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Dear Colleague,

APPENDIX 1

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LGPS Stakeholders in
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25 June 2009

LOCAL GOVERNMENT PENSION SCHEME DELIVERING AFFORDABILITY, VIABILITY AND FAIRNESS

1. This informal consultation exercise begins a series of steps to consider some possible amendments which initially focus for reasons of Scheme stability and viability on the 2010 Scheme valuation exercise. A later, separate exercise, will consider new ways in which the LGPS could possibly be reformed to provide more workforce - focused provision pension for the 21st century.

2. Ministers wish to see the full engagement of all stakeholders in this particular exercise to secure a consensus quickly on a number of practical and reasonable amendments to the Scheme's regulatory framework to beneficially impact on the conduct and outcomes of the 2010 valuation and to assist in maintaining Scheme viability generally. A parallel, separate consultation exercise on the broader debate, announced when John Healey spoke at the NAPF Local Authority Conference on 19 May, about the longer term future of the Scheme, and how it might best respond to changes in the workplace, workforce and economy will issue shortly.

Background

3. The LGPS, as provided in England and Wales, is a statutory, public service, funded, occupational pension scheme which provides guaranteed pension benefits to local authority employees, and to employees of related and admitted employers.

4. The Scheme's local administering authorities pay benefits and manage its pension funds within the terms set out in secondary legislation made under the Superannuation Act 1972. A prudential regulatory framework provides Scheme pension fund administering authorities with all the necessary powers to manage and invest their pension funds. Investment income generated, as well as the operating and other costs incurred, is the responsibility of the appropriate LGPS administering authority; any surplus is available to reduce employers' liabilities and to re-invest within the authority's investment strategy.

5. At the 31 March 2007 triennial actuarial valuation, funds' total assets were valued at £132 billion with liabilities totalling £159 billion giving a shortfall between assets and liabilities of £27 billion, or a scheme-wide funding level of 83% (up from 74% in 2004).

6. The LGPS provides inflation-linked pension benefits based on a member's final salary at retirement and has some 3.7 million members. Stewardship, policy and regulatory responsibilities for the Scheme in England and Wales rest with the Secretary of State for Communities and Local Government.

7 A major Scheme reform saw the introduction from 1 April 2008 of a new-look LGPS including revised benefit terms. The Scheme's accrual rate was improved from 1/80ths to 1/60ths with the normal retirement age of 65 years being retained and new ill health provisions and other benefit adjustments within a fixed, agreed cost-envelope. Employees currently contribute between 5.5% and 7.5% of their pay on a set tariff which yields about 6.4% of total payroll. Employers' contributions, fixed until 31 March 2011, are adjusted following the triennial valuation of individual LGPS pension funds. Each individual pension fund authority is required to set an employers' level of contribution to ensure its fund is solvent and able to meet its existing and future liabilities.

Scope of consultation

8. This discussion document sets out initial suggestions for stakeholders to consider as a feasible and balanced response to the current stock market impacts on LGPS pension fund liabilities likely to be identified in the forthcoming 2010 valuation exercise. The propositions principally focus on the important regulatory and operational relationship between the actuarial valuation exercise and the requirement on each LGPS administering authority to produce and maintain a Funding Strategy Statement. It would be appropriate also to support the proposals with new advice to stakeholders on the issue of Scheme funding, cost stability and security.

9. In addition, and alongside the introduction of the new LGPS cost-sharing regime, this may be an opportune time also to consider a re-alignment of the employee member pension contribution tariff, and particularly the proportion of pensionable pay being contributed by higher paid members Towards their pension benefits.

10. Ministers wish to see an authoritative, evidence-based debate on a range of elements which fall within the Scheme's current framework. It is proposed to issue a paper shortly which sets out several policy themes for analysis and discussion by Scheme stakeholders about the possible future direction of the LGPS in the medium/ longer terms.

11. Both strands need, to be seen within the broad context of all public service pension schemes. Communities and Local Government remains in close touch with other relevant sponsoring Government Departments, as well as Scheme-specific stakeholders.

Current public service pension policy context

12. The Government's overall commitment to public service pension provision generally and for the Local Government Pension Scheme in England and Wales in particular, is that such schemes remain affordable and sustainable in the long term, be consistent with the principle of fairness for all taxpayers and between generations.

13. Ministers are on record regarding their intentions to ensure that the LGPS can continue to meet the needs of its stakeholders. Their policy for the Scheme is one based on affordable retention within the broad national policy parameters expressed above. At the same time, the guarantees that underpin such arrangements, supported by taxpayers, require the terms of the Scheme to be kept under review, to reflect best practice and continue to be fair and cost-effective in terms of the level of provision and the cost of delivery.

14. The provision of a good quality occupational pension provision is a key part of the total remuneration package of public servants. The Local Government Association see the LGPS as an essential component of the total reward package currently available to recruit, retain and to motivate local authority employees. The local authority trade unions take much the same view.

15. However, in providing any level of public sector benefit provision, it is acknowledged by stakeholders that it remains essential to ensure an equitable balance at all times between the full cost of providing LGPS benefits within that statutory, guaranteed framework, and the standard of the actual pension benefits provided by the Scheme for its membership.

16. In assessing the prospect of any possible regulatory changes to the LGPS in England and Wales, the Government wishes to continue to maintain a viable and affordable Scheme, one that caters for its current and future workforces' needs and which remains fair both to providers and beneficiaries, as well as to taxpayers who ultimately guarantee its pension promise.

Actuarial valuations and Funding Strategy Statements

17. The next LGPS actuarial valuation exercise in England and Wales, required by regulation 36 of the 2008 Administration regulations, takes place as at 31 March 2010. This event, along with the influences of each administering authority's Funding Strategy Statement and Statements of Investment Principles, will determine new rates of Scheme employer contributions from 1 April 2011 until 31 March 2014. The subsequent valuation takes place on 31 March 2013.

18. Many stakeholders believe that unless some adjustments are made to stabilise the treatment of scheme liabilities at the 2010 valuation, and so mitigate any short term adverse impacts of the current economic recession on the Scheme, the effect on members, employers and taxpayers could be disproportionately significant in terms of increased costs and so potentially council tax bills from 1 April 2011, notwithstanding the application of the new LGPS cost share / capping provisions.

19. The actuarial valuation exercise and its attendant regulatory structures involving Funding Strategy Statements and Statements of Investment Principles, are in place to protect taxpayers' interests through the efficient long term management of liabilities within a prudent regulatory framework. Regulation 36 (6)(b) of the LGPS Administration Regulations 2008 requires that contribution increases for employers in general, following each valuation exercise, should be set at as constant a rate as possible, and each LGPS administering authority engages with its actuary to determine how best to focus on the longer term funding plan each LGPS fund authority needs to achieve that position.

20. The 2010 valuation exercise will provide regulatory stability and discipline, and its interaction with funding strategies which continue to statutorily protect taxpayers, and guarantee the pension promise for Scheme members. Nevertheless, there remains the likelihood of an adverse 2010 outcome. Ministers believe that a closer regulatory realignment, therefore, between the two could be useful to counter any risks that might otherwise adversely affect employers costs and taxpayers and the on-going stability of the Scheme.

21. The following paragraphs explore steps to stabilise future Scheme costs arising from the 2010 valuation exercise. The propositions draw on the outcome of views expressed by key national stakeholders in recent discussions. Liaison will continue with the interested parties over the coming months, particularly on the details of actual proposals and any necessary guidance, including the involvement of the LGPS Policy Review Group.

A possible new approach to solvency

22. Consultees are invited to comment on a proposition involving an amendment to the Scheme regulations, which already include a specific (but undefined) solvency requirement (Regulation 36(5) of the 2008 Administration Regulations), and modify it with a provision which requires each fund's actuary, first to take full account of the affordability of employers' liabilities to pay pensions and to meet liabilities when undertaking three-yearly fund actuarial valuations and, second, to ensure consistency with an administering authority's funding objectives as set out in its Funding Strategy Statement.

23. In practice, this will result in new employer contribution rates being set at each valuation at such a level as to ensure that, over time, sufficient monies are available as required to meet all employers' liabilities.

24. Although a shortfall or deficit may be identified by individual fund valuations, it appears to be the case across the Scheme that contribution rates are set by pension actuaries, for each triennial valuation period, to ensure that the fund will be able to meet its pensions promise by achieving 100% funding in the long term, to meet the funding strategy set by the administering authority.

25. Stakeholders have mentioned in recent discussions that a uniform 100% funding target can become artificial and impose significant short term cost pressures on employers during times of economic downturn and falling investment returns. It fails also to take into account the effect on employers' who have to meet cost increases up front, and over the short term, when in every case this is far from justified.

26. For the LGPS, the effect has implications for council tax payers, particularly in the current economic recession. Measuring the Scheme, therefore, against an actuarially-defined notional 100% funding target automatically creates the concept of a deficit-event whenever the funding ratio falls below 100%. This is frequently misinterpreted by commentators as creating an immediate, and global cost penalty for council tax payers. The essence of the proposition in this paper, therefore, is to consider better reflecting in the regulations the actual local funding dynamics of the Scheme and to remove the opportunity for any negative interpretations which can fail to understand the Scheme's inherent funding disciplines and its protections for taxpayers and members, along side its regulatory permanence.

27. Although liquidity is a measure of the ability to pay pensions as they become due, solvency is concerned with the capacity and status of scheme employers to meet the pensions promise. That means having sufficient assets to meet all future pension liabilities. At present, this test often becomes a target of 100% funding but, given the strong liquidity of the Scheme, the constitutional permanence of local government and a strong employers' covenant, it is questionable whether fund authorities need to build up what, in effect, amounts to a financial reserve in the process of achieving that solvency level.

28. Clearly, a financial reserve and investment assets, are needed to meet short-term liquidity requirements but, equally, setting employer contribution rates at a level to achieve long term funding targets can be considered to be a blunt instrument which imposes unrealistic and burdensome short/medium term costs on scheme employers, and, potentially, council taxpayers.

29. Looking ahead, therefore, a more flexible model might be appropriate, to better reflect the individual circumstances of each pension fund authority and which takes full account of the long term constitutional permanence of local government, its employer covenant and its statutory basis. In informal discussions with stakeholders, two separate sets of proposals have emerged. First, involving the introduction of a new Financing Plan underpinned by a completely new funding strategy and secondly, the establishment of funding targets set locally by fund authorities within much of the existing funding and valuation framework.

Financing Plans

30. The first approach would mean that, instead of fund authorities coming forward with full (100%) funding recovery plans to make good all past service deficits, it is suggested that, integral to the preparation of their Funding Strategy Statements, each LGPS administering authority could additionally prepare and maintain a Financing Plan to demonstrate how over the short, medium and then long term, they will fund pension liabilities for their fund and for each of its employer bodies. The Financing Plan would detail and determine local future income streams and how it is proposed to manage the funding of long term liabilities, demonstrating that it has taken a prudent approach, based always on reasonable, realisable assumptions and qualified professional advice. It would also take into account local budgetary constraints and recognise the reality of local resource and other parameters within which each fund must operate.

31. A Financing Plan could include the following key components and these could, in due course, be reflected in the regulations, or in authoritative guidance: -

- base information :-
    - short to medium cash flow projections
    - actuarial estimate of long term funding needs
    - current funds and projected changes
- key assumptions
- risk management analysis
- employing body contribution rates to provide sufficient resources to meet the liability projections for the fund overall and each employing body
- certification of the plan by the fund officer responsible for the administration of the fund's affairs and the appointed actuary

- agreement to the Financing Plan by the authority's formal pension committee, after proper consultation with all interested parties.

32. This approach would require formal amendments to the Scheme's regulations to require the preparation and inclusion of new Financing Plans, within an amended Funding Strategy Statement, no later than 1 October 2010 or another date following the 2010 valuation, and no later than six months after the valuation date specified. This is intended to ensure that strategic decisions taken by individual local administering authorities on funding and contribution levels are prudent and viable, locally transparent and capable of delivering secure, guaranteed payments alongside regular monitoring. It would provide a clear regulatory-based timetable over which individual LGPS funds can meet their own, locally adopted, prudently funded and financed payment plans.

33. However, the Department is mindful that the proposed Financing Plan, whilst having the effect of removing the current actuarially-set long term solvency test involving a "deficit funding" approach, would, at the same time, introduce a funding regime based on a much shorter time frame which may be regarded by some commentators as being inconsistent with current funding best practice. Although the policy aim would be to stabilise pension costs going forward at the same time as moving away from rigid, long term 100% funding targets, it is equally important that the Scheme retains the confidence of all stakeholders in being able to meet its statutory-based pension promise. No changes are envisaged to the Scheme regulations which currently require specific provisions to set employers` contributions to retain a constancy which eliminates any possibility of contributions being reduced and continues to ensure stability.

Local Funding Targets

34. An alternative approach could involve essentially retaining the existing Scheme funding regime but additionally would allow an LGPS administering authority to adopt a long-term funding target which would not necessarily always be set at 100%, provided this could be sustained and transparently justified by the pension fund administering authority within its published Funding Strategy Statement.

35. Long term funding targets would, therefore, continue to be an essential feature of the Funding Strategy Statement, as indeed would deficit recovery plans over a locally chosen period. This new adjustment could ensure that any longer-term funding shortfall could be recovered within a prudentially-set, and publically accountable timescale. It stabilises pension costs going forward, without losing sight of the fact that the Scheme must meet its statutory pension promise.

36. This does not mean that LGPS administering authorities are to be given unfettered powers to set funding levels and employer contribution rates. That would be to deny the prudentially critical role of the valuation and subsequent actions by the administering authority. The intention rather is for the normal pre-and post-valuation dialogue between administering authorities, fund actuaries, and other stakeholders to continue with the view to reaching an agreed funding position in the light of the valuation exercise outcome. However, the proposed regulatory changes would put beyond doubt that ultimately it is for each locally administering authority, and most importantly its elected committee members, to have the final say on questions of affordability and sustainability and fairness to local taxpayers, within the framework set by the Scheme's regulatory framework.

Next steps

37. Discussions with stakeholders are being arranged to consider the merits of these possible new arrangements which could then be carried forward into draft amending regulations to be issued later in the year as a statutory consultation. Detailed guidance could be prepared with the assistance of CIPFA, to help LGPS authorities prepare for any regulatory changes.

38. Consultees are therefore invited to comment on both how a proposed financing plan approach could apply, when read in conjunction with the existing Statements of Investment Principles and Funding Strategy Statements, and also how to ensure that fund authorities are able to adopt favourable short term positions consistent with their long term pension liabilities. Alternatively, consultees are invited to comment on whether there is merit in the other approach involving locally selected funding targets, also within the framework established by existing Funding Strategy Statements and Statements of Investment Principles.

A Revised Employee Contribution Tariff

39. A proposition is also being considered to amend the existing LGPS tariff which set the level of employee contributions linked to their pensionable pay, with new, higher tariffs for members who annually earn in excess, say, of £75,000, together with an extension of the lower rate of contributions for the lower paid.

40. The new LGPS Scheme introduced on 1st April 2008 included a new banded contribution arrangement with a top level of 7.5% of pensionable pay for those whose earnings are in excess £75,000. However, it is now believed that there are many high earners in the local government workforce who are paying a proportionately modest amount towards their pension benefits.

At the same time, given the very high proportion of part-time employees in the Scheme, it is seems equitable to re-consider the extent, in tariff terms, of the lower rate of 5.5% of pensionable pay. This latter step should directly help to recruit and retain membership of lower paid employees into the Scheme who, according to recent UNISON research, find the costs of membership prohibitive.

41. An example of the scope of a possible future regulatory amendment is illustrated below. Under this example, members earning over £110,000 per year could pay a contribution rate of 10% of pay, and those below in the next band (earning over £75,000) a rate of 8.5%. Meanwhile, many members earning less than £22,001 p.a. would benefit from a lower rate. The table is illustrative at this stage and does not represent any firm commitment by Ministers.

42. Those earning between £30,001 to £75,000 per year would also have to contribute more: +0.2% or +0.3%, to avoid “cliff edge” increases in contributions within the tariff.

43. Subject to the outcome of any statutory consultation the new contribution tariff could take effect from 1 April 2010.

Table 1 – Possible New Contribution Tariff

Band	Pay Range (pay per year)	New Contribution Rate	Difference from current LGPS rate
1	£0 - £15,000	5.5%	No change for members earning up to £12,000 per year -0.3% for members earning from £12,001 to £14,000
2a	£15,001 to £18,000	6.0%	+ 0.1% This apparent anomaly is justified by the significant reduction in rate for Band 3 below
2b	**£18,001 to £22,000**	6.0%	**-0.5%**
3	£22,001 to £30,000	6.5%	No change
4	£30,001 to £40,000	7.0%	+0.2%
5	£40,001 to £75,000	7.5%	+0.3%
6	**£75,001 to £100,000**	8.5%	**+1.0%**
7	**£110,001+**	10.0%	**+2.5%**
Yield = 6.42% of payroll			

Responses

44. Consultees are invited to respond to this informal consultation exercise no later, please, than 30 September and preferably by the middle of September, if this is at all possible. The LGPS Policy Review Group will be considering the paper in the course of its deliberations.

45. Responses should be sent to Richard McDonagh at the above address, Zone 5/F6, or e-mail to richard.mcdonagh@communities.gsi.gov.uk. Telephone for enquiries is 020 7944 4730.

46. If any consultees would like to meet to discuss the propositions in detail and any other matter which stems from this exercise, could they please contact Diana Abelson at diana.abelson@communities.gsi.gov.uk or by telephone on 020 7944 5971, to make the necessary arrangements.

Yours sincerely

Terry Crossley.

TBJ Crossley