of the pensions process under one change event would avoid lengthy and repeated re-engineering of IT and administrative processes.

Cost-effectiveness

A process of change that spans several years will inevitably be more costly than a single change. The communications and change processes outlined above could also be delivered far more cost-effectively if scheme changes can be combined into one package with a shared implementation date.

Given that the Chief Secretary to the Treasury has indicated that a "single change" event approach may be possible, we would therefore recommend that this option be thoroughly explored.

4. Reductions in employer contribution rates (or deferral of planned increases in employer contribution rates) should be avoided until the outcome of the 2013 fund valuations have been fully evaluated

CIPFA understands that the one of the main drivers behind the government's aim to raise £900 million from changes to the LGPS is to allow that saving to be passed on to scheme employers in the form reduced contributions.

Whilst CIPFA recognizes that employers would no doubt welcome some easement on scheme contribution rates, we are concerned that that there remains considerable uncertainty as to whether savings generated through increased employee contributions would in fact be realized given the concerns on opt-out rates raised in 1 above. Given that the primary risk of the savings not being realized comes from the uncertainty of the level of income that might be generated through contribution increases, one way of reducing this risk would be to shift the emphasis onto other cost-saving measures (as we have set out in Annex A).

However having mitigated this risk to some extent, when one considers the considerable shift in scheme membership that is taking place (reducing active membership, increasing deferred and pensioner members) and the consequences that this has for scheme financing, and the deterioration in fund asset values and continuing volatility in world financial markets, it would still seem premature to reduce employer contributions until funds have a clearer position of their financial standing and what shape their future cashflows may be taking.

The scheduled 2013 valuation would provide the ideal opportunity for such a stock-take and would also allow scheme actuaries to evaluate the extent to which increases in employee contribution rates have been successful. This would then allow, if appropriate, any employer contribution rate “dividend” to be applied to contribution rates from April 2014.

I hope you find these observations useful and I and the Panel look forward to discussing this further with you soon. As ever, if you would like to discuss further any of the points raised, please do not hesitate to contact CIPFA via the Pensions Panel Secretary, Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

Bob Summers

Annex A

Further option for the £900 million cost savings in the Local Government Pension Scheme

The example below is based on the principles set out above, and using the same planning assumptions and costing approach as set out in the DCLG letter of 7 October. This is intended to be merely indicative of what might be achieved by utilising the cost-savings variables in one particular way and is offered as a potential alternative to those options proposed by DCLG and the LGA (in their 21 September submission).

	2012/13	2013/14	2014/15
	£m	£m	£m
Tariff increase (0.4% from 1 October 2012)[2]	60	120	120
Accrual rate change (60ths to 65ths)		450	450
Normal Pension Age (NPA) link to State Pension Age[3]		300	300
	60	900	900

Using the same contribution bands as suggested in the letter of 7 October, this would result in revised contribution rates as follows:

Tariff Band (%age of membership)	Current to 30 September 2012	From 1 October 2012
£0 - £12,900 (8.67%)	5.50%	5.50%
£12,901 - £15,100 (10.61%)	5.80%	5.80%
£15,101 - £19,400 (25.20%)	5.90%	5.93%
£19,401 - £21,000 (7.47%)	6.50%	6.58%
£21,101 - £32,400 (31.34%)	6.50%	6.76%
£32,401 - £43,300 (11.16%)	6.80%	7.17%
£43,301 - £60,000 (4.18%)	7.20%	7.63%
£60,001 - £81,100 (0.91%)	7.20%	7.81%
£81,101 - £100,000 (0.25%)	7.50%	8.30%
£100,001 - £150,000 (0.16%)	7.50%	8.57%
£150,000+ (0.05%)	7.50%	8.30%

[2] A 0.4% increase in contributions is suggested here as it allows the required savings to be balanced at £900 million once the other changes have been taken into account, based on the costings in the DCLG paper.

[3] The DCLG paper of 7 October indicates that GAD had calculated the saving from linking the LGPS NPA to SPA at £330 million. This calculation pre-dates the Chancellor's announcement in the Autumn statement that the State Pension Age will move to 67 between April 2026 and April 2028, 8 years earlier than planned. This will increase the potential saving if this option is adopted and may allow some further reduction in the necessary contribution increase or lessen the reduction in the accrual rate.

Annex B

2 November 2011

Terry Crossley
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Dear Terry

Local Government Pension Scheme reform

On behalf of CIPFA and the Panel, thank you again for the opportunity to meet with Bob and yourself to discuss in more detail the DCLG proposals for raising the 3.2% short-term savings as required by government and the longer-term scheme reform design principles. It was a very productive session and, as you suggested, it would be beneficial if this type of dialogue can routinely follow PRG meetings in future. Bob Summers and I will discuss how we can facilitate this, and will come back to you with proposals.

In the meantime, as agreed at the meeting, I have summarised below the key points arising from our discussions.

DCLG proposals for raising the 3.2% short-term savings

Throughout the reform process, CIPFA has consistently drawn attention to the risk reform poses to participation rates in the LGPS and the implications that increasing opt-out rates may have for both funds and the long-term public finances.

Fund cashflows are already feeling the effects of workload reductions, with the net position down by over 20% in the last two years and active membership falling to pre-2006 levels over the course of the last year.

We discussed the potential behavioural impact of the changes set out in the DCLG paper of 7 October and the consensus of the Panel is that, notwithstanding the strong "economic rationale" for members to remain in the scheme, the combination of pay restraint policy and wider economic factors singles out employee contribution increases as the single factor most likely to prompt members to consider opting out.

Whilst the options put forward by DCLG recognise this to an extent, insofar as the proposed contributions increases do not go as far as those proposed for the Teachers, NHS and PCSPS, the Panel believes that there remains considerable risk of opt-out even with a proposed average contribution increase of 1.5%. This is based upon experience on the ground and the weight of anecdotal evidence pointing to potential large scale opt-out in responses to contributions changes.

The Panel also drew attention to the considerable challenges posed by the timetable for enacting changes by April 2012. The technical implications of updating and testing payroll software to be compliant with a new range of tiered contributions for the many thousands of LGPS employers and admitted bodies within such a short-timescale should not be underestimated. It should also be noted that undertaking work as such short notice and not necessarily in tandem with other, routine software updating may command a premium from suppliers and present employers with unexpected costs.

Given the above the Panel feels that there may be merit in considering other options for achieving the required savings that mitigate the opt-out and timetabling risks, which may involve bringing forward some elements of the scheme reform package as an alternative to contribution increases.

However before we can detail specific proposals, we do feel that some detail and certainty on the scheme reform proposals is needed, as there is clear interaction between the two. Our thoughts on this are set out below.

Scheme reform

There are several areas of the scheme design/cost ceiling proposals where the Panel felt further information would be useful, particularly in framing a response to the DCLG proposals as discussed above. These are:

- What constitutes "accrued rights"?
- What is meant by "early and late retirement on a cost neutral basis"?
- Greater detail on transitional arrangements (this is particularly important given the Chief Secretary's announcement on protection for those "within 10 years of retirement")
- It would also be useful to the Panel if GAD could expand on some of the costings for items for negotiation within the cost ceiling, particularly the option to retain final salary (the cost of 0.1% appears low?).

I hope you find these comments useful and I and the Panel look forward to discussing this further with you soon, particularly in light of today's announcements by the Treasury. As ever, if you would like to discuss further any of the points raised, please do not hesitate to contact CIPFA via the Pensions Panel Secretary, Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

Bob Summers