LGPS reform and the future!

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This briefing will cover

- The reform process so far.....
- Affordability and sustainability – facts and figures
- Affordability and sustainability – the issues and options
- Costs and value – facts and options
- A proposal for a new administration – a personal view

Reform so far – a bit of history

- Independent Public Service Pensions Commission
- Established under the Coalition Agreement
- Chaired by John Hutton with terms of reference :-

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."

- Interim report published in October 2010
- Final report published in March 2011
- Independent Commission de-commissioned almost immediately

Reform so far – a bit of history

Hutton's main recommendations and conclusions :-

- Retain defined benefit arrangements
- Move away from final year arrangements
- Defined contribution for all ruled out – no race to the bottom
- Explore options around career average/hybrid arrangements
- Move members into new scheme for future service
- New schemes to be in place by 2015
- Maintain final salary link for accrued service
- Achieve short term savings by increasing member contributions

Followed up by PSP Bill in 2013 which was enacted in 2013 after some debate particularly in the Lords

LGPS 2014 – a reformed scheme

- CARE
- 1/49th accrual
- CPI revaluation (could go minus)
- Pension age linked to State Pen Age (min 65)
- Voluntary retirement from 55 (full cost to employee)
- 50/50 option
- Cost management
- Rule of 85 retained (60+?)
- Protection for all pre 2014 service
- Underpin for those within 10 years of age NPA at April 2012
- CLUB transfers retained

Reform of structure – stalled or dead?

- May 2013 DCLG/LGA roundtable
- June 2013 Call for evidence
- Dec 2013 Hymans report
- May 2014 government response to call for evidence
- May 2014 open consultation – CIVs and passive investment
- July 2014 consultation closes
- April 2015 – pre election period and conspicuous silence

Affordability and sustainability – facts and figures – the financial background

- 40% cut in government funding since 2010[1]
- £10 billion of gross savings found in the three years from 2011/12[1]
- Council tax now funds around half of local government spending* (up from 40% in 2010)[2]
- Net service spend down from £115b in 2009-10 to £95b in 2014-15 [2]
- Spending per person down by 23.4% on average [2]
- Cuts in spend have varied across the country from 46.3% to 6.2% per person [2]
- Largest cuts in spend have fallen on London, North West and North East [2]
- 53% (and rising) of net service spend goes on adult social care [2]
- A further £13b is to be found from government departments from 2015 to 2019/20 when expenditure will rise in line with growth
- However local authority reserves rose to approximately £24b only £4b of which is neither ring-fenced nor earmarked [4]

Source [1]LGA [2] IFS * excluding directly funded activities [4] DCLG

Affordability and sustainability – facts and figures – LGPS 2014 annual report

- Average LGPS pension £5000 per annum (includes part time members)
- Number of employers is 10,000 up 700 from 2013
- Number of total members is 5m (actives 1.8m, deferred 1.7m pensioners 1.5m)
- Active membership up 5.0%, (90,000) in 2014
- Total income £12.7b (inc £3.4m investment income) total expenditure £9.7b
- Contributions income £8.7b (employee £2.2b employer £6.5b)
- Benefit payments £8.5b
- Total assets £192b, up from £181b (2013)
- Asset split includes - equity £74b, £79b pooled vehicles, £15.2b bonds, £12.6b property, £3.6b private equity
- Return figures average 6%, relative performance +2.6% (compared with WM corporate universe[1])

[1]WM Company Local Authority universe based on 85 LGPS funds with a total Market Value of £175bn; and the Corporate Pension Fund Universe based on 109 Funds (covering 60% of UK corporate funds) with a total market value of £327bn.

Affordability and sustainability – facts and figures – LGPS funding

- LGPS common contribution rates at 2013 valuation ranged from 13.5% to 39% of payroll[1]
- Funding ratios ranged from <u>56%</u> to 101% with the average at 79%[1]
- Average deficit contribution is 36% of total[1]
- Total local authority employer contributions in 2014 just under £5b[2] so about 5.25% of net spend (or 10.5% of council tax*)
- Of which around £1.8b goes toward paying off the deficit
- Total deficit is £48b (or £27b using HMT discount rates) [1]
- Scheme is cash-flow neutral at contributions and benefits level but £3b in the black when investment income is included
- Without the deficit the new scheme would cost local authorities about £2.9b[3] per annum or about 3% of net spend (or 6% of council tax*)

[1]SAB 2013 valuation report, [2]based on 75% LA membership of LGPS, [3]assumes a total £30b payroll and 75% LA membership
*excluding directly funded activities

Affordability and sustainability – the options – future service costs

- Future service costs linked to benefit structure and membership profile
- Benefit structure will be amended by cost management processes (49th may be short term)
- Employer FSR targets are 13% (SAB) and 14.6% (HMT)
- Cost management can bite up to 2% (SAB process) and is mandatory beyond 2% (HMT process)
- Changes to benefit structure outside of cost management can only be made by meeting ‘the high hurdle’ (PSP Act 2013)
- Detrimental changes would further increase intergenerational inequality and risk opt outs potentially worsening membership profile and cash-flow
- Closing scheme to new members would immediately increase FSR by around 2-3% and significantly worsen cash-flow situation
- Cash-flow and profile helped by more and younger members
- Cash-flow/liability balance exemplified by 50/50 and transfer to DC potential – both reduce long term liabilities but worsen cash-flow

Affordability and sustainability – the options - deficits

- Over a third of cost relates to past service deficit. Deficits can be better managed but can only be reduced by extra contributions, lower liabilities or better investment returns
- Benefits (liabilities) already accrued are protected by primary legislation (Pensions Act and European property rights) Any real impact on liabilities would therefore require primary legislation and a radical shift in government policy
- How should deficits be measured? Standard discount rates, best estimate?
- Is cash-flow management a more appropriate target than deficit reduction?
- Could deficit reduction plans take into account forecast spending levels and target extra contributions when they can be best afforded?
- Could a look at LA financing, for example, rules around the use of reserves and treatment of contributions in spending totals lessen the strain without losing sight of the objective?
- Is there a case to conditional indexation of pensions or deferred pensions?

Costs and value – facts and options

- Total expenses £644m (£504m investment, £140m administration) [1]
- Disclosed investment costs were 0.26% but these ranged from 1.13% to 0.02%[1]
- Hymans estimated actual investment costs (including transaction fees) at £800m but some estimates put costs nearer double at over £1b
- Using £1b for investments then total costs 0.63%[2] in 2014
- Consultation highlighted potential savings of £230m by moving to passive and £240m by moving away from fund of funds for alternatives
- DWP proposed charge cap for DC pension schemes is 0.75% The LPGS as a whole would be fine but 6 funds would have broken it at disclosed fee levels and up to 31 if investment fees are assumed to be double[1]
- Could a more open market, following a similar path to transparency as in DC, drive value for the LGPS without having to resort to active v passive arguments?
- Would a similar charge cap to DC drive innovation amongst funds to seek more cost effective ways of investment without mandating CIVs?

[1]LGPS Annual report 2014

[2]using a total asset value of £190b

Proposals for a new administration? – a personal view

- **Get real about problem funds**– *provide the data needed for effective use of Section 13*
- **Cap future costs** – *effectively use the SAB/HMT process to limit cost pressures by changing the future benefits package*
- **Balance deficit reduction and cash-flow** - *Set realistic deficit measurement parameters together with reduction and cash-flow objectives that take into account the current financial strain on employers*
- **Regulate for value and transparency** – *drive value through open and transparent investment markets*
- **Cap fees** – *drive innovation through a fund level charge cap*

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