

Response of London Pensions Fund Authority (LPFA) to HM Treasury Consultation on Fair Deal

1. Introduction

In submitting this response we seek to address the issue of continued access to the Local Government Pension Scheme (LGPS) via Transferee Admitted Body Status (TABS) rather than commenting on Fair deal across the public sector as a whole.

Therefore our comments are in the form of an overview response and not as individual responses to the questions posed.

In formulating this response the board of LPFA make no comment on the merits or otherwise of outsourcing services. Such decisions are rightly within the realms of national and local politicians.

The response seeks to address the following in considering the future of Fair Deal and the LGPS

- Lord Hutton's comments on the desirability of continued access to public sector schemes for those not directly employed in the public sector
- The potential benefits of the removal of Fair Deal
- The potential costs of the removal of Fair Deal
- The impacts on other policies and spending priorities
- The improvements/simplification that could be made to the existing process

2. Continued access

In both Lord Hutton's interim and final report on the future of public sector pension schemes he states his view that continued access for non public sector employees is "undesirable".

The backing for this statement would appear to be based around firstly the level of risk to tax payers associated with these members and secondly the barrier presented to movement of services by these provisions.

Without wishing to comment on this risk in respect of the unfunded schemes, we would seek to challenge it with regard to the LGPS.

Employers who gain access to the LGPS via TABS will have to have undergone

"an assessment, taking account of actuarial advice, of the level of risk arising on premature termination of the provision of the service or assets by reason of the insolvency, winding up or liquidation of the transferee admission body." (LGPS Administration Regulations 2008 Reg 6(5)).

And where that risk is such as to require it, provide an indemnity or bond which

"must be with—

(a) a person who has permission under Part 4 of the Financial Services and Markets Act 2000(3) to accept deposits or to effect and carry out contracts of general insurance;

(b) an EEA firm of the kind mentioned in paragraph (5)(b) and (d) of Schedule 3 to that Act, which has permission under paragraph 15 of that Schedule (as a result of qualifying for authorisation under paragraph 12 of that Schedule) to accept deposits or to effect and carry out contracts of general insurance; or

(c) a person who does not require permission under that Act to accept deposits, by way of business, in the United Kingdom." (LGPS Administration Regulations 2008 Reg 6(8)).

Furthermore each such organisation will be individually assessed at valuation and an employers contribution rate set based on the actual experience of and future assumptions for that employer.

With such safeguards in place we do not consider the risk to the taxpayer to be any worse than before the transfer took place and in some cases that risk could even be less.

Even were the worst to happen and the organisation fall into insolvency, the staff would transfer back to the local authority and the risk would be exactly the same as it was before the original transfer took place.

With regard to the provisions being a barrier to movement of services, the experience in local government is that the ability for contractors to have access to the scheme via TABS has if anything improved the ease of transferring staff and

made outsourcing services considerably less of a problem than it would have been otherwise.

Indeed in their evidence submitted to Lord Hutton, the CBI asked for the LGPS model to be expanded to all public sector schemes stating that

“Experience in local government has already demonstrated that an approach of this kind can work successfully. In that sector there is well-established scope for contractors to secure membership of the local government pension scheme (LGPS) in respect of those staff transferred to them as part of contracting arrangements, paying the required employer contribution into the LGPS. While the operation of these admitted body status (ABS) arrangements is not always entirely straightforward, with good sense on the part of both local authorities and contractors the system can work well. The instances where it works best are where private sector providers take responsibility for those risk factors that are under their control, such as the level of pay increases and approvals of early retirement, and other risks inherent to the scheme design and structure remain with the local authority.”

Response 1. LPFA cannot agree with Lord Hutton’s view of the undesirability of continued access for non public sector employees in respect of the LGPS.

3. Potential Benefits

There are without doubt financial benefits to the removal of Fair Deal. These include;

- The potential for lower contract prices
- A reduction in cost and complexity for contractors
- Potentially a more level playing field

Lower contract prices should be available for all new contracts particularly if, as is claimed, pensions are the second highest cost to contractors after salaries. Contractors will no longer have to provide a myriad of mirror image schemes depending on where the staff transferring originated and the greater costs of the contractor having to provide a Defined Benefit (DB) scheme would be removed.

We would not seek to minimise the benefits of the reductions to contract prices and the greater competition brought about by lower market entry costs especially in these times of financial belt-tightening. Indeed as a third party supplier ourselves we totally understand the desire for and the benefits of a level playing field.

However apart from the short term reductions in contract prices which would no doubt be realised by the removal of Fair Deal, the other potential benefits are based on assumptions that require a little more questioning before acceptance.

The cost and complexity argument is based on the contractor having to set up run and pay for an equivalent defined benefit scheme. Access to the LGPS via TABS removes everything except the requirement to pay employer contributions. However those contributions are derived from membership of a much larger fund and are therefore less than those the contractor would have to bear on their own.

The level playing field is only such if all parties have the same overheads. Of course it is not fair if contractors' pension costs are so much higher than in-house teams, however it would surely be equally unfair to remove the requirement for DB pensions for contractors whilst retaining it for in-house teams.

Response 2. LPFA accept the potential for and would welcome the reductions in contract prices brought about by the removal of fair deal but cannot accept without condition the evidence for other benefits with regard to the LGPS

4. Potential Costs

Local government is facing significant financial challenges and will no doubt be seeking the assistance of the private and third sectors in meeting them. We therefore anticipate a large number of local authority staff being subject to TUPE provisions in the coming months and years. Without the ability for contractors to have access to the LGPS via TABS, the scheme faces a sizeable reduction in membership.

A reduction in active membership of this scale would have a detrimental effect on scheme cash flows. Currently cash flows throughout the LGPS are positive and are forecast to remain so at least into the medium term. The increased maturity of funds brought about by significant reductions in active membership would radically change that situation. A 2010 Audit Commission report estimated that such reductions in membership would result in the LGPS having to sell assets to pay pensions as early as 2016.

The resulting impact on investment strategy would be substantial and may well see a mass migration of funds from equities to bonds as funds are forced into a more defensive stance. At the present time, the LGPS has some £130 billion in assets, with some £80 billion in equities. Probably around £40 billion is invested by the LGPS in UK companies. A major switch from equities to bonds would have a significant impact on stock markets.

In addition, future actuarial valuations would need to factor in this derisking, and the lower investment returns from bonds, which will lead to increased employer contributions reducing or in some cases removing altogether any savings from lower contract prices. The reasons why a reduction in active membership would affect scheme finances are as follows:

- Lower amounts of employee contributions mean higher amounts of investment income is used to pay existing pensions
- in the event of an economic slowdown the investment income available reduces;
- asset values also fall (because companies are not making as much in profit);
- contributions from employees and employers plus investment income may not be sufficient to meet pension payments;
- in which case assets would need to be sold to meet pension payments at a point in the economic cycle when asset prices are historically depressed;
- meaning that the Pension Fund funding level quickly reduces, requiring ever higher amounts of employer contribution.

Therefore as schemes mature investment allocations between asset classes need to change to constrain these risks. This generally involves a switch from equities



(highly variable income) to bonds or bond like investments (predictable income) - but over long periods bonds perform on average about 3% per annum worse than equities. Accordingly this mitigation technique also increases costs because ultimate asset values are lower and liabilities are discounted by a lower discount rate.

Response 3. LPFA are extremely concerned about the potentially disastrous effect on cash flows and employer contributions resulting from the removal of TABS which in our view outweigh the potential for savings via reduced contract prices

5. Impact on policies and spending

The removal of Fair Deal would probably result in outsourced staff receiving a future pension based on Defined Contributions (DC) which may have negative impact on both participation and accrual. According to an IFS report in 2010:

“..we find that individuals are significantly more likely to be a member of an occupational DB scheme and significantly less likely to be a member of a workplace or other DC scheme..”

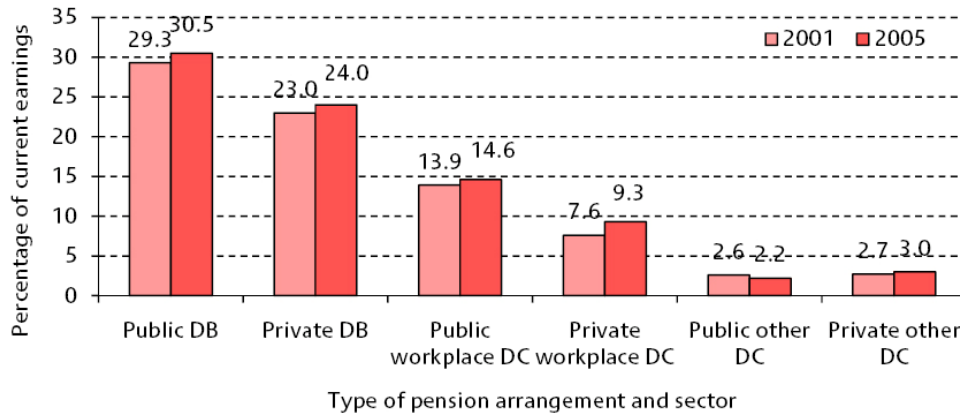
Figure 3.1 Pension participation among employees, by sector and year



Such a drop in participation in pensions would not be compatible with initiatives by other departments (in particular the DWP) to raise participation and reduce the figure of 7m currently without a pension in the UK. To on the one hand introduce auto enrolment whilst on the other denying access to the LGPS and thereby discouraging participation gives the appearance of a discontinuity in policy.

More worryingly the same report also noted significantly lower annual pension accrual in DC schemes (30.5% of earnings in DB and 9.3% of earnings in DC).

Figure 3.2 Mean value of annual pension accrual to members



Reduced accruals on this scale for those who no longer have access to the LGPS could well lead to significant knock on effects later in life. Evidence is clear that lower incomes result in greater dependence on the state either directly through benefits or indirectly through ill-health, crime or other poverty driven issues. Thus short term savings in contract prices could well result in greater long term spending due to increased demand on services.

Response 4. There is a good chance that denying access to the LGPS will result in both lower participation and lower pension accrual. Such a result would lead to greater long term demands on public services and contradict other initiatives designed to encourage increased pension saving.

6. Improvements to Fair Deal

Whilst defending the principles of Fair Deal and TABS, we acknowledge the process is not without fault.

Our proposals therefore cover both simplifying the process and ensuring greater consistency of application.

With regard to simplification we would propose that bulk transfers are removed from the process leaving individuals with the option to transfer an amount based on their own circumstances.

Bulk transfers, as they are negotiated, not only incur considerable delay but are completely out of the control of the individuals concerned. This delay and lack of control can leave members confused and concerned over the future benefits. Moving to individual transfers would make the process easier to explain to the staff involved and more transparent to all involved. It would also considerably speed up the process and reduce administrative overheads

We would encourage a review of the application of TABS and in doing so support the CBI's call (in their evidence to Lord Hutton) for a greater consistency of approach by funds. For example;

- The bonds and indemnities required should not vary significantly for the same contractor across different LGPS funds
- Assumptions made by different funds in determining employer rates should be more consistent with regard to the same contractor
- The TABS should be agreed on and settled much earlier in the TUPE process

Guidance should be made available to funds to assist them in ensuring a consistent approach across these and other areas of the TABS process.

Response 5. LPFA believe there is scope to simplify and improve the consistency of application of the TABS process in order to encourage the easier movement of services

7. Conclusion

LPFA believe there is a strong case for retaining and improving the TABS process in the LGPS. In our view that case can be made on the grounds of fiscal and social cost and as an enabler of service movement between the public and private sectors.

LPFA Board June 2011