

Cllr Kieran Quinn

Executive Leader of the Council
Tel: 0161 342 3016 Fax: 0161 342 3543
E-mail: leader@tameside.gov.uk



The Right Honourable George Osborne MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Your Ref:
Our Ref: KQ/JB
Doc Ref: 175Chancellor
Ask for: Janet Burke
Direct Line: 0161 342 3016
Date: 9th February 2011

Dear Chancellor

Local Government Pension Scheme - Proposals for Increased Employee Contributions

Tameside MBC is the administering authority of Greater Manchester Pension Fund. At 31st December, the Fund had over 265,000 members, over 200 employers and assets of £11bn. This makes GMPF the largest fund in the Local Government Pension Scheme in England and Wales and equates to about 8% of the value of the LGPS by value of assets.

I am the Leader of Tameside Council and Chair of the Greater Manchester Pension Fund Management Panel and it is in this latter role that I write to you about the impact of the proposed increases in employee contributions being considered by CLG and the Treasury.

It is good that you have agreed to allow more time to consider and assess the complex issues associated with increasing employee contributions. I hope you find my contribution useful to the consideration of this very important matter.

As an administering authority, our responses to CLG on LGPS consultation issues have traditionally recognised the importance of CLG, employers and employees representatives in determining the value of the pension package and how that cost should be split between employer and employee. Our responses have focused on the efficient and effective operation of the LGPS. However, an important aim of our Management Panel is to encourage good secure pension provision for eligible employees, an aim I am sure that is shared by yourself and the Government. The main purpose of this letter is to highlight the potential consequences of the measures currently being considered and suggest an alternative way forward that better meets the needs of Government, employers and employees.

These are exceptionally difficult times and your plans to reduce the deficit are understood. My perception of the proposed way forward of considering employee contributions by LGPS scheme members separately from the benefits package and age of retirement, is a policy that could have very significant short and long term adverse consequences, not just on Scheme members but on public finances in the long term and society as a whole, through the adverse impact on membership of the LGPS.

From the Chair of an LGPS Fund's perspective, it feels like we are about to enter a perfect storm. GMPF currently has 97,000 employee members and membership has fallen by 4,000 so far this year.

My expectation is that the number of employee members will fall significantly further in the next 3 years as a result of:

- (i) employers reducing their staffing levels;
- (ii) employers closing their admission agreement to new members and/or future accrual;
- (iii) employers ceasing to be financially viable;
- (iv) employees opting out of the pension scheme.

With the spending cuts announced for the next 2 years, and assuming no material change to Scheme design or share in the cost of the Scheme between employers and employees, my expectation would be a 20%-25% fall in employee members, with a corresponding 20,000 – 25,000 increase in pensioner and deferred members. The scale of increase proposed in employee contributions is likely to have a further significant detrimental impact on membership.

I set out below some matters that I consider relevant to a rational consideration of the way forward.

1/ The LGPS is a funded scheme

This means that any change in benefit structure or change in retirement age will have an immediate impact on employer costs. This was illustrated by your change in the measure of inflation from RPI to CPI and taking account of the pay freeze in determining the 2010 actuarial valuation assumptions. Funding levels improved and employer contribution rates were lower than would have otherwise been the case. Thus significant cost savings have already flowed through into the costs of the LGPS in a way that will not have occurred within the Pay as you Go public sector schemes.

2/ The demographics of the LGPS are different

The nature of the work undertaken in local government and employees' work patterns, means that the benefits earned by LGPS members are on average, a lower value than other public sector schemes and the proportion of staff on lower pay bands is greater. Lord Hutton highlighted this point in his interim report.

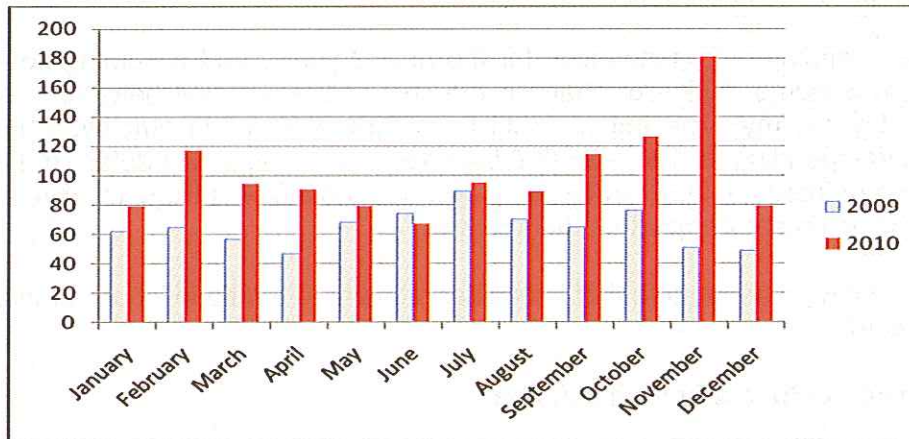
The consequences of these demographic differences and the starting point of banded employee contribution rates (current rates 5.5%-7.5% dependant on pay) means that if consistent protection for those on lower pay scales across public sector schemes is applied, then the necessary increases for employees on higher pay must be correspondingly higher for LGPS scheme members. An "illustration" of the impact presented by CLG showed an increase of 3.2% (from 6.5% to 9.7%) for those earning £24,001 to £31,500 and an increase of 4.2% (from 6.8% to 11%) for those earning £31,501 to £42,000, with materially higher increases for those on higher pay bands, e.g. 14% for those receiving £75k to £100K. This means that employees on similar pay levels in different public sector organisations are likely to be paying materially different employee contribution rates and thus, those on higher rates will have a greater incentive to opt out. In reaching a decision,

on any increases in employee contributions, it is important to consider cross-public sector comparisons and fairness.

3/ Increasing employee contribution rates – impact on the number of members opting out

I set out below at Chart 1, a monthly comparison of the number of members opting out of Greater Manchester Pension Fund in 2009 and 2010. These numbers do not include those that choose to opt out within 3 months.

Chart 1 – Number of Members Opting Out



The reason for the growth in members opting out is driven primarily by affordability and in addition the member's view on value for money.

From the individual member's perspective:

- their own financial outlook is likely to become more challenging;
- they are experiencing a pay freeze;
- some members will see pay reductions as a consequence of the implementation of pay and grading reviews;
- and inflation is running materially higher than the Bank of England target.

Thus members are experiencing significant reductions in their level of real pay and it is understandable that opt out rates are rising and the rate of increase is likely to accelerate. The Fund is endeavouring to mitigate the effect, e.g. through its publications (I enclose a copy of the latest *pension power*, please see pages 6-8) and its roadshows.

Thus, my expectation is that proposals to increase employee contributions at this stage will rapidly accelerate the rate of opt outs. Such an outcome would be the opposite of Government policy of encouraging long term saving for pensions and what the Pension Commission is trying to achieve.

4/ Will increasing employee contributions deliver the planned savings?

For the LGPS, in my view, it is not possible to generate the extra income planned from increasing employee contributions, because as more members opt out, the income shortfall grows and the need for higher increases to

compensate etc. The Treasury assumed rate of 1% of members opting out is clearly unrealistic and a vicious circle develops in that the more contribution rates increase the more members will opt out.

As we all appreciate, the employer will make short term gains in reduced employer contributions as more members opt out, the longer term consequences for all stakeholders are difficult to forecast, but clearly the likelihood of passing on a problem to future generations increases.

5/ 2010 Actuarial Valuations

The last decade has been an exceptionally difficult time for managing a pension fund (in both the private and public sector). Investment returns particularly from equities have been much lower than historical norms and this has coincided with interest rates being at historical lows. The consequence is that most if not all LGPS funds are likely to be in deficit at March 2010. The actuaries and administering authorities have endeavoured to take a long term view in setting contribution rates at a time of expected unprecedented declines in employee members of the Scheme. In such an environment the prudent approach and the approach that is likely to yield the most long term financial benefit would be to allow any additional employee contributions to improve funding levels, helping long term stability and sustainability of cost.

6/ Investment Strategy

As we have seen in the private sector, as pension fund liabilities mature, investment strategies develop that focus on controlling volatility of cost by improving the match between asset returns and movements of value in liabilities. This results in funds holding less equities and more bonds. At GMPF we are laying the foundations for providing the scope to adopt a similar approach at the individual employer level. If this applies across the LGPS, not only will this probably have a long term adverse impact on the cost of pension provision, it will of course have wider economic implications.

7/ Alternative Way Forward

Lord Hutton in his initial report commented that final salary pension schemes did not offer a sustainable way forward and you agreed with that view.

My expectation is that the headline of his final report will be that public sector pension schemes should switch to a Career Average Revalued Earnings scheme or something similar. Such a change will reduce the volatility of cost by eliminating 1 or more risk factors. The design of the pension promise and retirement age will be key factors in determining the cost of the Scheme. I am also expecting that Lord Hutton will be keen to see measures in place that encourage pension savings. If these are the outcomes from the increase of public sector pensions, the case for differential employee rates based on pay will be much reduced.

It would be very disappointing if measures were taken now to significantly increase employee contributions, with the consequential impact on membership levels and under the "new scheme" employee contributions being (much) less. Once a member has opted out, it will be very difficult to persuade the member to rejoin the scheme.

As we all know, the cost of the pension scheme to the employer is driven by 3 factors:

- a) the pension promise/benefit package;
- b) duration on pension;
- c) share of cost between employee and employer.

In determining the way forward, the "best" solution is likely to come from considering the whole package rather than individual factors in isolation.

In summary, the potential scale of increase to employee contributions in the LGPS will have a long term adverse impact on the sustainability of the Scheme and it will not generate the target level of additional income.

A better way forward would be to develop the LGPS to create a revised scheme that best meets the needs of Government, employers, employees and other stakeholders. The work of Lord Hutton should create a framework for progressing this review.

If you or a member of your team need any further information or clarification on the matters raised in this letter, please contact me or Peter Morris, (0161 342 3438) the Fund's Director of Pensions.

Yours sincerely



**Executive Leader of the Council and
Chair of Greater Manchester Pension Fund Management Panel**

I have copied this letter to:-

The Right Honourable Danny Alexander MP – Chief Secretary to the Treasury
The Right Honourable Eric Pickles MP – Secretary of State
Lord Hutton