



**London Pension Fund Authority
Chief Executive**

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Lord Hutton
Independent Public Service Pensions Commission
Room 1/04
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Dear Lord Hutton

INDEPENDENT PUBLIC SERVICE PENSION COMMISSION

Thank you for your letter of 2 July. You have an awesome task! We should be glad to help in any way we can (e.g. on numbers and technicalities)

I attach:

- a paper setting the initial responses of the London Pensions Fund Authority to the questions/issues you are raising for the first phase of your work
- our recently published Green Paper on the reform of public sector pensions schemes.

LPFA has been heavily involved over the last nine months in raising the level of debate about the future of the Local Government Pension Scheme (LGPS) in the context of fairness and affordability. Such involvement has included;

- Keynote speeches at major pensions and Local Government conferences
- High profile coverage in both the national and industry press
- Hosting a symposium on the subject in February of this year at City Hall, London
- Hosting a subject specific website www.affordable-lgps.org.uk
- Investigating alternative and successful solutions such as the Dutch public sector scheme
- Publishing a green paper entitled a fair and affordable LGPS

Our aim throughout has been to promote a recognition that change is necessary whilst challenging some of the unsubstantiated and potentially misleading coverage that has appeared in some parts of the press.

The questions raised whilst we have been promoting the debate are very similar to those you are now faced with namely;

- What does the government's commitment to the preservation of accrued rights mean?
- What is a decent income in retirement?
- How to ensure the long term affordability for the provision of a decent pension?

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- How to address the apparent unfairness of higher earners' pensions?
- Should the benefits paid be dependent on the fund income, namely employer (taxpayer) contributions and the investment returns of funded pension?
- Is the current balance between employer and employee contributions right?
- How do we stop the LGPS being put in the same box as the unfunded schemes which have different issues?
- How to address the significant imbalance in public and private sector pension provision whilst recognising the historically opposite imbalance in the total remuneration package?
- How to negate the effect of short term political expediency on a long term need?

In dealing with these questions LPFA has come to the view that the LGPS needs to change in order to deliver a decent pension that is fair on the taxpayer, relevant to the needs of members in the 21st century and affordable in the long term. The paper attached outlines our proposals for achieving this aim and I commend it to you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mike Taylor', with a long horizontal flourish extending to the right.

Mike Taylor
Chief Executive



A fair and affordable LGPS – LPFA’s proposals

The Remit

In your letter of 2nd July you ask for views on the following;

- Affordability, fairness, impact on mobility and plurality of current public service provision of the current public sector pension schemes and;
- The objectives that should guide public service pension in future.

‘In addition, as set out in the terms of reference, I have been asked to consider the case for delivering savings on public service pension ahead of the Government’s spending review. I would welcome any thoughts or observations on whether given the long term nature of structural reform there is a case for more immediate action on public service pensions, in the context of affordability and fairness, and if so, what options there might be to deliver savings within the spending review period.’

This paper also seeks address the terms of reference of the Commission which are;

- To conduct a fundamental structural review of public service pension provision and to make recommendations to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead, while protecting accrued rights.

In reaching its recommendations, the Commission is to have regard to:

- the growing disparity between public service and private sector pension provision, in the context of the overall reward package – including the impact on labour market mobility between public and private sectors and pensions as a barrier to greater plurality of provision of public services;
- the needs of public service employers in terms of recruitment and retention;
- the need to ensure that future provision is fair across the workforce;
- how risk should be shared between the taxpayer and employee;
- which organisations should have access to public service schemes;
- implementation and transitional arrangements for any recommendations; and
- wider Government policy to encourage adequate saving for retirement and longer working lives.



The Response

1. LPFA have already made a significant contribution toward the debate via our green paper 'a fair and affordable LGPS' (attached). This paper promotes the concept of the independent pensions chamber to 'take the politics out of pensions' and ensure the future affordability of the scheme by adjusting, as required, for future increases in longevity and investment returns:
 - The benefit structure (e.g. accrual rates)
 - Employee contributions
 - Retirement age
 - Indexation
2. This paper aims to put that proposal into the context of the remit of the commission. Although we concentrate on the LGPS, as our area of experience and expertise, we believe similar principles are also applicable to the unfunded public sector schemes. The paper also identifies some quick wins that will contribute to the spending review and explores the options for a scheme that will meet the needs of taxpayers and members in the 21st century.

Quick wins

3. These should take the form of provisions which are as simple as possible to implement whilst having the maximum immediate impact on the liabilities and therefore employer contribution rates via the current valuation. All LGPS schemes in England are currently undergoing the statutory triennial valuation as at 31 March 2010. Changes announced now can be taken account of by actuaries so that the implications can be reflected in budgets for 2011/12.
4. First, cut the long-term liabilities of pension schemes, by announcing in September changes to the scheme effective from next April which actuaries can then take into account when determining the results of the current valuation. The lower the liabilities, the less the pressure to increase total contributions. The aim would be to keep total contributions at no more than current levels, and if possible, lower. Cuts in liabilities can be achieved through a cocktail of the following measures:



- **Application of CPI indexation to LGPS pensions in payment and deferred pensions** – easy to put in place via the Pensions Increase order and can be taken into account this valuation. Already signalled by the Chancellor in the budget so no surprise. Overall, liabilities are likely to fall by an average 10% as a result of the change from RPI to CPI indexation
 - **Increase in retirement age to 66 from 2016** in line with planned increases to State Retirement Ages, and linked thereto for the future. Again a minor amendment to regulations and not a surprise to anyone. Also many low paid staff will not be able to retire until they are eligible for their state pension so 66 will be the de facto retirement age for many
 - **Adjustment of future accrual rates – say move to 65ths** rather than 60ths. More controversial than the above and may be seen as tinkering prior to a new scheme being implemented
 - **Cap on pensionable pay** – limit to £75,000 or £100,000 – may be good politics and appease the unions but won't save much money
 - Commitment to protect existing rights via a **CPI indexed preserved benefit** when introducing a revised scheme – clarifies what is meant by retained rights but also allows actuaries to take a more certain view of the future cost of past service. Also ensures the issue is dealt with before discussions on a new scheme (* see paragraphs 16 to 19 for more on this matter)
5. Second, in the context of the spending review, immediately increase employee contributions and/or pare down tax breaks to reduce employer (taxpayer) contributions. Any increase in employee contributions should be skewed to protect low earners who might otherwise choose to opt out of the scheme.
 6. The net result of implementing these proposals should be a reduction in employer contribution rates flowing from the results of the 2010 valuation and therefore an immediate effect in terms of local authority spending requirements for 2011/12 budgets and future years.



A new scheme

7. We have already suggested that a chamber be put in place to implement and maintain the LGPS but what kind of scheme could it be given the remit of the commission?

Affordability

8. There are two key elements here; firstly determine an objective benefit level that is affordable now, then ensure there are mechanisms in place to maintain that affordability without a long winded and politically vulnerable process. The first element is addressed by the quick wins identified above together with the proposals in the following paragraphs.
9. The second element, the continued affordability of the scheme, is addressed by LPFA's suggestion of an independent chamber adjusting future contributions, benefits, retirement age and indexation to best meet the objectives of the scheme whilst remaining within predetermined affordability parameters.

Fairness

10. There are two aspects to this within the scheme and across industries. The first is dealt with by a move to Career Average rather than final salary, as the current final salary approach disproportionately benefits long serving high earners.
11. The second is less easy to deal with as the reduction in good private sector schemes in recent years has brought about a short term disparity between the private and public sectors. One point to bear in mind is the short term nature of the difference and that over the last 10 or 20 years the private sector package has been worth much more than that in the public sector.
12. However we must accept political reality and ensure that the gap between public and private sector provision is minimised. This will be achieved by the significant and understandable changes outlined in this paper.
13. The whole issue of the negative effects FRS17 has had on provision of decent pensions in the private sector (and on some employers within the LGPS) needs to be addressed. This is no doubt outside of the remit of the commission but is a major contributor to the disparity in pension provision. The use of spot interest rates to discount liabilities up to 60 years ahead is not logical and has had severe unintended consequences.



Mobility/Plurality

14. The question has often been raised of why there are so many schemes in the public sector and doesn't this make it hard to move between areas within the sector? Of course some areas have different needs (e.g. fast accrual rates and excellent health benefits in the armed and uniformed services) but that alone cannot account for the myriad of schemes.
15. History no doubt plays a part, as has the treatment of retained rights which means that even if the new schemes are brought closer together, there would still be a legacy of retained benefits under different rules, so what is the point?
16. By crystallising retained rights via a preserved benefit, the issue of complexity can be removed (reducing long term administration costs as a side effect) and the costs capped. Using this method will enable schemes to move much closer together and could enable the merger of some of the non-funded schemes, enabling greater mobility and reducing plurality.
17. The issue of retained rights is particularly important when considering significant changes to a pension scheme. Firstly unless the protection of such rights is clearly defined there will be confusion amongst the membership and the possibility of industrial action over what may appear to be semantics.
18. Secondly different definitions of protection will lead to different costs being carried forward into the new scheme. For example, protected service up to a date that will still have a benefit calculated on final salary is significantly more expensive than calculating the benefit at the preservation date then indexing its value by CPI. Even if the preserved benefit route is used, there remain questions such as should the original unreduced scheme retirement age apply to those benefits or that which applies to the new scheme?
19. LPFA's view is that a strict definition of retained rights should be implemented reducing the uncertainty of future costs as much as possible. By doing so existing scheme members will make some contribution to the past service deficit which weighs so heavily on most funds. Also, such a 'clean break' approach will enable significant savings to be made on administration costs once the initial preserved benefit calculations have been completed.



Risk

20. Linked to the fairness issue, there is a question to what point, if any, should the taxpayer guarantee the benefits to be paid? At one extreme, a wholesale change to Defined Contribution arrangements could remove all risks to the taxpayer. However, we do not believe this is in the interests of scheme members or society as a whole. The answer should lie in the debate over what the minimum level of income in retirement should be which is good for society as a whole. Up to that point it makes sense for a taxpayer guarantee to be in place, beyond that the case is less easy to make if at all possible. Therefore some form of cap on the guaranteed element of the pension would seem sensible. Beyond that point the risk would fall entirely on the individual through top-up Defined Contribution arrangements or whatever other options they choose.
21. LPFA propose that the element of the benefit subject to taxpayer guarantee be limited to 50% of the pay between £10,000 and £75,000 per annum. The reasoning for the lower level is that the state pension already provides for roughly 50% of the first £10,000, so including that would be in effect be asking taxpayers to guarantee that income in retirement twice over.
22. The higher level is designed to provide a maximum guaranteed benefit (including state pension) broadly in line with the higher rate tax limit. To expect taxpayers to guarantee benefits which are greater than the higher rate tax bracket would seem unreasonable.

Objectives of the schemes

23. As stated above the core objective should be to provide a minimum income in retirement to ensure that individuals are able to enjoy a good standard of living without having to fall back on state benefits.
24. Beyond this minimum the schemes should be structured to provide an incentive to save for retirement without committing the taxpayer to unlimited costs. There are a number of different models for such a scheme and this is a good opportunity to address its appropriateness to the current workforce.



25. The scheme should be able to be marketed as a tax efficient saving scheme with extra benefits, thereby being more attractive to younger employees and potential recruits. Beyond the guaranteed core pension there could be a non-guaranteed top up pension, perhaps provided under a Collective Defined Contribution scheme. Also perhaps a choice of additional benefits would be more attractive and appropriate than the existing fixed elements. Such choices could include;

- Additional non-guaranteed pension
- Death cover
- Health cover at different levels
- Health benefits (e.g. annual medical check, subsidised gym membership)
- Partner's pension
- Children's pension
- Redundancy cover
- Early retirement option
- Early lump sum drawdown
- Assignment for mortgage purposes

26. The benefits would be individually costed with the member and/or the employer being able to pay additional amounts for any combination of optional elements. Changes to the elements selected would be allowed as the member's needs change through their career.

27. The inclusion of new items such as early lump sum drawdown (say a maximum of 10% of total value of the pension pot) and assignment for mortgage purposes (of the amount above the guaranteed minimum) would make the scheme more attractive as they enable use of benefits earlier when they may be of better use to the member (e.g. when having to fund university fees or to reduce mortgage costs).



Implementation and transition

28. The implementation tasks and timetable would be as follows;

- September 2010 recommend quick win changes to the scheme
- October to January draw up Statutory Instrument's required for above
- February make recommendations for new CARE scheme (with core guaranteed element, non guaranteed top up plus optional elements) and Pensions Chamber to maintain affordability
- April 2011 publish regulations and implement quick wins
- Remainder of 2011 negotiations, legislation and formation of chamber, preparation of administration system changes and member information
- April 2012 new scheme regulations published, chamber in place

Summary

29. In summary, LPFA believes that the LGPS needs to change in order to deliver a decent pension that is fair on the taxpayer, relevant to the needs of members in the 21st century and affordable in the long term. The paper attached outlines our proposals for achieving this aim and I commend it to you.

30. In terms of the other public sector schemes, LPFA would prefer to see similar principles also applied across the unfunded schemes. Ideally we would wish to see all new entrants having the option to join a funded scheme to provide a guaranteed appropriate level of benefits, with the option to choose other arrangements to top-up savings as they choose.

London Pensions Fund Authority July 2010

A fair and affordable LGPS

Green paper discussion document by LPFA

Introduction

Within the ongoing debate over the reform of the LGPS, LPFA has called for the setting up of an Independent Commission (The Local Government Pensions Commission) with a remit to ensure its future sustainability and affordability over the long term. This discussion paper sets out more detail about the terms of reference of such a commission and how it might be structured and operate.

The case for an affordable LGPS

An affordable, well structured pension scheme appropriate to its membership and meeting the requirements of its sponsors is a vital element in long term public expenditure, health and welfare policy. Encouraging saving for retirement promotes financial responsibility and ensures the availability of an adequate income in retirement the amount of which is directly related to the demands individuals place on health and welfare provision.

The case is made the question is whether the present statutory structure of the LGPS will be able to ensure it continues to be affordable, appropriate and responsive to the needs of its sponsors into the future. The question is particularly imperative at this time given the challenges of increasing longevity and a shift in the perception of the importance of pensions in the press and public.

Background

At present, the LGPS is a statutory scheme whose trustee is the Secretary of State for Communities and Local Government. It is governed by Acts of Parliament supplemented by complex regulations and Statutory Instruments issued by a specialist team in the Department for Communities and Local Government (CLG). Any changes go through a statutory consultation process involving the employers (Local Government Employers (LGE, part of the Local Government Association (LGA)) and representatives of the employees (Trades Unions). Consultation is then considered by the minister before passing decisions to CLG lawyers for drafting of regulations.

This process is by necessity lengthy, sluggish and has tended to result in tinkering rather than the wholesale addressing of the scheme required to ensure its future sustainability. This is not a criticism of the personnel involved in the process but rather the process itself.

The 2008 Regulations are an example of the results of this process, they were late, did not address the fundamental issues and in some cases are still not complete.

At the centre of the problem with the current situation is asking a political system with understandably short to medium term priorities and pressures to take the long term view necessary for effective management of LGPS issues.

LPFA proposes that the politics be taken out of the LGPS by the establishment of an Independent Commission working within a broad statutory framework of objectives agreed and monitored by the Secretary of State.

In effect the Independent Commission will replace the day to day involvement of the Secretary of State and the CLG. Their role will reduce to one of monitoring the performance of the Commission in achieving an affordable scheme within the agreed framework.

In order to set the Commission up and regulate its operation the Secretary of State would make regulations defining the structure and remit of the Commission and the framework within which it should operate.

Remit and Framework

Its remit will be twofold,

- firstly to determine an appropriate and affordable scheme structure within the framework and
- secondly to manage the affordability of the scheme going forward using the tools available to it and to make recommendations for effective reduction in scheme deficits

In setting up the Commission the Secretary of State will retain powers to:

- Set an overall cap on total contributions to the scheme
- Determine the scheduling of employers and administering authorities within the scheme

The framework within which the Commission would operate would be to ensure that;

- The scheme provides an effective retirement provision that fits within overall government targets for public expenditure
- The scheme operates within overriding regulatory, pensions and fiscal legislation
- The scheme operates within a fair balance of cost between beneficiaries and contributors, both employers, taxpayers and future pensioners;
- The scheme operates within acceptable solvency parameters;
- The scheme is regulated by an appropriate balance of contribution changes and benefit accrual adjustments, not just rely on employer contributions;
- Retirement age reflects wider societal changes and is in line with state retirement safety net provision;
- Indexation of pensions, both pensions in payment and accrued rights, is conditional upon the overall solvency and health of the scheme, in particular the achievement of investment returns

The Commission would be accountable to the Secretary of State by reporting annually on the achievement of the remit with a special report every three years after a statutory triennial valuation.

Structure

The Commission should be structured with a Chairman appointed by the Secretary of State and, say, 10 Board members acting in a trustee capacity for the scheme as a whole. The Board members should be drawn equally from those

responsible for paying for the scheme (employers, taxpayers) and those representing scheme members, be they active employee members, deferred members or pensioners. The Board should be appointed for a fixed 5 year term.

The Commission will be assisted by a secretariat which would be drawn from existing experienced and appropriate CLG, LGE and/or LGPS administration staff.

Determining an appropriate scheme

The key decisions that the Commission will be required to take when determining the scheme would be;

- The basis of the scheme, be it defined benefit final salary or career average or a hybrid DB/DC arrangement
- The balance of cost between beneficiaries and contributors
- The solvency parameters
- The conditional indexation parameters
- The normal retirement age
- Accrual rates

In determining and applying the appropriate scheme the Commission will be obliged to consult interested parties and may take advice from experts it chooses to call before it.

The Commission will be free to make or amend existing scheme regulations and call for whatever information it thinks appropriate from individual funds whenever it feels it appropriate to do so.

The total cost of the appropriate scheme shall not be in excess of any cap set by the Secretary of State.

Maintaining an affordable scheme

As necessary the Commission will determine and publish national standard guidance for triennial valuations including longevity tables and discount rates. In doing so it will take full account of advice requested from the relevant professional bodies.

In line with LGPS valuations the Commission will be required to review the cost of the scheme and if necessary make use of one or more of the following tools to maintain affordability;

- Changes to the balance of cost between employers and members (replacing the proposed cost sharing mechanism)
- Changes to retirement ages
- Changes to future accrual rates
- Conditional indexation for both future benefits and pensions in payment
- Changes to the future structure of benefits

The Commission will also report on the local costs of each scheme and make recommendations to the Secretary of State as to the cost effectiveness of the administration and governance arrangements of the scheme.

As well as managing the ongoing affordability of the scheme the Commission will be required to make recommendations for reducing existing scheme deficits, In doing so it will take account of the views of interested parties and the advice of relevant professional bodies.

Recommendations will be submitted to the Secretary of State who would then make regulations to enact any recommendations s/he chooses to accept.

Impact on LGPS Administering Authorities

The role of the administering authority will continue to be to administer the scheme at local level within the parameters laid down by the Independent Commission. In particular Administering Authorities will retain existing levels of control over investment policy within the parameters set by the Investment Regulations which will continue to be set by the Secretary of State

The main changes will be:

- Indexation of pensions in payment and accrued service will be dependent upon the local performance of the scheme
- Valuation assumptions will need to reflect the standard guidance issued by the Commission rather than be a wholly local negotiation between Actuary and Administering Authority

Statutory implications

As stated the Commission would take over the roles of the Secretary of State in determining many aspects of the scheme. The effects in terms of legislation would be;

- New governance regulations would cover the set up, structure, remit, framework, operation and powers of the Commission together with powers retained by the Secretary of State
- The administration and membership and benefit regulations would be subsumed within the Commission and replaced with trust based scheme rules
- The investment regulations would continue as now.

Conclusion

Setting up the Commission would provide a long term focused forum able to respond effectively to long term cost issues in order to ensure an affordable LGPS which provides levels of benefit appropriate to overall public expenditure, health and welfare targets.

LPFA
April 2010