



Rt Hon Eric Pickles, MP
Secretary of State for Communities and Local Government
Eland House
Bressenden Place
London
SW1E 5DU

21 September 2011

Dear Eric,

Local Government Pension Scheme – Proposed increase in employee contributions

Thank you for your letter of 20 July 2011 inviting the Local Government Group to conduct discussions with the local government trade unions with a view to establishing a package of measures to secure short term savings by 2014/15, equivalent to a 3.2% increase in employee pension contribution rates.

The LG Group and the unions have held a series of constructive discussions over the last 8 weeks. We are committed to ensuring that the Local Government Pension Scheme is affordable and sustainable, and is fair to employees and taxpayers.

The LGPS is unique amongst the main public service pension schemes in that it is a funded scheme. This means that, as recognised in your letter of 20 July 2011, it is possible to come forward with a bespoke solution for the LGPS which delivers the required savings in ways not readily available to the other public service pension schemes. Unfortunately, despite the best efforts of both sides, it has not so far been possible to reach an agreement. However, we are still committed to continuing with those discussions.

During the discussions to date the employers' side has put forward a proposal which delivers the required level of savings, other than wholly through an increase in employee contributions, minimises the impact on the lower paid and offers choice to individuals. Our proposition is outlined further in this letter.

Background

Following your letter of 20 July 2011, the LG Group and the unions held their first joint meeting on 27 July 2011. This was followed by joint meetings on 11

and 19 August during which a range of matters for consideration were discussed, including some suggested potential solutions outlined by the employers' side, and it was agreed that costings on a number of items should be obtained from our actuarial adviser.

Following an employers' side meeting on 31 August a further joint meeting was held on 2 September at which the unions put forward a view that changes already made to the scheme (e.g. the changes made in 2008 and the move to link the indexation of benefits to the rise in CPI rather than RPI), and the combined effects of no pay rises and a reduction in the number of active scheme members, meant that enough savings had already been made. The employers' side was of the view that these could not be used as offsets against the 3.2% (£900 million) savings target.

As no further progress was made at a joint meeting held on 9 September the LG Group sought clarification from yourself and the Chief Secretary to the Treasury on the questions of whether some additional time could be granted to try to reach a solution and whether any of the items identified by the unions could be used as offsets against the 3.2% savings target. It was agreed that the employers should seek a further joint meeting with the unions during week commencing 19 September with a view to making progress towards an agreement but that the matters identified in the paragraph above could not be used as offsets.

A joint meeting between the employers and unions was held on 21 September at which the proposed solution set out later in this letter was outlined by the employers' side.

Unfortunately, despite the efforts of both parties to the discussions, it has not so far proved possible to reach an agreement.

The employers' side is, however, of the view that the following offers a good solution to deliver the level of savings required (as an alternative to the level of increases in contributions that DCLG might otherwise come forward with).

Core elements of the employers' side proposal

In coming forward with our proposal we have sought to ensure that the level of savings required are met other than wholly through an increase in employee contributions, that the higher paid nevertheless have to pay some extra contributions if they wish to retain a 1/60th accrual rate, that the lower paid are protected, and that there is an element of choice for individuals.

Our proposal offers a bespoke solution for the LGPS and allows for the effects to be reflected in employer contribution rates from 1 April 2014 (following the 31 March 2013 valuation of the Funds).

For the purpose of our proposal we have used national salary data to estimate the possible savings and have assumed a £30bn payroll split as shown in the following table.

	Lower band	Upper band	Current rate	Actual salary
Band 1	£0	£12,600	5.5%	£465,749,324
Band 2	£12,601	£14,700	5.8%	£903,561,303
Band 3	£14,701	£18,900	5.9%	£4,336,702,797
Band 4	£18,901	£31,500	6.5%	£12,966,837,271
Band 5	£31,501	£42,000	6.8%	£6,132,933,585
Band 6	£42,001	£78,700	7.2%	£4,433,984,527
Band 7	£78,701	Plus	7.5%	£730,231,193
Total				£30,000,000,000

We appreciate that the pay bandings in the table above do not correlate to the current level of pay bandings but we have used them as we only have salary data broken down by reference to the pay bandings in the table. All salary levels quoted in this letter relate to full-time equivalent salary rates. Our proposal assumes that opt out rates do not increase beyond current levels.

Core element 1

We propose that the normal pension age in the LGPS is increased from 65 to 66 in respect of future service¹ from 1 April 2014. It is estimated that this would generate savings in the range of 1.0% to 1.5% of pensionable payroll although this will vary across Funds. We assume that GAD may value this on detailed national data on an average set of fund valuation assumptions and so, for the purposes of our proposal, we will assume that 1% of payroll will be saved by adopting this change. This equates to £300m per year based on the data shown above.

Core element 2

We propose that the balance of £600m should be delivered via an increase in the employee contribution rates. We would protect those earning less than £15,000 from any increase in contributions, raise the level of contributions for those earning between £15,000 and £21,000 by 1.5%, and increase the contributions of those earning over £21,000 by between 2.0% and 2.5%. This would generate around £605m and could be implemented on 1 April 2014 or, subject to core element 3, could be phased in over a three year period starting April 2012, as shown in the attached tables (assuming 20% of the increase is applied in 2012/13, another 40% in 2013/14, and the final 40% in 2014/15). The benefit accrual rate would remain 1/60th.

The above meets the objective of ensuring those earning less than £15,000 (the "lower paid" threshold) see no increase in their contributions and that those earning between £15,000 and £21,000 pay no more than an additional 1.5%. The spread of the size of increases for those earning above £21,000 is much narrower than under suggested tariff tables put forward to date by DCLG but this is to accommodate the option set out in core element 3.

¹ The normal pension age for service prior to April 2014 would remain age 65.

Core element 3

Given that, due to a range of other pressures on their income, an increase in contributions may be difficult for some employees to fund, we propose that employees be given the choice of a reduction in their accrual rate instead. This would mean that those earning above £15,000 would see no increase in their contribution rate, but a reduction in the accrual rate to in the region of 68ths. Those earning below £15,000 would see a corresponding reduction in their contribution rate if they wished to move to a reduced accrual rate (e.g. their contribution rate would reduce to 60/68ths of their current contribution rate if the reduced accrual rate was 68ths).

If all members simply chose to pay the contribution rates shown under core element 2, this would generate £605m. If all members chose, instead, to move to the lower accrual rate, this would generate in the order of £675m. As it is not possible to predict with any degree of certainty which members may choose to pay the contribution rates shown under core element 2 and which may choose, instead, a lower accrual rate, and in order to avoid selection against the fund, it is necessary to err on the side of caution when setting the level of the accrual rate (i.e. to a level around a 68ths accrual rate).

If core element 3 is taken forward then it would seem logical, given the timescales needed to communicate the option to scheme members, for members to make their election and for payroll and pensions administration systems to be amended, for any increase in contributions or reduction in the accrual rate not to be implemented until 1 April 2014. Furthermore, it would not appear to be a workable solution to offer choice from, say, 1 April 2013 i.e. the choice of a reduced accrual rate from 1 April 2013 or stepped increases in employee contributions over 2013/14 and 2014/15. Hence, our view is that offering choice means there should be a single implementation date (i.e. 1 April 2014).

Given the administrative complexity, and that we expect a new scheme to be in place from April 2015, a scheme member's election for the higher contribution rate or a reduced accrual rate would be a one off choice². Members should not be allowed to change their option at some future time. If a member has multiple jobs they should have an election in respect of each job.

Overall impact of core elements 1, 2 and 3

The overall impact of core elements 1, 2 and 3 would be as follows:

- i) the normal pension age in the LGPS would rise by 1 year for future service from 1 April 2014. This draws forward part of an element proposed for the new, post 2015, scheme (i.e. to link normal pension age to the rising State Pension Age)

² Unless the concept of a choice between contribution rate and accrual rate carries forward into the design of a new look LGPS post March 2015.

- ii) those whose full-time equivalent salary is above the "lower paid" threshold of £15,000 will see their contributions rise if they wish to retain the current 1/60th accrual rate (although the rise will be limited for those whose salary is between £15,000 and £21,000). Alternatively, they can continue to pay the present contribution rate but their accrual rate for future service will drop.
- iii) those whose full-time equivalent salary is below the "lower paid" threshold of £15,000 will retain the current 1/60th accrual rate for the same contribution rate as they currently pay. Alternatively, they can choose the lower accrual rate for future service and, in return, see a reduction in their contribution rate.

Variations

Other variations on the accrual and contribution rates set out above are possible. Samples are set out in the attached document. These are based on national data available to our actuarial adviser on a summary basis and the proposals have been costed on what we consider a reasonable average funding approach.

Why are our proposals a good solution?

We believe our proposals:

- overcome the issue of part-time employees having to pay an increased contribution rate determined by reference to their full-time equivalent salary (i.e. they would have the choice of being able to take the reduced accrual rate option instead)
- encourage the low paid to stay in the scheme and reduce opt out rates
- give employees choice
- ensure that those employees earning above the "lower paid" threshold who want to keep their current accrual rate will have to pay more to retain that accrual rate
- reduce the risk of industrial action

The fact that there is an element of choice in our proposed solution enables employees to make a decision in the light of their own personal circumstances. Giving choice will have the benefit of minimising opt out rates i.e. those concerned about the level of their take home pay can choose the lower accrual rate option instead and, when coupled with the reduction in the contribution rate for those earning less than the "lower paid" threshold, it has the added advantage that it might encourage more of the lower paid to join / stay in the scheme (assuming it is in their interests to do so). Reducing opt out rates is a crucial factor for the funded LGPS which needs, for cash flow and investment profile / fund maturation reasons, to maintain a strong level of active membership.

Other elements for possible inclusion in a package of measures

Other elements which we believe should form part of the package are:

- 1) adjust the current actuarial reduction factors to a cost neutral level (as, based on current life expectancy levels, we believe they are currently overly penal at present)
- 2) move to a 2 year vesting period (with existing active members who leave with 3 or more months but less than 2 years membership having the choice of a deferred benefit or a refund of contributions). This would generate minimal savings on the employer contribution rate, of around 0.02%, but there would be considerable administrative advantages and savings on administration costs. The LGPS in England and Wales is the only public service pension scheme with a 3 month vesting period and the DWP has recently concluded that it will not reduce the compulsory vesting period for defined benefit schemes to below the current level of 2 years.

Councillor members

Our proposals only relate to employees who are active members of the Local Government Pension Scheme (LGPS). They do not relate to councillors who are already in the Career Average Revalued Earnings (CARE) section of the LGPS. Whether any changes to the CARE scheme for councillors are required is a matter for the government to consider.

Conclusion

It is unfortunate that, despite the efforts of both the employer and trade union negotiators, it has not so far proved possible to reach agreement on a joint proposal to put to you. However, we hope that the suggestions we have put forward in this letter will be of help to you when considering how best to take this matter forward.

Yours sincerely



Chairman, Local Government Association

Costings

Client: Terry Edwards, LG Employers

Date 9 September 2011

Subject: Options raising 3.2% of payroll or £600m from the LGPS

1 Data

1.1.1 We have used national salary data to estimate the possible savings. We have assumed a £30bn payroll split as shown below.

	Lower Band	Upper Band	Current Rate	Actual Salary
Band 1	£0	£12,600	5.5%	£465,749,324
Band 2	£12,601	£14,700	5.8%	£903,561,303
Band 3	£14,701	£18,900	5.9%	£4,336,702,797
Band 4	£18,901	£31,500	6.5%	£12,996,837,271
Band 5	£31,501	£42,000	6.8%	£6,132,933,585
Band 6	£42,001	£78,700	7.2%	£4,433,984,527
Band 7	£78,701	plus	7.5%	£730,231,193
Total				£30,000,000,000

1.1.2 This is the best available national data we have and is available in summary form only.

1.1.3 We note that contribution bands have changed but the overall shape of the salary distribution is assumed to remain relevant for this exercise. Any further up to date data becoming available should be used to update the calculations.

1.2 Core element 1 - increasing normal retirement age

1.2.1 Increasing the retirement age for all by one year reduces the ongoing cost of the Scheme by about 1% to 1.5% of payroll though this will vary by fund. We have assumed that GAD may value this on detailed national data on an average set of fund valuation assumptions and have assumed that 1% of payroll will be saved by adopting this change. This is equivalent to £300m per year on the data shown above.

1.3 Core element 2 - accrual or contribution rate changes

1.3.1 We have therefore considered how we can raise the further £600m being required by HM Treasury.

1.3.2 There are infinite combinations of contribution increases that will provide the £600m provided there are no opt outs, the data remains as estimated above and at this stage we are considering that 60ths accrual remains.

1.3.3 We have shown 3 examples below. These show the impact and make no allowance for any further options being proposed.

	Lower Band	Upper Band	Current contribution	a) same increase	b) same uplift	c) Steeper increase
Band 1	£0	£12,600	5.5%	0.0%	0.0%	0.0%
Band 2	£12,601	£14,700	5.8%	0.0%	0.0%	0.0%
Band 3	£14,701	£18,900	5.9%	2.1%	1.9%	1.5%
Band 4a	£18,901	£21,000	6.5%	2.1%	2.1%	1.5%
Band 4b	£21,001	£24,000	6.5%	2.1%	2.1%	2.0%
Band 4c	£24,001	£31,500	6.5%	2.1%	2.1%	2.5%
Band 5	£31,501	£42,000	6.8%	2.1%	2.2%	2.5%
Band 6	£42,001	£78,700	7.2%	2.1%	2.3%	2.5%
Band 7	£78,700	plus	7.5%	2.1%	2.4%	2.5%
Total raised				£600m	£605m	£605m

- 1.3.4 We have assumed that lower paid protection level is set at £15,000 and members with salaries below this level will not be required to increase their contribution levels going forward.
- 1.3.5 As can be seen, all these options will provide for the required income target. However, there is a higher risk of opt out for higher contribution increases, especially at lower salary levels. We consider that steeper patterns than option c) will effect much higher levels of opt out at higher salary bands, with the possible cascade effect as members follow behaviour patterns of their senior managers or directors.
- 1.3.6 Option c) also meets the patterns required for other public sector schemes in that a 1.5% limit is set for those with salaries up to £21,000.

1.4 Core element 3 - reduce accrual option

- 1.4.1 This section shows the possible savings from providing a reduced accrual option.
- 1.4.2 These savings assume that all members opt for the reduced accrual option.

	Lower Band	Upper Band	Current contribution rate	Reduce accrual (67ths)	Reduce accrual (68ths)	Reduce accrual (69ths)
Band 1	£0	£12,600	5.5%	0.0%	0.0%	0.0%
Band 2	£12,601	£14,700	5.8%	0.0%	0.0%	0.0%
Band 3	£14,701	£18,900	5.9%	2.1%	2.4%	2.5%
Band 4a	£18,901	£21,000	6.5%	2.1%	2.4%	2.5%
Band 4b	£21,001	£24,000	6.5%	2.1%	2.4%	2.5%
Band 4c	£24,001	£31,500	6.5%	2.1%	2.4%	2.5%
Band 5	£31,501	£42,000	6.8%	2.1%	2.4%	2.5%
Band 6	£42,001	£78,700	7.2%	2.1%	2.4%	2.5%
Band 7	£78,700	plus	7.5%	2.1%	2.4%	2.5%
Total raised				£600m	£675m	£715m

- 1.4.3 The accrual reduction that provides for £600m will depend upon both how the GAD value the reduced accrual change of the benefits on national detailed data.
- 1.4.4 It will also depend upon where the lower paid protection limit gets set and the above assumes that this is set at £15,000.

1.5 Core element 3 – the lower paid

- 1.5.1 The model suggested allows for lower paid members to pay reduced contributions if they choose the lower accrual route. We have used 68th accrual in the following table and assumed that a reduction in contributions of say 60/68 times the current rate would be a fair level of reduction.

Table 1.5	Lower Band	Upper Band	Current contribution rate	Reduce accrual (67ths)	Reduced contributions	Net effect
Band 1	£0	£12,600	5.5%	2.4%	0.6%	1.7%
Band 2	£12,601	£14,700	5.8%	2.4%	0.7%	1.7%
Band 3	£14,701	£18,900	5.9%			
Band 4a	£18,901	£21,000	6.5%			
Band 4b	£21,001	£24,000	6.5%			
Band 4c	£24,001	£31,500	6.5%			
Band 5	£31,501	£42,000	6.8%			
Band 6	£42,001	£78,700	7.2%			
Band 7	£78,700	plus	7.5%			
Total raised				£32m	£10m	£22m

- 1.5.2 As can be seen above the saving will depend upon how much a reduction in contributions is offered to the lower paid members and how many of the lower paid opt for reducing accrual compared to the status quo.
- 1.5.3 However, we feel it remains equitable to offer this reduced cost option, setting the possible accrual level at the same level as the higher paid to provide the lower paid with a similar choice.
- 1.5.4 Any savings made from the above will depend on members choice so should not be included as certain in the total costs.

1.6 Core element 3 – the higher paid

- 1.6.1 The model suggested that higher paid members will retain their current 60th accrual by paying more into the scheme. However we recognise that this will not be attractive and perhaps unaffordable for some.
- 1.6.2 In this section therefore we have shown possible reduced accrual options that would provide these members with an alternative allowing their current contribution rates to remain.
- 1.6.3 We have shown three cases below corresponding to the tables of proposed contribution increase tariffs within section 1.4.

	Lower Band	Upper Band	Current contribution rate	a) same increase	Reduce accrual (67ths)
Band 1	£0	£12,600	5.5%	0.0%	0.0%
Band 2	£12,601	£14,700	5.8%	0.0%	0.0%
Band 3	£14,701	£18,900	5.9%	2.1%	2.1%
Band 4a	£18,901	£21,000	6.5%	2.1%	2.1%
Band 4b	£21,001	£24,000	6.5%	2.1%	2.1%
Band 4c	£24,001	£31,500	6.5%	2.1%	2.1%
Band 5	£31,501	£42,000	6.8%	2.1%	2.1%
Band 6	£42,001	£78,700	7.2%	2.1%	2.1%
Band 7	£78,700	plus	7.5%	2.1%	2.1%
Total raised				£600m	£600m

	Lower Band	Upper Band	Current contribution rate	b) same proportionate increase	Reduce accrual (68ths)
Band 1	£0	£12,600	5.5%	0.0%	0.0%
Band 2	£12,601	£14,700	5.8%	0.0%	0.0%
Band 3	£14,701	£18,900	5.9%	1.9%	2.4%
Band 4a	£18,901	£21,000	6.5%	2.1%	2.4%
Band 4b	£21,001	£24,000	6.5%	2.1%	2.4%
Band 4c	£24,001	£31,500	6.5%	2.1%	2.4%
Band 5	£31,501	£42,000	6.8%	2.2%	2.4%
Band 6	£42,001	£78,700	7.2%	2.3%	2.4%
Band 7	£78,700	plus	7.5%	2.4%	2.4%
Total raised				£605m	£675m

	Lower Band	Upper Band	Current contribution rate	c) steeper increase	Reduce accrual (69ths)
Band 1	£0	£12,600	5.5%	0.0%	0.0%
Band 2	£12,601	£14,700	5.8%	0.0%	0.0%
Band 3	£14,701	£18,900	5.9%	1.5%	2.5%
Band 4a	£18,901	£21,000	6.5%	1.5%	2.5%
Band 4b	£21,001	£24,000	6.5%	2.0%	2.5%
Band 4c	£24,001	£31,500	6.5%	2.5%	2.5%
Band 5	£31,501	£42,000	6.8%	2.5%	2.5%
Band 6	£42,001	£78,700	7.2%	2.5%	2.5%
Band 7	£78,700	plus	7.5%	2.5%	2.5%
Total raised				£605m	£715m

- 1.6.4 Of course there is no way of telling which way members will opt and most will need some help and financial advice to make the correct decision but the above shows that we can design a scheme which meets the required target.
- 1.6.5 As there is a risk of members selecting the option that does not raise sufficient income the accrual rate for a steeper contribution increase pattern than 1.3 c) will mean the accrual that can be offered as an option will become very unattractive.

1.7 Stepping any changes

- 1.7.1 We understand that stepping any changes over the three year period may be acceptable. Administratively no changes will be very straightforward but stepping changes to the contribution patterns will be possible whereas stepping the reduction in accrual will not be feasible.
- 1.7.2 A possible spread of increase in step of 20%/40%/40% will defer much of the change until the new scheme takes shape.

1.8 Summary

- 1.8.1 Therefore we have the following patterns or options.
- Steeper stepping patterns for contributions than we have considered in section 1.3 which incur very high opt out risk, especially at middle to high salary bands. We have rejected this option due to opt out risk at all levels that may cascade throughout the workforce in general.
 - Contribution patterns considered like those in section 1.3, which also have the appeal of being more easily phased in over a three year period.
 - Contribution patterns with a suitable accrual reduction depending upon the upper contribution bands to ensure the required savings are met. As accrual reduction cannot be phased in it would need to be accepted that this change would only be practical in say year 2014.
- 1.8.2 Due to administration simplicity and the ability to step the costs it seem that an option like 1.3 c) may be most favourable.
- 1.8.3 However if options and choice for members are consider a more key factor then 1.6 b) would appear to offer a good solution as the accrual reduction is minimised.
- 1.8.4 Alternatively, option 1.6 c) meets the contribution increase limits applying to other public sector funds, whereby the increases at lower salary bands are restricted. It also offers flexibility and choice for members, perhaps being an advantage outweighing the simplicity of 1.3c)
- 1.8.5 I trust this helps show possible saving patterns and the consequences of the options for the members.
- 1.8.6 I look forward discussing this with you in due course.

Regards

Alison Hamilton FFA

ACA LGPS committee, chair.

Partner, Barnett Waddingham LLP

