

30 September 2009

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Dear Bob

CIPFA response to “Delivering Affordability, Viability and Fairness”

Thank you for your letter of 25 June 2009, in which you sought comments on some possible amendments to the Local Government Pension Scheme (LGPS) which focus on Scheme stability and viability as we approach the 2010 Scheme valuation.

At CIPFA we believe that pensions policy must factor in the wider long-term benefit to the community of people in older age having adequate income levels, so avoiding increased calls on state funding to make good retirement income deficits. We therefore emphasise the importance of achieving a financially sustainable future for the LGPS. We are also keen to see that the pensions futures of both local government workers and others across the public sector, are managed in a way that does not result in the same large-scale departure from high-quality defined benefit pension provision, as in the private sector.

The LGPS stands apart from the vast majority of public sector schemes by virtue of its funded status and this should be recognised as an important advantage in the debate surrounding the long-term financial sustainability of public sector pensions. We are therefore particularly sensitive to the short-term challenges facing the LGPS with regard to the next valuation and, as one of the stakeholder bodies involved in the initial discussions on this subject back in November last year, we are pleased to offer our comments on the proposals in your paper.

Actuarial valuations and Funding Strategy Statements

There is no doubt that the financial and economic turmoil of the last two years has had a detrimental effect on LGPS asset values. Equally, although the mood in the financial markets has changed in recent weeks, there remains considerable uncertainty on the future direction of the markets and how this might impact on discount rates, all of which are fundamental to LGPS valuations.

We also believe that the challenges for the 2010 actuarial valuation will come not just from the stock markets, but from concerns about increases in life expectancy. We believe that there is an opportunity to mitigate this problem.



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If the allowances for life expectancy that we understand are typically being used in the private sector were applied in local government, they could add significantly to the value of liabilities. This would in turn have a dramatic effect on employer contributions if it just feeds straight through to the bottom line without any mitigating actions. The LGPS cost-sharing arrangements are part of the solution, but these only affect future accruals.

The difficulty here is that the extent of future improvement is uncertain. The general acceptance of the uncertainty – together with the rapid improvements over the last decade – has led to a change of the actuarial mindset, with the potential to cause some fund actuaries to seek extra funding on a prudent basis (allowances for future improvement in the 2007 valuation varied greatly).

The considerable costs of longer lives can be managed in other ways than simply paying more cash into the fund. As a first step, administering authorities could be asked – if they have not already done so - to review their strategy for paying for longer life expectancy ahead of the 2010 valuation. This would give them more time to consider this complex issue and to avoid unnecessary short-term concerns for employers.

A possible new approach to solvency

As noted above, whilst we recognise the issues facing the LGPS, we do have some concerns at the proposition set out in paragraph 22 of your letter. A regulatory provision which requires the actuary to prioritise the affordability of the employer contribution rate infers that fund solvency becomes a secondary consideration. Whilst this may not have been the intention, it has certainly been interpreted as such by many industry commentators.

We believe that any perception that the LGPS is prepared to position itself as anything other than a funded scheme (and by that we mean a scheme that aims to be 100% funded through its Funding Strategy Statement) is potentially damaging to the unique position the LGPS enjoys amongst the major public sector pension schemes in the UK. The ability to portray the scheme as one that is self-contained and which imposes no burden on the tax-payer to meet the future cost of unfunded liabilities adds considerably to its long-term financial sustainability, and helps rebuttal of any claims of a lack of inter-generational equity. The Institute would therefore recommend that CLG be clear that the scheme will retain 100% funding as its long-term aim.

The 100% funding approach will continue to give rise to the scrutiny of funds with a funding ratio below 100%. Whilst this might be interpreted in a negative manner in some quarters, CIPFA is committed to working with CLG to continue to correct these misrepresentations. On the plus side, such scrutiny is an important part of scheme governance and can be helpful in maintaining a fund's focus on its funding and investment strategies.

Liquidity v. Solvency

The Institute does not consider there to be a conflict between liquidity and solvency in the LGPS. The scheme must be able to meet its cash needs in the short-term (liquidity) and demonstrate it has the capacity to do so in the long-term (solvency). However,

even in the aftermath of what is likely to be a poor set of valuation results for 2010, the latter need not necessarily lead to unsustainably high employer contribution levels.

We agree with your assessment in paragraph 26 that the scheme benefits from good liquidity, a strong employer covenant and the constitutional permanence of local government. These factors taken together, particularly the latter, should allow funds to take a longer-term view of deficit recovery than may have previously been the case and provide a basis for a contributions strategy that strikes a balance between the fund's requirements and the employer's ability to pay. We believe that this can be achieved through guidance and without recourse to further regulatory changes. We would be happy to discuss how this might be taken forward.

It should also be borne in mind that although the 2010 valuations are likely to reveal higher fund deficits than at the 2004 and 2007 valuations, we, along with CLG, have consistently extolled the virtues of taking decisions on scheme funding with the long-term perspective firmly in mind. However the proposals set out in your paper appear to suggest long-term, structural solutions are being considered to address what may actually be a relatively short-term deterioration in funding positions. We are concerned therefore that these proposals seem contrary to the established position and may undermine the arguments we have assembled in favour of taking the long-term view of LGPS funding.

Financing Plans

We support the development of financing plans to supplement and strengthen the current version of the Funding Strategy Statement (FSS). We believe that the additional information suggested will help to better inform strategic decision-making within funds, particularly the enhanced focus on cash-flow, key assumptions and risk management. The enhanced FSS will also prove a valuable tool in communicating scheme funding matters to the wider stakeholder community and improve the transparency of pension fund financing. This is particularly true when applied to fund employers, where an enhanced FSS could be a vehicle for better engagement, enabling employers to contribute, through the fund's Pensions Panel or Committee, to discussion and decision on the risk management issues around future fund investment strategy and employer contribution rates.

However, we view such a development as an enhancement to, and not a replacement for, an actuarially-determined plan to achieve 100% funding. For the reasons set out above, we view the long-term goal of 100% funding as fundamental to the long-term health of the LGPS.

Local Funding Targets

For much the same reason, we would find it difficult to support a proposition which permitted funds to adopt a less than 100% funding target. Whilst we agree with the principle that it is for the decision-making bodies of individual pension funds to have the final say on questions of affordability, sustainability and fairness to local taxpayers, this must be in the context of an LGPS-wide long-term funding target that will enable the fund to meet its liabilities.

In the process of compiling this response we have spoken with a number of practitioners who have pointed to the period in the 1990's when funds were permitted to lower the threshold to 75% funding. A number of funds have subsequently struggled (and continue to struggle) to achieve 100% funding and many feel that any deviation from the principle of 100% funding might lead to a recurrence of the issues that arose from the short-term decision taken in this period.

Revised employee contributions

We note with interest the proposition to amend employee contributions rates. We are concerned by the timing of this proposal, divorced as it is from the consideration of employer contribution rates following the next valuation and from the wider review of the LGPS which is trailed elsewhere in your paper, particularly as it is not designed to, nor expected to, increase the total employee contribution into the scheme.

We are also concerned that this proposal is looking at employee contribution rates in isolation from the total reward package. For example, there does not appear to be any consideration here of the potential for increased salary demands amongst higher earners in response to increased employee contribution rates. Other factors that need to be taken into consideration include how contributions might be structured under different approaches to the accrual of benefits and increased retirement ages.

We would therefore like to see the evidence to support the statement made in the paper that concludes that high earners in the local government workforce "are paying a proportionately modest amount towards their pension benefits". We would also like to see the evidence that supports the conclusion that it is the cost of contributions which lower paid employees find is the main barrier to joining the scheme. There may be other contributing factors which we feel should be explored further, particularly whether the scheme properly meets the career structures and pensions savings needs of lower-paid or part-time workers.

Overall we would welcome measures designed to retain and increase scheme membership. Such measures also serve the long-term interests of the scheme, strengthen its contributions base and contribute to its financial sustainability.

The next consultation

We note with some concern that the "parallel, separate consultation exercise on the broader debate" which was mentioned by John Healey at the NAPF conference in May and which is trailed in your paper, has yet to be issued.

The Institute would urge CLG not to miss this opportunity to open up a debate which would allow discussion about the long-term financial sustainability of the scheme and what steps might be taken (changes to benefit calculation such as CARE, raising the retirement age etc) to address concerns over the affordability of the scheme. It would also provide a platform to challenge some of the misconceptions regarding public sector pensions by moving onto an evidence-based debate of the issues.

I hope these comments are a useful contribution to the development of your response to the challenges posed by the 2010 valuation. As ever, if you would like to discuss further any of the points raised, please do not hesitate to contact CIPFA via the Pensions Panel Secretary, Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

Bob Summers
Chair, CIPFA Pensions Panel

