MERCER VIEWPOINT
REFORM OF THE LOCAL GOVERNMENT PENSION SCHEME
OCTOBER 2011
CONTENTS

1. Introduction .................................................................................................................. 1

2. Consultation on proposed changes from 2012 .............................................................. 2
   • Financial Aspects ..................................................................................................... 4
   • Employer Contribution Reductions ........................................................................... 5
   • Communication ....................................................................................................... 6
   • Administration ......................................................................................................... 6
   • Alternative Proposals .............................................................................................. 7

3. Longer Term Changes .................................................................................................. 8

4. Conclusion .................................................................................................................. 11

Appendix: Reference Scheme details ............................................................................. 12
Introduction
The statutory consultation on the proposed changes to the LGPS from 1 April 2012 was published on Friday 7 October. At roughly the same time, but less publicly, the Chief Secretary to the Treasury wrote to the TUC to set out the Government’s proposals on the framework for the public sector arrangements post 2015. Whilst these details have not been formally released, they have been widely reported in the media. In this note we comment on both the consultation and the longer-term proposals, and look at the scope for tying together the outcomes of the two exercises more closely.

Whilst the principal focus of the reforms is the financial aspect there are many different facets which the LGPS funds and the participating employers will have to consider e.g. communication, administration etc. We therefore comment on these too. Given the changing pensions landscape emerging due to auto-enrolment and pensions taxation over the next few years, the strategy around the pension arrangements of many non-public sector employers may well change. The implications of these changes and the reforms for the LGPS, against the backdrop of the current economic downturn, will take some time to emerge fully.

This report has been prepared for the purpose of providing commentary to the Administering Authority in relation to the pension reforms for the LGPS. This note cannot be provided to a third party without permission from Mercer and even if such permission is provided we do not accept liability to any third party in respect of this advice; nor do we accept liability to the Administering Authority if the information is used for any purpose other than that stated.
Consultation on proposed changes from 2012
Full details of the consultation can be found at


The primary aim of the exercise is to achieve a cost saving within the LGPS of around £900m by 2014/15. The consultation takes into account earlier proposals made by the Local Government Group, and even goes so far as to include those earlier proposals for consideration alongside the Government’s own “Approach 1” and “Approach 2” options.

The key elements of each of the approaches are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Approach 1</th>
<th>Approach 2</th>
<th>LGG Proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member contributions</td>
<td>Average increase of 1.5%, phased in from 1 April 2012</td>
<td>Average increase of 1%, phased in from 1 April 2012</td>
<td>Increase of up to 2.5%, possibly phased in from 1 April 2012</td>
</tr>
<tr>
<td>Pension Accrual Rate</td>
<td>1/64ths from 1 April 2013 1/65ths from 1 April 2014</td>
<td>1/67ths from 1 April 2014</td>
<td>Optional: earners under £15K can reduce contributions from 1 April 2014 and move on to accrual rate of around 1/68ths. Others may keep existing contribution rates, with accrual rate of around 1/68ths.</td>
</tr>
<tr>
<td>Normal Pension Age</td>
<td>No change</td>
<td>No change</td>
<td>Increase to 66 from 1 April 2014</td>
</tr>
</tbody>
</table>

The consultation asks 5 questions about the proposals. Our preliminary views are set out alongside each one, and are developed further below.

1. Do the proposals meet the policy and objectives to deliver the necessary level of savings in the LGPS?

   Yes, we believe that all three sets of proposals have been constructed so as to ensure the necessary savings are met.
2. Are there any consequences or aspects of the proposals that have not been fully addressed?

The areas of communication, administration and change management have not been fully explored in the consultation. All will require considerable work in order to enable any changes to be implemented successfully.

3. Is there a tariff or alternative measures which consultees think would help to further minimise any opt outs from the scheme?

In our view, in order to minimise opt-outs any increases in member contributions need to be kept to a minimum, and any changes in benefits kept as simple as possible. This would point towards Approach 2 in the DCLG proposals.

4. Are there equality issues that could result in any individual groups being disproportionately affected by the proposals? If so, what are considered to be the nature and scale of that disproportionate effect? What remedies would you suggest?

In some respects the proposals for reduced benefits run counter to one of the original stated aims of making the low paid no worse off: a reduction in employee contributions for this group would offset this effect, although we accept that such a move might well require even higher contribution increases further up the earnings scale. The proposals as they stand could lead to some lower paid members opting out and disadvantaging themselves in their retirement, particularly part-time members where the contributions are based on the full-time equivalent rather than actual earnings.

5. Within the consultation period, consultee’s views are invited on the prospects of introducing into the LGPS a link with state pension age as recommended to the Government in Lord Hutton’s report.

This adds another layer of complexity, at a time when there are Government proposals for further changes to state pension age, and the interaction with existing pension age protections under the LGPS could be particularly difficult for members to understand. We therefore think the link to state pension age is probably best deferred until after 2015.
Mercer comment:
We strongly support the proposals for a large part of the required savings to be generated by way of benefit changes, rather than purely contributions increases. Indeed it would be perhaps preferable to deliver the savings solely through benefit changes to minimise the opt-out risk. However, for political reasons and comparability with the other public sector pension schemes, where an increase in member contributions seems almost certain, we would suspect that the Government would be very unlikely to accept a proposal for the LGPS which does not contain a significant element relating to member contributions increases. The Government also seems to favour changes in the pensions accrual rate rather than in the scheme’s normal pension age: we would surmise that their preference is to defer the change in pension age until the wider Hutton reforms are introduced in 2015.

Financial Aspects
The savings for employers, as set out in the consultation document, which are expected to result from each set of proposals are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Approach 1</th>
<th>Approach 2</th>
<th>LGG Proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012/13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contribution increases</td>
<td>£180m</td>
<td>£95m</td>
<td>Up to £120m</td>
</tr>
<tr>
<td>Benefit changes</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Total</td>
<td>£180m</td>
<td>£95m</td>
<td>Up to £120m</td>
</tr>
<tr>
<td>2013/14</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contribution increases</td>
<td>£360m</td>
<td>£220m</td>
<td>Up to £360m</td>
</tr>
<tr>
<td>Benefit changes</td>
<td>£360m</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Total</td>
<td>£720m</td>
<td>£220m</td>
<td>Up to £360m</td>
</tr>
<tr>
<td>2014/15</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contribution increases</td>
<td>£450m</td>
<td>£300m</td>
<td>£600m</td>
</tr>
<tr>
<td>Benefit changes</td>
<td>£450m</td>
<td>£600m</td>
<td>£300m</td>
</tr>
<tr>
<td>Total</td>
<td>£900m</td>
<td>£900m</td>
<td>£900m</td>
</tr>
</tbody>
</table>

Clearly each set of proposals achieves the £900m savings by 2014/15, although the savings in earlier years could vary significantly. Our own calculations indicate that the change in pension age to 66 under the LGG proposals would need to include the abolition of the existing pension age protections in order to deliver the required savings. This is an area to be investigated further if the LGG proposals are to be pursued and it is not clear whether this was intentional or if there was an overstatement in the possible saving.
Obviously the details will vary from fund to fund, and by employer within each fund, so any fund/employer requiring their own particular analysis may need specific calculations carrying out.

A key financial aspect is the impact on the members – in particular the different earnings groups. The Government has made no secret of the fact that members will need to pay more for lower benefits. There are examples of the impact of each option in the consultation document.

An important dynamic is the effect on the “lower” earners when compared to the option of collecting the savings solely through increased member contributions (as per the unfunded public sector schemes). In practice, the changes for the lower earners are helping to support a marginally lower increase in contributions for the middle to high earners. The LGG proposals mitigate this by including a contribution reduction for the lower earners. This issue could very well become an area where the unions make a case for showing where the proposals are at odds with the original intention to protect those members earning under £15,000 per annum.

**Employer Contribution Reductions**

Paragraph 4.11 of the consultation raises the prospect of employers benefitting from the effect of the changes via reductions in contributions in advance of the next actuarial valuation. In current market conditions this could prove somewhat difficult to justify. For LGPS Funds, funding positions generally have deteriorated significantly since the contribution rates were set in England and Wales as part of the 2010 actuarial valuation, with investment markets over the last 3-4 months being particularly difficult and volatile. In general, it would be difficult for us to advise funds to allow contribution reductions, were they to be given such a choice. In any case, the majority of the savings would seem to be planned for 2014/15, which is when the contribution rates certified at the 1 April 2013 valuation would come into effect.

**Mercer comment:**

A more general power to amend contribution rates in between actuarial valuations would seem more appropriate than a specific one targeted at these particular changes. This could be framed to be less restrictive than suggested in the current consultation, and could allow individual funds to reach the right decision for them based on their own particular circumstances, having regard to their own Funding Strategy Statement. In practice, this would allow funds to take account of the likely longer term contribution requirements, having regard to current financial markets, the effects of the short-term savings and the likely cost of the scheme post 2015.

Given that funding levels have typically fallen by around 10% since the 2010 valuations it would seem difficult to support a reduction in contribution rates without careful consideration of the potential impact on rates emerging from the 2013 valuation. It is likely that funds will come under pressure from some employers to reduce contribution rates but in our view funds should maintain contributions as far as possible. To support this we would recommend that funds consider an update in the funding position and impact on contribution rates if this has not yet been completed.
Communication

There are a number of different audiences, each with their own key messages. To pick a few examples, employer finance contacts will want to know the implications for the costs of the scheme, both in the run-up to and after 2015; HR contacts will need to know the details of the changes so that they are in a position to deal with queries in an informed way; and of course members will want to know precisely how it affects them – getting timely messages across in the right way will be one of the key factors in minimising opt-outs from the scheme.

Mercer comment:
Communication is a key issue, which must demand sufficient resource at all stages of the process. Inevitably there will be significant comment about the changes both in the press and from employee representative organisations. Much of this comment will be negative from a member perspective, so it is essential that Funds promote continuing benefits of the Scheme at an early stage and reinforce the “value” of the LGPS in terms of long term retirement planning.

There is clear scope for Funds to collaborate to keep stakeholders informed and we would support a strong communication strategy from Funds either on an individual or collective basis. Care would need to be taken over the wording used to ensure that Funds are not considered to be giving financial advice.

We would be happy to assist and share material accordingly and we would expect other groups (such as the LGE) to continue to provide useful material.

Administration

The effect on the administration of the Funds, both at employer and Fund level, is often low down on the list of considerations with those responsible for the making the decisions. However, the complexity of these changes should not be underestimated. Potentially they involve a combination of a greater number of pay bands for contributions-setting purposes, a change in accrual rate (perhaps even more than one change), and a change in pension age. At the same time, it should not be forgotten that there will also soon be considerable change needed to HR and Payroll processes for employers as a result of auto-enrolment which will add to their administrative burden.

Mercer comment:
From both an administrative and communication point of view, we believe that a change in pension accrual rate is simpler than a change in normal pension age, particularly when the interaction with existing protected pension ages is taken into account. It would also be preferable for just one set of benefit changes to be made from a single implementation date. Of all the options put forward, we believe the LGG proposals are likely to be the most complex administratively, as they involve a combination of all three changes plus an element of member
choice. Approach 2 is, in our view, the simplest of the three to introduce, but slight variations could be made to Approach 1 which would simplify that particular option. Of course, with any of the options, changes could be made to simplify the process. For example, adjusting the LGG proposals so there is a consistent change in contributions and benefits across the membership would be preferable when coupled with an option for members to increase benefits via additional contributions. Essentially this is the position in the Scheme now via AVCs or ARCs.

Alternative Proposals

The Government has welcomed the possibility of respondents submitting alternative proposals, provided they are properly costed and are submitted in sufficient time to have any costs verified by the GAD. Clearly a package of changes based simply on reducing benefits might well be more attractive to members, and therefore minimise opt-outs from the scheme. However, as mentioned above we suspect this could prove difficult from a political perspective. The intention to submit a proposal was required by 28th October in theory. However, if a fully costed proposal was to be submitted we expect that the DCLG would still accept it, provided it was submitted by 25 November.

Mercer comment:
Costing and submitting alternative proposals is an area where there are clear potential benefits from collaboration between funds. Whilst the DCLG/HM Treasury would consider individual responses, a collective proposition will provide greater strength to the proposals put forward. This would need proper costing, although we believe most of the information is readily available from the details already in the public domain. We do have some concerns regarding the costings for the LGG proposals which are commented on above.

If there is sufficient interest we are happy to facilitate further “round table” meetings to groups of funds. Please let us know if this is of interest to funds and we will arrange these with the appropriate stakeholders. This could cover discussions around an alternative proposal or to agree the support of one of the approaches included in the consultation document (including the LGG proposal).
Longer Term Changes

The Government's proposals for the longer-term LGPS have been emerging gradually over the last few months. On 7 October HM Treasury wrote to the TUC with final details of the proposed Reference Scheme, against which the long-term costs will be benchmarked.

At the date of writing, details of the Reference Scheme had not been formally released, but the main details as reported in the media are set out in the Appendix. The main features for the four largest public sector pension schemes are a Career Average Revalued Earnings (CARE) pension scheme with an accrual rate of 1/65ths and a normal pension age linked to State Pension Age.

The gross and net cost ceilings (allowing for modified employee contributions) for the 4 main schemes in England and Wales are set out below, as reported from various sources and other papers:

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Gross cost</th>
<th>Net cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Government Pension Scheme</td>
<td>17.3%</td>
<td>9.3%</td>
</tr>
<tr>
<td>NHS Pension Scheme</td>
<td>20.2%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Principal Civil Service Pension Scheme*</td>
<td>20.8%</td>
<td>15.2%</td>
</tr>
<tr>
<td>Teachers Pension Scheme</td>
<td>20.1%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

* includes Scotland

The position on the gross cost ceiling for the LGPS seems to be less clear than for the other schemes, and this must be because there is interaction with the level of member contributions emerging from the short term changes proposed. The actual gross cost of the Reference Scheme for the LGPS, as determined by GAD, has been reported as 18.8% of pay. However, the HM Treasury has indicated a gross cost ceiling for the LGPS of 17.3% of pay. Based on our interpretation of the information, the Reference Scheme could not have been accommodated within this cost ceiling and, as we expected, some further clarification of HM Treasury's intentions has emerged. HM Treasury's initial proposals on the short-term changes to the scheme had been for employee contributions to increase by about 3%, whereas an increase of up to about 1.5% appears to be emerging from the recent consultation under Approach 1 of the consultation. HM Treasury therefore seem to be taking the view that a further increase in
member contributions is unlikely, and that the LGPS benefits will therefore be lower than the Reference Scheme. However, this seems pre-emptive and we would have thought it better for such a position to arise following discussion with stakeholders.

Irrespective of the above debate, the net cost ceiling i.e. the cost to employers/tax payers is 9.3% of pay. In our view, this is the key statistic which will drive long-term costs, so how this is arrived at, either via member contributions increases or benefits, is perhaps a moot point when considering the employer costs. However, the gross cost ceiling is very important for designing the benefit structure of the Reference Scheme.

One point to note is that it would appear that nothing has been built into the Reference Scheme for the continuation post 2015 of the pension age protections which currently apply (principally these are for the “Rule of 85” retirement age to be protected up to 2016 with the protection tapering out up to 2020). Should these be a feature of the new arrangements, then there may need to be other compensating adjustments to benefits and/or contributions to remain within the overall gross cost ceiling.

Gross cost ceilings for the other main public sector schemes are shown in the table above. The PCSPS net cost is substantially higher than for the LGPS at 15.2%, as a result of the lower average employee contribution rate, even after the proposed increases in the run up to 2015. The equity of the various member contribution levels across the schemes has been debated many times during the Hutton review, and it appears that despite many practitioners pointing out this apparent inequality, the relative positions will not change.

For employers, the new LGPS cost seems targeted to be perhaps 5%-6% of pay lower than the existing arrangements. Much of this is due to the proposed increases in employee contribution rates (which have a £ for £ effect on employer contributions), but it also takes account of a lower accrual rate of 1/65th and the later pension ages which apply under the Reference Scheme. What it does mean however is that, ignoring any deficit contributions, the employer to employee contribution ratio will be closer to one to one that the often debated two to one ratio.

There is, however, much that still needs to be discussed, and a significant part of the proposals would seem to depend on the extent to which it proves possible to implement increases in employee contributions as part of the shorter term reforms. It therefore remains to be seen whether the Government’s initial proposals will survive substantially intact, or whether significant change will be required.
Mercer comment:

In the majority of pension scheme design exercises it would be standard practice to make changes to the scheme at one point in time, as opposed to twice in a short period – essentially the single change we experienced in the 2008 reforms. However, it is clear that the Government, for both political and financial reasons, needs to consider the changes in two stages. Nevertheless, it would seem sensible to us to at least consider the direction of the post-2015 changes to accrual and possibly normal pension age in order to debate whether it would be preferable to bring some aspects of the 2015 reforms forward. To some degree this would avoid further communication and administration complexity as only one set of changes would be implemented. In the context of the consultation on short term changes this would require a separate proposal. Even then, whether this is politically acceptable is debateable and our understanding is at this stage it is highly unlikely.
Conclusion

The short-term changes should not be considered in isolation from the longer-term position and, in particular, it would seem bizarre if any of the short-term changes were to be undone when the new scheme is introduced in 2015. We are, however, aware that the changes are potentially fraught with difficulty, and that compromises are necessary. The reality is that compromises often do not make good long-term policy.

The historic benefit complexities within the LGPS, alongside the parameters set by HM Treasury, lead to an obvious desire to avoid adding a further tangled web of difficulty for administrators and pension fund managers – not to mention the communication challenges that would need to be addressed. This leads us to the conclusion that, in the short term, there is perhaps little room for innovation around the changes that would ultimately deliver the savings demanded. The only practical options in the short term seem to be changing the balance between the main parameters (member contributions, accrual rate and normal pension age) which are covered by the approaches in the consultation. Other design areas that could be considered are around ancillary benefits such as pensionable pay, spouses benefits etc, but in our opinion these are benefits that should be dealt with in the long term reform proposals to achieve a scheme which is fit for purpose for some time to come.

Therefore, on balance, we would support a short term reform option which gives the lowest impact on member contribution increases to minimise the risk of opt-outs, whilst as far as possible keeping a level of simplicity of design. In terms of the current options proposed, this would be either:

- Approach 2 of the consultation document; or
- The LGG proposal with some further modification in the accrual rate and the structure of the benefit increase options made available to members. Whether this would be acceptable politically (given the base option would need to reduce member contributions for lower earners) is questionable.

Furthermore, ideally the “short” and “long” term reforms should be considered together and not in isolation, principally to help with the transition from the old to the new scheme. We understand at the present time this is highly unlikely given the various factors in play.

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Reference Scheme details

The principal areas of the Reference Scheme, against which the cost of the new public sector pension arrangements will be benchmarked, which have been reported to date are:

- The benefits structure is a Career Average Revalued Earnings (CARE) pension scheme, with revaluation for members in service linked to National Average Earnings;

- The accrual rate for pensions is 1/65ths;

- The Reference Scheme’s normal pension age is linked to State Pension Age;

- Benefits for service up to 2015 will be fully protected, including a link to the individual’s future earnings progression;

- Pension increases are linked to CPI;

- Member contributions are assumed to be roughly 3.2% of pay higher, on average, than under the current arrangements, although there seems to be a suggestion that the increase may be assumed to be 1.5% of pay for the Local Government Pension Scheme.