Pension Fund Committee
Meeting to be held on 18 November 2011

Electoral Division affected: All

Consultation on proposed changes to the Local Government Pension Scheme
(Appendices 'A', 'B' and 'C' refer)

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Executive Summary

Following the publication of Lord Hutton's final report on the future of public service pension provision, the Government has been conducting talks with stakeholders in order to develop proposals for short-term changes to schemes in order to reduce the cost of schemes, and includes proposals to increase contribution rates averaging 3.2% of the pay bill.

In parallel to these discussions around short term changes to schemes, the Government has been developing the post 2015 reference scheme which will provide the template for schemes across the public sector.

Recognising the significantly different nature of the Local Government Pension Scheme (LGPS) as a funded scheme, the Government has facilitated separate discussions involving the Local Government Association (LGA) and Trades Unions to examine means of achieving the cost reductions required by Government without wholly relying on contribution increases which it is accepted would run the risk of increasing opt out rates, already higher in LGPS than other schemes.

Following these various discussions the LGA and Trades Unions have been unable to agree a package of measures and both the Government and LGA have now published proposals for change which the Department for Communities and Local Government (CLG) have included within a statutory consultation process, details of which are at Appendix 'A'.

The consultation period runs until 6 January 2012. Responses that include alternative proposals are specifically requested by 25 November 2011.

The background and advice section of this report provides a comprehensive appraisal of the proposals contained within the consultation, as well as a number of key principles that could be included within a potential response and alternative proposals to be made by the Committee. The draft response and alternative proposal are set out at Appendix 'B' and Appendix 'C' respectively.

Lancashire County Council

Recommendation

The Committee is asked to consider the proposed response from the Lancashire County Pension Fund, together with the alternative proposal, as set out at Appendix 'B' and Appendix 'C' respectively.

Background and Advice

Following the publication of Lord Hutton's final report on the future of public service pension provision, the Government has been conducting talks with stakeholders in order to develop proposals for short term changes to schemes including increases in contribution rates averaging 3.2% of the pay bill. Recognising the significantly different nature of the Local Government Pension Scheme (LGPS) as a funded scheme the Government has facilitated separate discussions involving the Local Government Association (LGA) and Trades Unions to examine means of achieving the cost reductions required by Government without wholly relying on contribution increases which it is accepted would run the risk of increasing opt out rates, already higher in LGPS than other schemes.

Following these various discussions the LGA and Trades Unions have been unable to agree a package of measures and both the Government and LGA have now published proposals for change which the Department for Communities and Local Government (CLG) have included within a statutory consultation process.

In parallel to these discussions around short term changes to schemes, the Government has been developing the post 2015 reference scheme which will provide the template for schemes across the public sector.

The Proposals Being Consulted On

The detail of the various proposals is set out in the consultation document at; http://www.communities.gov.uk/documents/localgovernment/pdf/2004147.pdf, which is attached at Appendix 'A'. In essence, both the CLG proposals and those of the LGA seek to achieve a reduction in the costs of the LGPS of £900m per annum through a combination of:

- Increasing employee contributions while protecting the lowest paid in order to reduce the risk of opt outs by the lowest paid members. Contributions for staff earning £19,000 - £40,000 currently range from 6.5% to 6.8% and could rise to 7.7% to 8.7% under one option and 6.8% to 8.2% under another.
- Changing the accrual rate on a phased basis, i.e. changing the rate at which scheme members build up benefits. This means that the pensions eventually paid will be smaller thus reducing liabilities and the required scale of employer contributions.

Within the consultation, specific reference is made to the point that it is expected that these savings be used to reduce employer contributions, rather than reduce the level of deficit on the scheme.

The Local Government Association has also published proposals, also set out within the document at Appendix 'A', which in addition to the above include:

- An early increase in the normal retirement age within the scheme to 66, from the current 65.
- The option for members to either pay an increased contribution for a pension based on the current accrual rate or to pay the same level of contribution as now but receive a smaller pension through a reduced accrual rate.

Although the fundamental issue is the future shape of the LGPs and its affordability, it should be noted that both of these approaches contain significant administrative challenges in terms of implementation. .

The Government have asked for consultees to come forward with alternatives to their suggestions. However, CLG officials have suggested that ministers are very unlikely to accept any alternative that does not include some element of increases in employee contributions.

The Impact of the Cost Reductions on the Fund and Employers

Within the consultation document CLG indicate that they will consider including provision for scheme actuaries to issue new rates and contributions certificates between formal valuations. This would then allow an employer to benefit from reduced contributions as soon as the increases in employee contributions and changes in scheme design come in. However, when questioned CLG officials accept that within the LGPS, the situation is, in fact, far more complex than simply trading employer contributions for employee contributions.

Funds remain in deficit, and given the significant recent volatility in bond yields and the ongoing global economic challenge, these deficits are likely to have significantly increased since the 2010 valuation. Given these circumstances it would not be prudent for the Fund to allow an overall reduction in employer contributions. The most prudent course would be to change the balance within the contributions set at the 2010 valuation between future service and deficit recovery. This could also serve to minimise turbulence in contribution rates at the 2013 valuation. Clearly this is an area where the interests of employers and the Fund might diverge.

The Issue of Opt Outs

On average 25% of eligible employees do not take up membership of the LGPS, a figure around 10% higher than the average for the public sector generally. It is thought that this reflects the fact that on average the local government workforce is lower paid than other parts of the public sector, while average contribution rates in the scheme are higher than in other public sector schemes.

The potential for an increased rate of opt outs as a result of increases in employee contributions represents a significant risk for Funds, particularly when coupled with the impact of workforce reductions. It is likely that the combination of these factors will result in Funds becoming "cash flow negative" much earlier than previously anticipated (i.e. Funds will need to use investment income to pay benefits). A reduction in active member numbers of perhaps only 10% might well be enough to put the Lancashire County Pension Fund into a cash flow negative position.

The proposals by both CLG and the LGA seek to reduce the risks of additional opt outs by weighting contribution increases to the higher paid. Certainly, all other things being equal, this measure may have the desired effect for the lower-paid groups. However, even with this level of protection to employees earning under £21,000, there remains significant concern across local government commentators that further reducing take home pay during the current economic climate, which for local government staff includes inflation at 5% together with a two year pay freeze, will increase opt out rates further.

This may be mitigated by the impact of auto enrolment, however this is impossible to quantify.

There is also considerable concern over the impact of increased contributions on those earning £21,000 to £40,000, which is the pay range which contains most of local government's non-manual graduate workforce, including staff such as planners, social workers and engineers. In addition to the impact of the pay freeze, this group will also be affected by other elements of government policy, particularly the increase in university tuition fees. This impact cannot be quantified but clearly there is a significant risk. It may be that this could be addressed through some form of age related "low start" rate which could be incorporated in the design of the post 2015 scheme.

In order to minimise the number of opt outs, Funds will need very quickly to develop positive promotional campaigns which emphasise that whatever the changes eventually agreed LGPS will still provide a much better than average benefits package.

Alternatives to the Proposals on the Table

It would be possible to develop alternatives to either the CLG or LGA proposals which do not involve increases in employee contributions. This could be achieved either solely through changes to the accrual rate or through a combination of this and the LGA's proposed change to the normal retirement age. It is suggested that this approach would minimise the level of opt outs. However, as we have been led to believe that ministers would not accept an option which does not include some increase in employee contributions, it has been suggested that it would not be productive to devote resources to developing proposals of this nature.

There are though further options within the overall framework suggested by both CLG and the LGA which could be developed.

In terms of a package that seeks to address the risk of opt out, it is considered that by reducing the accrual rate much earlier, with a smaller increase in employee contributions would seem to offer a viable approach. This also has the benefit of being deliverable in administrative terms.

While the earlier increase in the normal retirement age put forward by the LGA significantly reduces the costs of the scheme, it would seem more appropriate that this change be made at the same time as the phased increase in the state pension age, which the post 2015 reference scheme will need to mirror.

Conclusion

It is clear that there are no easy solutions in terms of the shorter term changes proposed by the Government in order to reduce the cost of public sector pensions. From the point of view of the Lancashire County Pension Fund, as opposed to any employer, the following represent the suggested key points of a response (see Appendix 'B') and an alternative proposal (see Appendix 'C'):

1. The fact that Funds are operating with deficits must be recognised and any reduction in employer contributions should be considered at the next valuation, which will take into account the overall position of the Funds.

2. Any proposals for change from April 2012 need to minimise the risk of increased levels of opt out from the scheme.

3. Any proposals for change from April 2012 need to be administratively deliverable.

4. The preference of the Fund would be for a series of changes which do not require increases in employee contributions which at the current level are already higher than in many public sector schemes where average member earnings are higher than in LGPS.

5. Given that Ministers are likely to view options which do not increase employee contributions unfavourably, a proposal which balances all of these objectives would be to make changes to accrual rates from April 2013 with any accompanying increase in employee contributions structured so as to protect the lowest paid.

6. Some of the additional "savings" from an earlier move to a reduced accrual rate should be used to reduce the level of increase in employee contributions for members earning in the range £21,000 to £40,000, which is the group where the risk of further opt outs seems most likely.

Consultations

Consultees' views on the proposals are formally sought by **6 January 2012**. Consultees who wished to submit alternative proposals were invited to signal their intention to do so by **28 October** with any specific costed options having to be submitted by no later than **25 November.**

Implications:

This item has the following implications, as indicated:

Risk management

The risks are set out in the report.

Financial

An increased rate of opt outs as a result of increasing employee contributions represents a significant risk for the Lancashire County Pension Fund, particularly when coupled with the impact of recent workforce reductions. It is likely that the combination of these factors will result in a "cash flow negative" position much earlier than previously anticipated, i.e. investment income will need to be used to pay benefits. A reduction in member numbers of around 10% may be put the Lancashire County Pension Fund into a cash flow negative position

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Directorate/Tel
http://www.communities.gov.uk/documents/localgovernment/pdf/2004147.pdf	7 October 2011	George Graham, 01772 538102, County Treasurers Department, george.graham@lancashire.gov.uk

Reason for inclusion in Part II, if appropriate

N/A