



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