LAPFF submission to the Independent Public Services Pensions Commission chaired by John Hutton

The Local Authority Pension Fund Forum (LAPFF) is a voluntary association of 52 public sector pension funds based in the UK. LAPFF exists to support and co-ordinate the views of members local government pension funds, particularly to promote vital investment interests and to maximise their influence as shareholders in promoting corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The following comments are made on behalf of LAPFF:

1) LGPS (Local Government Pension Scheme) is different to other public sector schemes

1.1 The LGPS is different to other public sector schemes in many of its features and its membership.

1.2 These differences are:

- The scheme is a defined benefit (DB) scheme funded with assets of over £100bn invested widely in global markets and it has a strong positive cashflow projected for the next 20 years. The funded nature of the scheme and cashflows does give stability and an ability to plan over the long-term, avoiding the need to overreact to short-term volatility in forecasting assumptions used to determine contribution rates.
- As a funded scheme, it is a significant source of long-term capital for the private sector.
- Also, as it is funded, it has the opportunity to produce returns that mitigate some of the liability risks and costs.
- It is a national scheme with approximately 100 funds in the UK which are administered locally. The administration of funds is locally based involving democratically elected councillors who exercise oversight in an open and transparent manner; the management of investment and liability risks being a key feature of these locally based arrangements.
- Employee contributions are tiered, ranging from 5.5% to 7.5% for the highest earners.
- Membership is largely from the low pay groups and the average annual pension in payment is around £4,000, broadly half the amount of other public sector pension schemes.
- Future service employee costs are of the order of 13%-14% of pensionable pay, comparable with open DB schemes in the private sector.
- A review introduced a new scheme from 1 April 2008 which was designed to be affordable and sustainable featuring a cost-sharing provision to protect employers from rising longevity costs.
- Normal retirement age is 65 years.
- Membership is over 4 million with pensioners of 1.2m, deferred pensioners 1.2m and contributors 1.8m.

- Employing body membership is diverse covering councils, non-uniformed staff at fire and police authorities, administration staff at universities and colleges, academies, private contractors with outsourced contracts, voluntary organisations delivering local services. Large funds will have over 100 employing bodies participating.
- Arrangements for both benefit administration and investments are administered locally, but under arrangements set by CLG (Government Department for Communities and Local Government) in England and Wales, the Scottish Public Pension Agency in Scotland and the Department of the Environment in Northern Ireland. These arrangements ensure a high degree of transparency for all interested parties with production of detailed annual reports and accounts, publication of policies and benchmarking data.

2) Summary

2.1 The main point in respect of the LGPS is that overall it represents a viable and sustainable scheme albeit with some amendments required. It makes a significant contribution to giving people on low incomes resources in their retirement to increase their financial independence and reduce their need for state benefits. The LGPS could be a key part of any national policy for ensuring people have sustainable income in their old age. The LGPS as part of a remuneration package is balanced and broadly reasonable in terms of its treatment of public sector workers relative to private sector employment.

It is recognised that some changes are required to ensure it remains fit for purpose and sustainable.

The Scheme is administered locally by councils and a non-departmental public body in Northern Ireland, and while the Scheme overall is robust, it is recognised that a few administering authorities have more challenging positions, due to local decisions taken historically and workforce changes. These should not be allowed to detract from the overall robust position.

3) Creating wealth for people in retirement

3.1 The LGPS has a contribution to make to any national policy for creating sustainable incomes for people in retirement and maintaining viable self sufficient local communities.

3.2 There is currently no declared national policy for providing wealth for people in old age, so it is not possible to clearly identify the LGPS specific contribution. It is clear, however, that there is a need for people to save throughout their working life in order to ensure they have a sustainable old age. A variety of provisions, encouragements and requirements are made by Government and there is much debate over how these should develop. The LGPS can play a significant part in any Government strategy. There are some obvious factors and issues to which the LGPS contributes:

i) State retirement pension levels do not provide individuals sufficient daily income to meet their basic needs, if it is their sole income. This results in substantial assistance being provided by the state in the form of assistance with heating, travel, accommodation costs, as well as assistance through pension credits. LGPS pensions eliminate or mitigate the need for this support for many individuals, largely providing pensions for the low paid, as many LGPS members are part-time workers.

ii) A key factor in keeping people fitter and healthier as they age and, thereby, avoiding the need for social care or medical services, is the amount of daily income they have available. The LGPS assists in reducing the need for care services as individuals are able to fund healthier lifestyles by choice because their income permits this.

iii) Many pensioners, when they retire, continue to live in the same area as before their retirement. Many live in what are regarded as deprived areas. The economic impact of pensions is significant, particularly as those with low to modest income levels are known to spend on local goods and local services.

iv) The LGPS contributes to being able to offer contracts of employment that reflect the nature of public service where, in many jobs, local knowledge, long experience and commitment to local communities is important.

3.3 The attached Appendix A provides outline information drawn together to illustrate the importance of resources in retirement and potential impact of the support needs from the state. Resources in old age come from state pension, occupational pension, savings, property and family to varying degrees. Government provides resources at a basic level (state pension), but has an important role in providing additional financial help for those with very limited other resources (pension credit). Incentives to save for old age are also given, but no direct connections are made between how the Government 'pot' of direct payments to pensions, incentivised savings (largely tax relief) and funding of care costs is distributed or targeted.

Whatever the balance between these elements which is taken forward, the LGPS is uniquely positioned to make a major contribution, providing resources to the lower income groups, reducing the need for state benefits and giving greater financial independence and mitigating long-term social care needs and costs. The costs of the LGPS in this setting offer good value for money.

4) Economic regeneration effect

4.1 Research has established the fact that many LGPS members when they retire do not move out of the area they have lived in for many years prior to retirement. Many pensioners live in deprived areas and the pension paid to these people has a significant, beneficial impact on local communities.

Attached at Appendix B is some research carried out by one LGPS Fund to illustrate the point.

4.2 The LGPS, being a funded scheme, has assets in excess of £100bn, and increasing due to the positive cashflow. A substantial proportion of that is invested through a wide range of instruments in the private sector, including corporate bonds, quoted equities and private equity, along similar lines to the very large US public sector schemes.

Due to the enduring nature of the public sector and pension funds, these assets tend to be invested for the long-term, making the LGPS an attractive shareholder for private sector companies seeking long-term capital.

5) The LGPS is not gold-plated

5.1 There is much misinformation circulating about public sector schemes and how much better they are than private sector schemes. Reviewing the position of the LGPS relative to the typical open DB scheme shows the following comparisons:

i) Strength of covenant

- very strong for LGPS compared with private sector. Facilitates longer term planning.

ii) Retirement age

- has always been 65 years of age in LGPS comparable with many private sector DB schemes. Some limited early retirement rights exist but these will be phased out by 2016.

iii) Benefits paid

- research by the Pensions Policy Institute in March 2010 finds the average effective employee benefit rates for the reformed LGPS (2008 Scheme) for new entrants matches the median DB scheme provision.
- analysis of pensions paid by one larger fund reveals that:
  72% of West Midlands pensions paid are less than £5,000 pa
  90% of West Midlands pensions paid are less than £10,000 pa

5.2 Many private sector DB schemes are closing as they are viewed as being not affordable - with a trend for these schemes to be replaced by DC schemes. The average DC scheme offers less than half the benefits of the DB scheme that it replaces and allows employers to cut their contributions by over 50%. Current workers retirement expectations will not be met at this level (see research by Pensions Policy Institute – Pension Facts March 2010 and earlier studies).

A critical issue is – 'should occupational pension schemes in the public and private sectors be levelled down to the lowest common scheme giving short term savings, but substantial long-term cost implications for the state; or should the current average open DB scheme of benefits be the goal?' The latter is clearly the preferred policy option from the perspective of the public purse and is achievable with the LGPS subject to some modifications.

6) Affordability

6.1 There are two aspects of affordability – current contribution rates and risk of future employing body increases. A problem arises of how the contribution rate is calculated. The traditional actuarial methodology has a number of problems. It produces significant volatility over short and long-term periods, making medium-term planning difficult. The process aggressively states a current funding shortfall that is volatile on a daily basis, very sensitive to small changes in assumptions and difficult to manage when investment markets are volatile. Actuaries have, over time, allowed reduced employer contributions at times when it would have been easier to maintain contributions or even increase them. In difficult economic times, they require higher contributions when they can least be afforded. The calculation can vary significantly on a daily basis. This is very difficult for private sector entities and, to some degree, public sector bodies. The problem is made worse in the private sector with FRS17 accounting standards.

However, when considering the LGPS, a long-term view can be taken. The actuary can be used to produce long-term cashflow projections, which are far more useful in making long-term financial plans to ensure liabilities are fully funded. Using cashflow projections is arguably more suitable for a funded scheme with strong cash inflows like the LGPS. If these are used, current contribution rates will secure positive cashflows over the medium-term for the vast majority of funds. If over the long-term retirement age rises with state retirement age and longevity risk is passed largely to the employee, then positive cashflow projections run into the very long-term (50 years) on current contribution rates. The LGPS as a whole should be able to contain contributions to the current levels excluding increased longevity risk in the future.

It is clear that employers in the LGPS and other public sector schemes cannot carry the full longevity risk and all other risks of meeting the pension promise. The LGPS has been modified to enable cost-sharing to be introduced to involve the individual in taking a share of the longevity risk. It has to be clear that this will work in the context of a cap on employers' contributions at around the current level of contributions.

6.2 Notwithstanding the difficulties of the actuarial valuation of liabilities the LGPS can demonstrate it has, overall, recognised the liabilities and their extent which is reflected in realistic contributions and recent scheme changes (eg, new scheme from 1 April 2008, cost-sharing revisions, strain for ill-health rules, etc). Also it is recognised that further changes are necessary to ensure the LGPS can fully manage significant changes in its liabilities.

6.3 There are claims of a widening pension gap between public and private sector being damaging to the smooth operation of the labour market.

It has to be recognised that many jobs in the public sector do not have similar jobs in the private sector, or are not impacted significantly, eg, teachers, social workers etc. The relevant professional bodies recognise that pension provision is an important tool in being able to offer the balance of working conditions in order to attract and retain staff of the right quality and experience to deliver key public services. What sort of individual do we want to teach our children or attend us if we have an emergency? There are groups where the job content and roles are similar in both the public and private sector and historically there have been competitive forces reflecting in these jobs, eg, pay rates, pensions, career opportunities etc. When labour markets are strong, you could expect market forces to correct any imbalance.

6.4 The vast majority of public sector workers enjoy a final salary pension scheme, unlike the private sector, where many defined benefit schemes have been closed in the last fifteen years driven by short-term cost-cutting and irrational FRS17 accounting rules. Some claim this is unfair as the taxpayers whose schemes have been ended are heavily subsidising better public sector schemes. This, however, ignores the facts, in that the short-term cost-savings achieved by this in the private sector will ultimately result in higher public sector benefit payments as defined contribution schemes fail to produce the expected level of income in retirement for those private sector workers.

There has been much misinformation produced around the cost to the taxpayer of public sector pension provision. The position of non-funded public sector pension schemes is difficult to be clear about because of the notional calculation to create a notional fund and investment returns. The LGPS can, however, be clear about its cost and how it is financed. These costs can and are benchmarked to enable value for money studies to be carried out and private sector comparisons made where relevant. Accounting for the real cashflow costs of the LGPS should not be confused with the actuarially calculated balance of assets and liabilities at today's prices and FRS17 accounting issues.

6.5 A further claim is that public sector workers earn on average 16% more than those in the private sector and again this is inaccurate.

As studies have shown, (Economic Journal *'What is a Public Sector Pension worth?'*, Disney, Emerson and Tatlow; also IFS *'Public Sector Pay and Pensions'*, Bozic and Johnson), it is not possible to make simple comparisons between the public and private sectors. What is clear is the gap is much smaller, varies over time, and there is no evidence that it creates a significant disruption in the medium to long-term jobs market. Many public sector jobs are very different to private sector jobs and the reward package varies to meet specific requirements. The reward package is not just salary and pensions, other relevant factors are health benefits, promotion opportunities, bonus payments and company vehicles. Other differences can be the need to retain experience, the need to meet rapidly changing demands, the public service ethic. The difficulty in filling some public sector jobs over various historical time periods gives the impression there is a long-term self correcting balance between the public and private sectors.

7) Fairness of the LGPS

7.1 Fairness has many subjective views, but can be illustrated in an objective manner when looking at the scale of pensioner wealth.

Pensioner wealth		Income (broad estimate)
Lowest -	Only state pension	£104 per week plus pension credit etc, plus care costs paid
	Average DC scheme	Approximately half former DB scheme which gave £8000 pa
	Average open DB scheme	£8,000 pa (LGPS £4,000 pa)
Highest -	Company director	Proportionately greater pension contributions or equivalent, earlier retirement age than average company employee

Likely to rely on state benefits and not have retirement income expectations met.

The Government's tax incentives to save for retirement are taken proportionately more by the higher wealth groups.

7.2 From this it is self evident that to reduce the LGPS benefits would not, in fact, be in the interests of taxpayers, as they would be picking up additional cost through the benefit system, albeit at a later date. It makes far more sense to collect contributions during the working life of members, which will be invested and earning a return until the funds are required to pay out the benefits.

High pensions in the public sector have been challenged as unreasonable. However, trying to measure what a high pension means is somewhat subjective. In contrast to the private sector, less than 4% of LGPS pensions exceed the level of four times the average LGPS pension, £4,000 pa, as can be seen from the analysis in Appendix A. Detailed analysis indicates the criticism is much overstated (see CRESC Working Paper Series No. 80 *'Moral Outrage and Questionable Polarities'*, Cutler and Wains April 2010).

8) Summary

8.1 The points raised in this paper support the continuation of the LGPS in its current broad form, but some reform is necessary to ensure it continues to be meaningful to employees and employers, and offer value to all interested parties.

8.2 i) All public sector schemes, including the LGPS, should move to a normal retirement age matching state retirement age (except for the recognised special circumstances of the uniformed services). There should be no protection for anyone under 45 years of age. Any early retirement should be with an actuarially reduced pension and no augmentation.

ii) Where early retirement is granted in special circumstances, the contribution history for that individual should be reviewed and the actuarial shortfall should be reimbursed by the employer, together with any strain costs for bringing benefits into payment early, before the benefits can be paid. Such expenditure should be separately identified in the accounts of the employer.

iii) Scheme members should be encouraged to make additional savings, using AVCs, if they want the option of retiring earlier with higher income than the scheme can provide and, in any event, AVCs should be used to help bridge the gap between earnings and retirement income expectations.

iv) Efficient exercise retirements should not be allowed. The only retirements should be normal retirement age, redundancy, ill-health and agreed early retirement with reduced benefits.

v) 'Club transfers' should be stopped and any transfer between funds and schemes in the public sector should be undertaken at actuarially calculated transfer values.

vi) Ill-health retirements to be restricted to the most serious cases and a very clear medical opinion confirming the individual will not work again.

vii) There should be a cap on the salary level for benefitting from the tax advantages and employer contributions. This could be achieved by limiting the tax-free lump-sum as normal pension payments will be taxed in due course. (This is an issue for all pension schemes, public and private, DB and DC.)

viii) The employers' contributions calculated under the national notional LGPS arrangement for 'cap and share' should be limited to 15% and future employee benefits adjusted appropriately or employee contributions increased. Employer contributions at 15% would be something close to the historical median DB employer contributions.

ix) The strong medium-term positive cashflows of the LGPS indicate a cautious approach should be followed when responding to funding calculations impacted by short-term volatile assumptions.

x) The actuarial profession should be charged with producing a valuation method which is philosophically sound, can produce a stable contribution environment and realistic current costs for pension accruals.

Post submission note
A number of member funds have made their own submissions largely to stress points or issues they consider relevant to their circumstances or views.

Any fund that wishes to make a cross reference, a link will be added here.

The Audit Commission made a submission *'Local Government Pensions in England - an information paper, July 2010'* which supports many of the points being made in the LAPFF submission.

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Local Authority Pension Fund Forum

Appendix A

Resources for people in old age and its impact

1) Resources for people in old age

1.1 The level of resources held by the individual in old age has a major impact on the extent of support pensioner members require as they get older and their ability to avoid needing support from state benefits or individual support services.

1.2 The household wealth as measured by the recent Office of National Statistics figures shows the following:

i) Most people are not saving sufficiently for their old age

ii) The richest 10% own 44% of the wealth and are five times richer than the bottom half

iii) Wealth is held as:

Property	39%
Pension	39%
Financial	11%
Physical	11%

The wealthiest 10% has more than half of the country's financial assets and pension wealth. Physical assets are the main asset for the poor, housing for those in the middle and pensions most important for the wealthiest. The report highlights the lack of preparation for retirement and potential call on state support.

Pension provision is critical to resources in old age but those with the lowest wealth are least likely to make a pension provision without some incentive or support.

1.3 The February 2010 Aviva *'Real Retirement Report'* further highlighted the resource difficulties facing an ageing population.

Key observations are:

- Pensioner poverty is a real issue with 21% of over 55s subsisting on an income of less than £750 per month
- The report found that state pension increases have outstripped inflation by 12% (state pension increase: 32% vs. inflation: 20%) over the last 10 years, but many pensioners struggle to survive on low monthly incomes.

  The over 75s (25%) are most likely to struggle, followed by ages 55 – 64 (23%) and 65 – 75 (19%). A number of pre-retirees (55 – 64), however, actually benefited as they reached the retirement age. Receiving their state pension means their incomes were pushed up.

  "The majority of retirees' incomes (42%) was derived from state pensions and benefits with employment (18%), occupational pensions (24%), personal pensions (4%) and investment/savings (11%) making up the remainder.

Contrary to popular belief, over the last decade – as a whole – general inflation (RPI) rose at a roughly similar rate for non-pensioners as it did for pensioners. However, as pensioners 'shopping baskets' are skewed towards certain products and services, they experienced different peaks and troughs than other consumers.

In the early part of the century, rising housing costs drove general inflation (RPI) for many UK consumers but these costs have slowed down due to falling house prices and a historically low base rate. Only 10% of pensioners have mortgage borrowings so while they were insulated from these increases, they did not benefit from the falling costs.

However, significant aspects of pensioners' spend increased sharply between 2005 and 2009; food increased by 25% and fuel and lighting by 77%. Between them these two costs account for 40% of a single pensioner's expenditure and 36% for a couple. At around a quarter of total pensioner expenditure, food takes up more than twice as much of a pensioner's budget than it does as a share of overall household expenditure (11.8% in 2009). The oldest pensioners have suffered the most as their budgets are more skewed to fast rising fuel costs than those in other categories".

1.4 A paper by the Pensions Policy Institute – *'Retirement Income and Assets: Outlook for the Future, February 2010'* – reinforced the issue of the cost of ageing and the ability of individuals to support those costs, or the steps to avoid them. It also highlights the uncertainty around personal funding of core needs relative to state support, the uncertainty around future private company pension arrangements and the impact of NEST.

Extracts of the report commenting on the role or impact of private pensions are:

"*Private pensions are an important source of income for pensioners on moderate to high incomes* - 67% of pensioners receive income from private pensions, though pensioners on high incomes receive on average a much larger proportion (around 35% of their income) from private pensions than pensioners on low incomes who receive on average between 9% and 14% of their income from private pensions."

"*Pensioners on low incomes receive the majority of their income from state pensions* - The private pension reforms could increase the proportion of pensions receiving income from private pensions."

"*Future levels of private pension saving will depend partly on employer responses to reforms.*"

"*Income from private pensions will be affected by changes occurring in the private pensions market* - Though work-based pension provision has traditionally been supplied in the form of defined benefit (DB) schemes, the last two decades have seen an acceleration in the trend for private sector DB schemes to close, either to new members or to new and existing members, and for employers to offer membership in defined contribution (DC) schemes instead. If current trends continue, then active membership in private sector DB schemes could reduced from 2.5 million today, to around 1.5 million active members by 2050."

"*A shift from DB to DC could mean some people will receive lower income from private pensions* - DC pensions could yield lower pension income than DB pensions primarily because contribution rates are often lower in DC pensions than in DB pensions. In private sector DC pensions, employers contribute on average around 7% of salary and employees contribute around 3% of salary. While in private sector DB pensions, employers contribute around 16% of salary and employees contribute around 5%. There is some evidence that employers lower their contribution rates when switching from DB to DC schemes."

2) Trend in population towards an ageing society

2.1 The problems drawn out in (1) above will grow as the population ages and obviously be added to if pension income is not sustained or even falls. Early sustainable pension saving in a person's working life is essential if the ageing trend is to be managed. The LGPS can make a significant contribution to facilitating pension saving in the lower and medium wealth groups in a way that other public sector schemes do not, as it actually collects the contributions and invests them for the long-term, creating genuine savings and investment within the economy.

2.2 The Audit Commission Report on Ageing, February 2010, highlights the trend in ageing and support issues:

The population in the UK is ageing. In 1982, 30% of people were over the age of 50; in 2009 it was 33%, and by 2026 it will be 40%.

As the population ages, the costs of some age-related health conditions will increase. Dementia costs the UK economy £17bn a year. In the next 30 years, the number of people with dementia in the UK will double to 1.4m, while costs could treble to over £50bn a year.

But the population is changing in other ways – economically active pensioners were 3% of the workforce in 1992, but were 5% in 2009. An increasingly older population doesn't just represent a cost to the public sector – it also provides an opportunity to make the most of older people's contributions to the community. 65% of volunteers are aged 50 or over. 25% of carers are aged 60 or over, and the support they provide may be worth around £22bn a year – more than double the current annual public expenditure on care services for older people. Many older people fund their own care needs in whole or part. The level of pension income is critical in keeping their care needs down and requirement for public sector funded assistance.

2.3 Councils must balance the need to provide social care and to support active ageing. If care service provision is simply increased alongside population growth, public spending on care services could nearly double between 2010 and 2026. Private spending on social care would increase from £5.3bn to £23bn over the same period, if trends in means-testing and self-funding continue.

3) The Audit Commission study highlights the impact of wealth in old age:

	Area A	Area B
Proportion of the population over 50	34 per cent of the population are 50 and over (in line with the national average).	45 per cent of population are 50 and over (upper quartile nationally).
Health and death rates	A typical 65 year old man will have good health till 76 and live till 80. A typical 65 year old woman will have good health till 78 and live till 83.	A typical 65 year old man will have good health till 78 and live till 81. A typical 65 year old woman will have good health till 81 and live till 85.
Indicators older people's poverty	20 per cent of people over 60 live in income-deprived households. 28 per cent of people over 60 receive pension credit.	13 per cent of people over 60 live in income-deprived households. 19 per cent of people over 60 receive pension credit.
Migration trends	Well-off older people are more likely to move away from this area, leaving a largely low-income older population.	Well-off older people are more likely to move into this area.

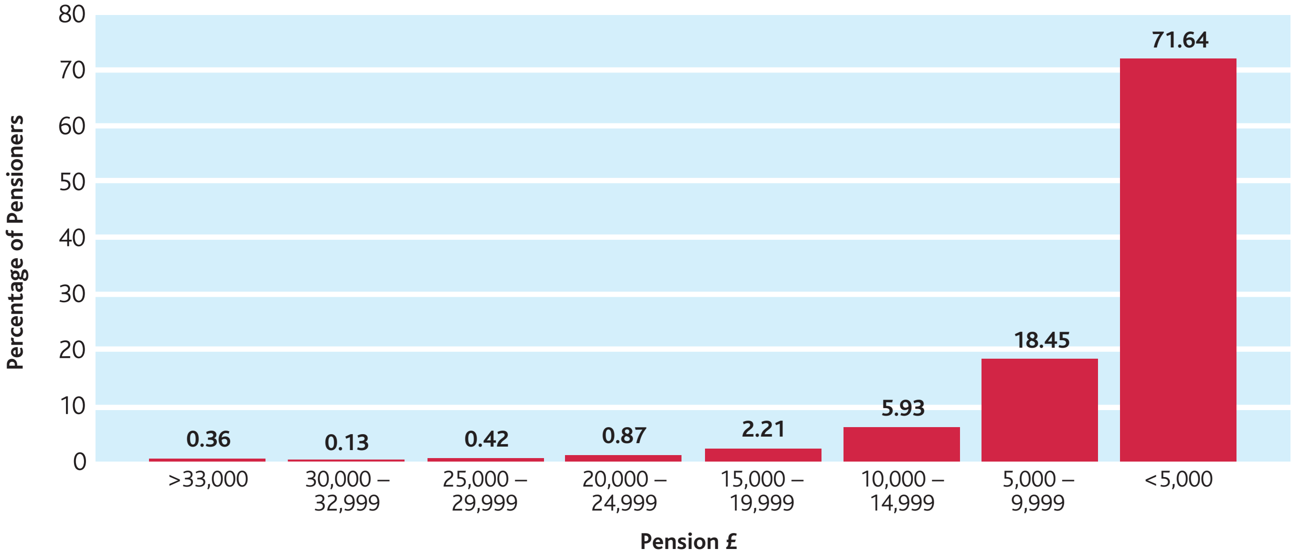
Appendix B

Local Authority Pension Fund Forum

Connection between LGPS pensions paid and geographical deprivation

Research by the West Midlands Pension Fund highlights the relatively low pensions paid by the LGPS and the destination of those payments to people living in areas of high deprivation with its resulting economic impact.

The West Midlands Pension Fund pays annually £250m in pension benefits and the average payment made to 60,056 individuals is £4,305 per annum with the following range:



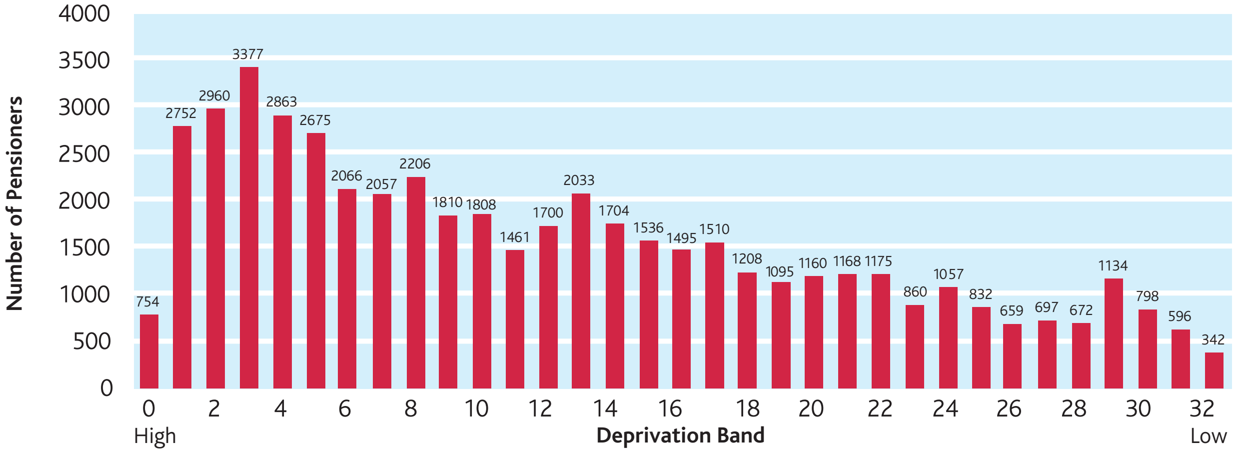
The majority of payments are into households in the most deprived areas of the West Midlands. Approximately £200m is paid to beneficiaries with a postcode located within the West Midlands urban area covering the seven district councils in and around the Birmingham area.

Mapping the post code of those receiving the £200m paid out annually to 50,220 people living in the West Midlands urban area, to the information from *'The English Indices of Deprivation 2007'* shows the following:

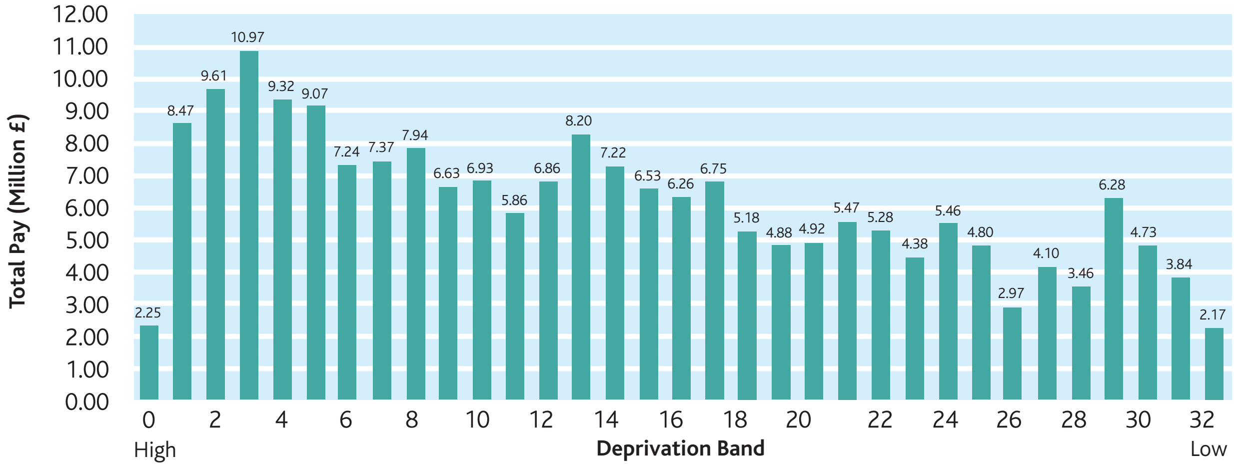
The majority of beneficiaries live in the 30% most deprived areas.

£85.8m per annum is paid in benefits to individuals (£3,400 per individual per annum) living in those areas giving a significant financial boost to families who have some of the lowest incomes per household. The pensioner individuals in the most deprived wards are likely to be on the state minimum pension and having to claim a range of state benefits, finance-related such as pension credit, housing benefits, as well as support-related such as attendance allowance or disability allowance. The LGPS allows many to live fully or partially independently of finance-related benefits. The charts overleaf show the distribution of payments relative to deprivation as measured by the overall index of multiple deprivation 2007.

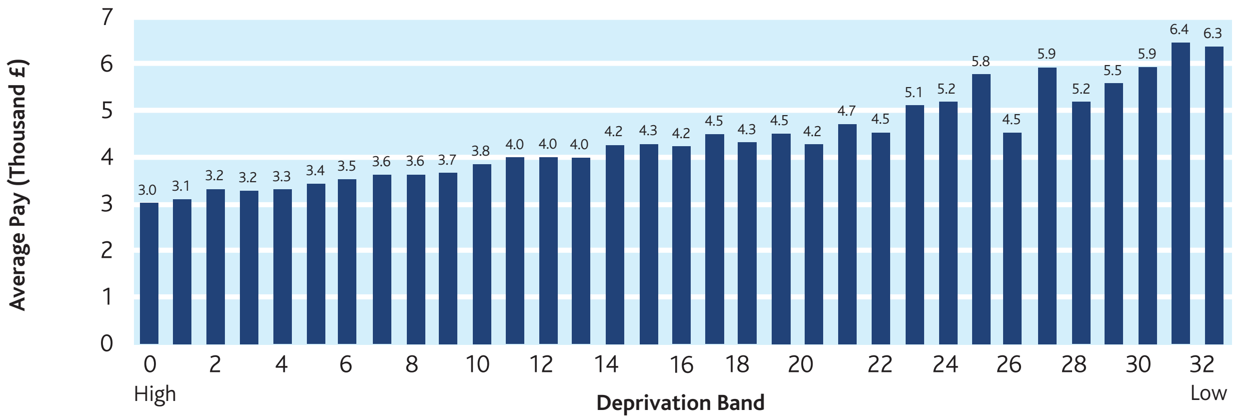
Number of Pensioners Versus Band - West Midlands



Total Pay Versus Band - West Midlands



Annual Pay Versus Band - West Midlands



Total Pay Versus Annual Pay - West Midlands