HYMANS ROBERTSON

pensions reform

Consultation on contribution increases for the LGPS October 2011

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Summary

On 7 October 2011 the Department of Communities & Local Government published a consultation paper with proposals to deliver short term savings in the LGPS (England & Wales) of £900m per annum by 2014-15, equivalent to a 3.2% of pay average increase in employee contributions. Further proposals will follow on longer term changes put forward by Lord Hutton as part of his review into public service pension schemes. In order to limit the size of employee contribution rises in the short term, while still delivering the required cost savings, the consultation paper proposes reductions in future accrual rates possibly combined with an increase to retirement age. In this briefing we summarise the consultation paper and our initial thoughts on the proposals and their implications for the LGPS.

Introduction

At the Spending Review in October 2010 the Chancellor announced that employee contributions to the LGPS (England & Wales) would be increased in order to deliver short term cost savings of £900m per annum by 2014-15, equivalent to 3.2% of pay on average. These increases, which are to be phased in from April 2012, will also apply to the unfunded public service schemes. However, the Government has since accepted that the funded LGPS can be treated differently and can use alternative ways to deliver the savings.

On 20 July 2011 the Secretary of State for the Communities & Local Government invited the Local Government Group (LGG) and local authority Trade Unions to propose their preferred approach to delivering the required cost savings by 2014-15. The LGG submitted a set of proposals to the Secretary of State on 21 September 2011 although these did not have the support of the Trade Unions. On 7 October 2011 the Department of Communities & Local Government (DCLG) published a number of options for consultation. The closing date for responses is 6 January 2012.

Proposals

DCLG has put forward two main options to deliver the £900m per annum cost savings by 2014-15. It has partially reflected the Government's previously stated aim of protecting low earners, with no increases in the employee contributions for those earning less than £15,000 on a full time equivalent basis and increases limited to 1.5% of pay by 2014-15 for those earning up to £21,000. In addition, high earners pay progressively more reflecting their higher pensions although increases should be capped at 6% of pay.

Rather than making all the savings by increasing contributions (subject to the above constraints), DCLG has proposed smaller increases in employee contributions combined with reductions in benefits:

Option 1:

- A phased increase in employee contributions from April 2012 to deliver an additional £450m per annum (equivalent to 1.5% of the pensionable pay bill) by 2014-15.

- The remaining £450m per annum to be achieved through a stepped reduction in the scheme's accrual rate from the current 1/60th to 1/64th for the year from April 2013 and to 1/65th from April 2014. This change will of course impact all scheme members (including the lower paid).

Option 2:

- A lower phased increase in employee contributions from April 2012 to deliver £300m per annum (equivalent to 1% of the pensionable pay bill) by 2014-15.

- The balance of £600m per annum to be raised by a larger reduction in accrual rate from 1/60th currently to 1/67th from April 2014. Again this will impact all scheme members (including the lower paid).

The consultation document also mentions the option to increase retirement age - in combination with changes to the accrual rate and/or employees' contributions. The Government Actuary's Department has calculated that setting the LGPS normal pension age equal to State Pension Age (SPA) would deliver annual savings of £330m if implemented for future service accruals. LGA proposals are also included as an option.

Finally, the consultation proposes a technical amendment to the regulations to allow a downward revision of employer contribution rates between the three-yearly actuarial valuations. This would allow employers to benefit from any savings achieved once the scheme amendments are introduced (although this requires careful consideration for the reasons we set out below).

It should be noted that this consultation only covers the LGPS in England & Wales. On 21 September 2011 the Scottish Government confirmed it will not impose the changes on the LGPS in Scotland, although changes resulting from the Hutton review will be considered at the appropriate time.

Our initial thoughts

We support proposals that avoid the full 3.2% average increase in employee contributions by 2014-15 since this should help reduce the number of people opting out. Although reductions in benefits are not ideal at a time when we need to encourage proper retirement provision, they may be unavoidable in order to minimise contribution increases and keep members in schemes.

The proposals will also put additional strain on scheme administrators. Administrators will have to implement short term changes in contributions and accrual rates, auto-enrolment and the Hutton reforms in 2015 at a time when staff numbers are, in many cases, being reduced.

These interim changes will increase complexity for members. Many members will end up with pre-2008, post-2008, post-2012 and post-Hutton benefits. These benefits could potentially have different accrual rates and different retirement ages.

In the interest of simplicity it would ideal for members and administrators if these changes could dovetail with any post-Hutton reforms.

The biggest challenge will be communication to members. It is in nobody's interest if people leave the scheme because of contribution increases, albeit we appreciate the financial pressures individuals are under and the impact apparent continual changes to their pension scheme have on their confidence in it. Members need to be reminded that they have a lot to lose by opting-out, including valuable employer contributions which can amount to tens or hundreds of thousands of pounds over a working lifetime, and that by doing so they will end up relying more on state benefits in future.

Members also need to understand that even with changes along the lines proposed, public service pensions would remain amongst the best in the UK. Experience shows that good communication aids this understanding and will help keep members in schemes. Communication is therefore the key to the reform process.

Although regulation changes might allow reductions in employer rates prior to the 2013 valuations to reflect increases in employee contributions and/or reductions in benefits, many Funds working with their advisors may conclude that it would not be appropriate to reduce employer contribution rates at the current time. Given the deterioration in market conditions since the 2010 valuation and the weakening of assumptions and (in some cases) lengthening of deficit recovery periods to help contain contribution increases at the 2007 and 2010 valuations, we believe there is currently a strong case for keeping employer contributions at their current levels. Even if contributions remain as they are until the next valuation, these changes will save employers and tax-payers money in the long term and will help avoid bigger increases in contributions in future. It is also worth noting that the savings could vary significantly between employers. We do, however, recognise that there will be local considerations and that decisions may also depend on the circumstances of individual employers.

Conclusions

Alternatives to a large increase in employee contributions are welcome since a big increase runs the risk of more members opting out. In considering the options on the table, we should remember the implications for administration and any additional complexity for scheme members. In an ideal world the short term changes would dovetail with the Hutton changes expected to take effect in 2015.

Finally, experience shows that there are benefits in communicating with members now even though changes are not yet finalised. Communication helps reduce anxiety, improves appreciation of benefits, keeps members in schemes and eases the path to reform.

Next Steps

The consultation on contribution increases runs until 6 January 2012. In the meantime we await more details on the post Hutton changes.

If you have any questions or comments on the initial thoughts set out in this briefing then please get in touch with your usual contact.

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