

# Local government pensions in England

An information paper

July 2010

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## Summary

The Local Government Pension Scheme (LGPS) in England is the UK's largest public sector pension scheme by membership.

- The scheme has 1.7 million active members, 1.15 million members with deferred pensions and 1.1 million people receiving pensions. Nearly three-quarters of members are women.
- The scheme is comprised of 79 separate funds in England, under the control of elected members, working to a common set of regulations and a common benefit structure.
- As employers, councils have limited influence over pension costs because it is a legal requirement for them to provide pensions and they cannot adjust the benefit package.
- The employer contribution rate for the LGPS is 18 per cent on average. The rate varies in different funds, typically between 14 and 25 per cent of pay.
- Employee members contribute 5.5 to 7.5 per cent of pay, depending on earnings.

The LGPS has funds to cover about three-quarters of its future liabilities,<sup>i</sup> and there is a positive cashflow.

- LGPS funds defray the cost of paying pensions. These funds cover about three-quarters of the total pension liabilities. The LGPS is the only major public service scheme with its own funds.
- LGPS funds currently have a positive cashflow: more money is going into the funds than is coming out of them.
- The LGPS assets will cover the costs of pensions in payment for the foreseeable future, given the positive cashflow and constitutional permanence of local government as an employer.
- It is likely that there will be fewer employees contributing to funds over the next few years, but this will not affect pensions in payment.
- A high proportion of the pension costs of current employees in the LGPS are paid for up-front, reducing the reliance on future generations to fund pensions in payment.

But the current approach cannot continue indefinitely because unfunded liabilities are being deferred into the future, to make the scheme more affordable to employers in the short term.

- The cost of providing pensions for local authority employees is rising in absolute terms and as a proportion of pay because of increasing life expectancy and action needed to recover funding deficits.

<sup>i</sup> This estimate is based on assumptions used by funds in the 2007 actuarial valuations, updated to reflect current asset values and the change to the method of indexation of pensions in payment announced by the government in the June 2010 emergency budget.

- Pension funds have been affected by lower than anticipated investment returns; the value of assets today is about 15 per cent lower than anticipated in 2007.
- The cost of pensions affects the amount of money available to fund services, and influences council tax decisions: there are questions about whether LGPS benefits are affordable in the long run.
- Some of the underlying affordability issues, such as the costs resulting from future improvements in life expectancy, have already been covered by forthcoming reforms to LGPS. But the proposals will not guarantee long-term sustainability.
- The LGPS needs further reform to address the growing mismatch between liabilities and the resources available to fund them.

There are radical changes that might appear attractive to policymakers, but they are not likely to serve local government well in the short term.

- Government could radically change the way pensions are delivered by:
  - merging funds in pursuit of lower fee rates and increased strategic capacity to manage investments over the long term;
  - reducing the target level of funding for the scheme; or
  - taking on the whole of the liabilities and running an unfunded scheme.
- The costs of such changes might outweigh any benefit.
- Incremental reform can put the LGPS on a more secure long-term footing.

Action is required now. The government should consider:

- reviewing employee benefits. For example, a change that would make quick savings would be to raise the normal retirement age and reduce accrual rates;
- giving more discretion to local pension funds to adjust the level of benefits they offer pension fund members; and
- raising employee contributions. Increases could be tapered to avoid increasing opt-out rates.

Any reforms to the benefit structure should take into account:

- the nature of LGPS membership: there are high proportions of part-time and low-paid workers; and
- the interaction between occupational pensions and state benefits: this should therefore be considered carefully because around half of pensions in payment are below £3,000.

To avoid significant increases in employer contributions, action at the local level is also required.

- Most LGPS funds could improve their funding position by adjusting actuarial assumptions; but this does not address the underlying issues.
- Instead, pension funds need to focus on improving their investment performance, within acceptable levels of risk locally.
- Employers should actively limit pension liabilities through measures such as controlling wage costs.

This information paper follows the emergency budget and the announcement of a pensions commission to be headed by Lord Hutton.

The paper:

- provides a contribution to the Pensions Commission;
- summarises the main choices for policymakers; and
- provides technical appendices to inform local discussions about pension funding issues.

# Introduction

**1** The cost of providing pensions for local authority employees is rising in absolute terms and as a proportion of pay. People live longer in retirement, wage levels have increased, and benefits have improved. But investment returns for the local funds in the Local Government Pension Scheme (LGPS) have fallen in recent years. There are questions about whether the benefits package is affordable in the long run. Recent reforms will address some of the underlying issues, but they will not guarantee long-term sustainability. There is no immediate crisis; but the system needs reforming to contain the growing mismatch between liabilities and the resources available to fund them.

**2** This information paper examines technical issues about LGPS funding. It should help decision makers understand these issues and their relationship to wider debates about the future of public sector pensions. This paper addresses a major financial issue for local government; it affects the cost of council services and will influence future council tax levels.

**3** Media reports about ‘gold plated’ pensions misrepresent the most important issues for decisions about the future of the LGPS. Around half of pensions in payment are below £3,000.

**4** For employers and taxpayers the more important issues are the balance between fund assets and liabilities and the rate at which benefits are accrued, which affect the current and future payroll costs.

**5** The paper summarises the main issues. It is accompanied by a glossary (see Page 38) and a series of technical appendices on the internet, cross-referenced in the paper. These technical appendices cover:

- a. interaction of pensions with tax and benefits;
- b. impact of changes to the size of the workforce on cashflow;
- c. impact of actuarial assumptions on pension scheme funding;
- d. modelling of 2010 funding position and its potential implications;
- e. approaches to investment risk;
- f. impact of longevity and eligibility on pension costs;
- g. performance comparisons of large and small LGPS funds.

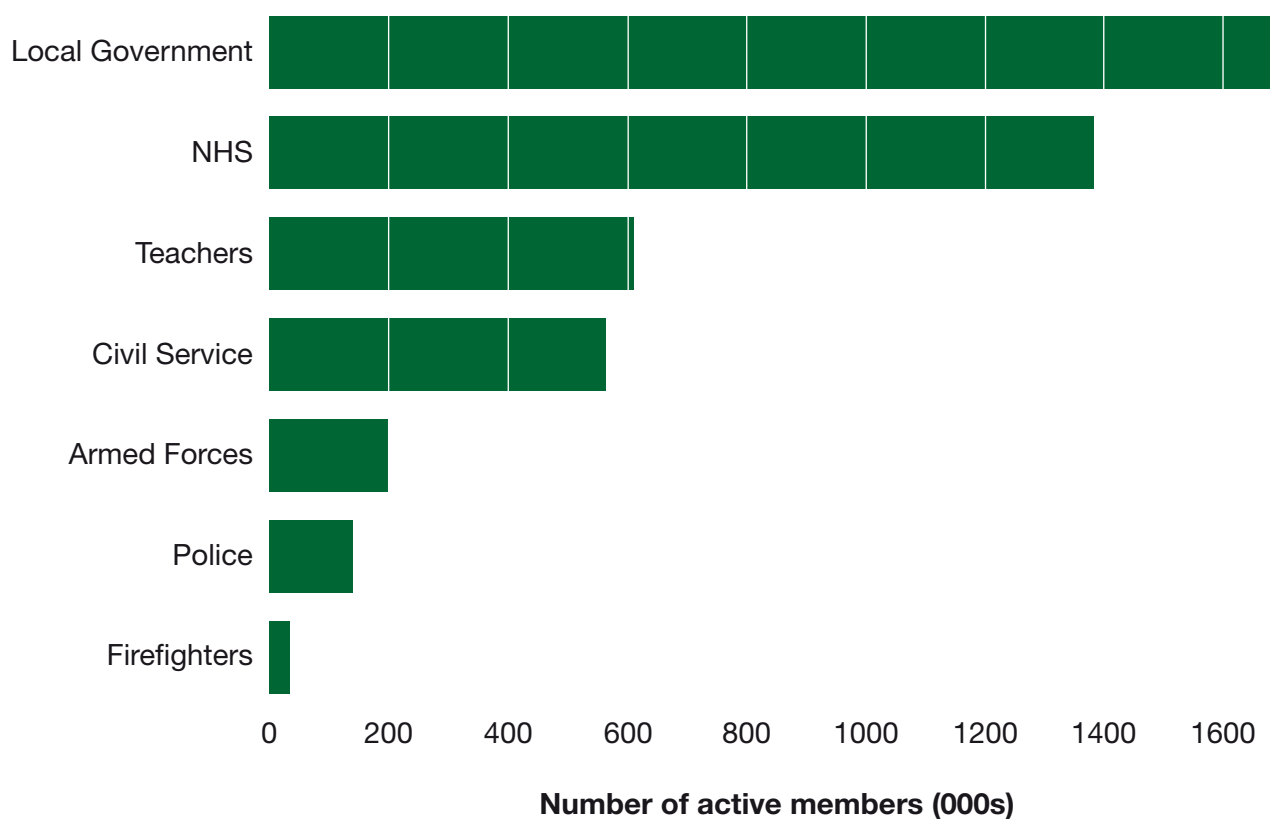
**6** This paper aims to inform the debate about the long-term health of the LGPS in England and to summarise the main choices for employers and policymakers. The 2010 Spending Review will consider the long-term affordability of public sector pensions, drawing on the work of a public sector pensions commission (Ref. 1). This paper is the Audit Commission’s first contribution to the discussion.

# The Local Government Pension Scheme

**7** The LGPS is the UK's largest public sector pension scheme by membership (Figure 1). However, unlike the other large public sector schemes, the LGPS has funds set aside to defray the future cost of paying pensions. (Figure 2).

Figure 1: **The LGPS is the largest scheme by membership**

Active membership of the main public sector pension schemes in England

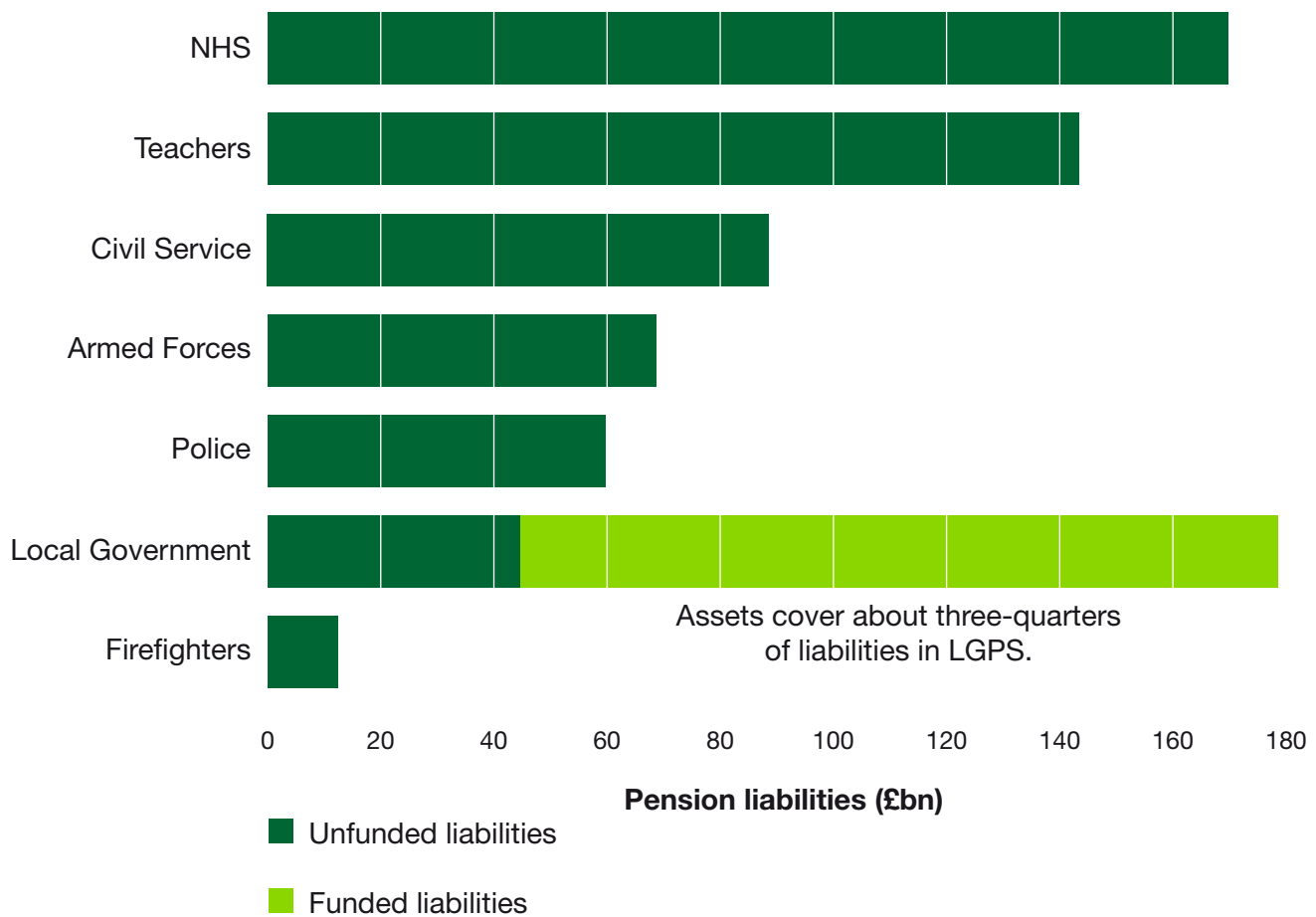


Source: Audit Commission analysis of published information<sup>i</sup>

<sup>i</sup> This report examines the Local Government Pension Scheme in England only. Where other schemes do not have England-only statistics the numbers have been scaled down in proportion to population to give an estimate for England. The different public sector pension schemes do not all have information available for the same periods; see note to Figure 2.

Figure 2: **The LGPS has funds set aside to defray future costs<sup>i</sup>**

Funded and unfunded liabilities of the main public sector pension schemes in England



Source: Audit Commission analysis of published data

**8** The funding basis of the LGPS is more like that of a private sector scheme than the other large public service schemes. But in other respects, it is different (Table 1). For example, it has a statutory basis: its regulator is the Department for Communities and Local Government. The corresponding role for private sector schemes is carried out by the Department for Work and Pensions and the Pensions Regulator.

<sup>i</sup> LGPS: estimated for end March 2010. NHS, Civil Service, Armed Forces, Teachers: resource accounts for end March 2009. Firefighters: actuarial valuation for end March 2007. Police: government estimate for end March 2006 (a formal actuarial valuation of the scheme at end March 2008 is not yet available).

**Table 1: Private sector schemes have a different legal basis from public sector pension schemes**

Comparison of defined benefit pension schemes in the public and private sector

<b>Features of scheme</b>	<b>Private sector defined benefit (funded)</b>	<b>Civil Service (PCSPS) (unfunded)</b>	<b>Local Govt (LGPS) (funded)</b>
<b>Benefits package defined in:</b>	Scheme rules	Statutory regulations	Statutory regulations
<b>Who can amend scheme?</b>	Employers and/or trustees depending on constitution of the scheme	Parliament	Parliament
<b>Employee contribution rates</b>	Scheme rules	Statutory regulations	Statutory regulations
<b>Employer contribution rates</b>	Trustees in agreement with employer	Statutory regulations	Administering authority (pensions committee)
<b>Fund governance</b>	Trustees	Minister for the Cabinet Office	Administering authority (pensions committee)
<b>Regulation of fund governance</b>	The Pensions Regulator	Accountable to Parliament and, through judicial review, the courts	Supervised by Secretary of State (CLG)
<b>Measures to protect against insolvency</b>	Member benefits covered by Pension Protection Fund	Insolvency risk does not arise	Insolvency risk does not arise for most public bodies. Individual funds manage risk of insolvency of other employers.
<b>Investment risk borne by:</b>	Employers	n/a	Employer bodies
<b>Longevity risk borne by:</b>	Employers	Government	Employer bodies

Source: Audit Commission

**9** The legal basis of pension schemes influences the way they have responded to rising cost pressures. Private sector employers have more scope to adjust the benefits of pension schemes than employers in the public sector.

- The types of action private employers would consider are: raising employer contributions; reducing accrual rates; reducing annual pensions increase; closing defined benefit schemes to new members; or closing defined benefit schemes to existing members, while preserving pensions accrued to date.
- In the public sector, the benefit structures are determined nationally. In the LGPS, changes to the regulations in 2007 introduced a new schedule of employer contributions (Ref. 2) and in 2008 reduced early retirement benefits by abolishing the 'Rule of 85' (Ref. 3). The government intends to introduce cap and share, which will limit the employer costs of future improvements in longevity (Ref. 4).

**10** The LGPS is not a single pension scheme: there are 79 separate local funds in England. The funds have limited discretion to respond to local pension issues. The national regulations define:

- governance procedures (Ref. 5);
- the benefit structure (Ref. 2); and
- employee contribution rates (Ref. 2).

**11** The Policy Review Group (PRG) provides a forum for discussions about changes to the LGPS regulations. Led by CLG, it includes local government employers, representatives from other bodies in the scheme and the trade unions.

**12** Most LGPS members work in local government. Other members work for employers such as: probation boards; housing associations; private sector contractors to local government; charities; community organisations; representative organisations; and schools (for non-teaching staff).

**13** The LGPS has three interlinked layers of governance. Each tier of governance has some influence over the cost of pensions (Table 2).

**14** The average employer contribution rate in LGPS funds is 18 per cent of pay,<sup>i</sup> but there is wide variation among funds. For example, at the 2007 actuarial valuation, average employer contribution rates in funds ranged from 14 per cent of pay in the Greater Manchester Pension Fund (GMPF) to 25 per cent in the London Borough of Tower Hamlets.<sup>ii</sup> Employers within the same fund can also have very different contribution rates. GMPF has over 300 employer bodies, and their contribution rates vary from 12 to 24 per cent of pay. This suggests that the affordability of public sector pensions is a local issue as well as a national issue.

Table 2: **Each tier of governance has some influence over the cost of pensions**

Governance layer	Responsibilities	What influences the cost of pensions to employers?
Central government (CLG)	<ul style="list-style-type: none"> <li>■ policy and regulation</li> <li>■ overall governance</li> <li>■ benefits</li> </ul>	<ul style="list-style-type: none"> <li>■ benefit structure</li> <li>■ schedule of employee contributions<sup>iii</sup></li> </ul>
Local government administering authority (single or upper tier authority or pension fund authority)	<ul style="list-style-type: none"> <li>■ local governance and performance including administration, investments and funding strategy</li> <li>■ limited discretion over pensions policy</li> </ul>	<ul style="list-style-type: none"> <li>■ investment performance</li> <li>■ employer contribution rates<sup>iv</sup></li> </ul>
Employer bodies (public, private and third sector)	<ul style="list-style-type: none"> <li>■ local employment policy and practice</li> <li>■ possible involvement in local governance</li> </ul>	<ul style="list-style-type: none"> <li>■ employment decisions affect pension liabilities</li> </ul>

Source: Audit Commission

- i** The LGPS is contracted out of the State Second Pension, so employers and employees pay reduced national insurance contributions (3.7 per cent and 1.6 per cent respectively).
- ii** The London Borough of Hackney Pension Fund has an employer contribution rate of 30 per cent but has been excluded from this analysis because it has an unusually short recovery period of 12 years.
- iii** Employee contribution rates are fixed according to a national schedule of rates in statutory regulations (Ref 2, regulation 3). Employees contribute on average 6.5 per cent of pay.
- iv** Employer contribution rates follow the 3-yearly valuation cycle. The authority administering the pension fund is responsible for setting employer contributions, which is influenced by its funding and investment strategy, and by past funding decisions and performance of investments.

## Affordability and fairness

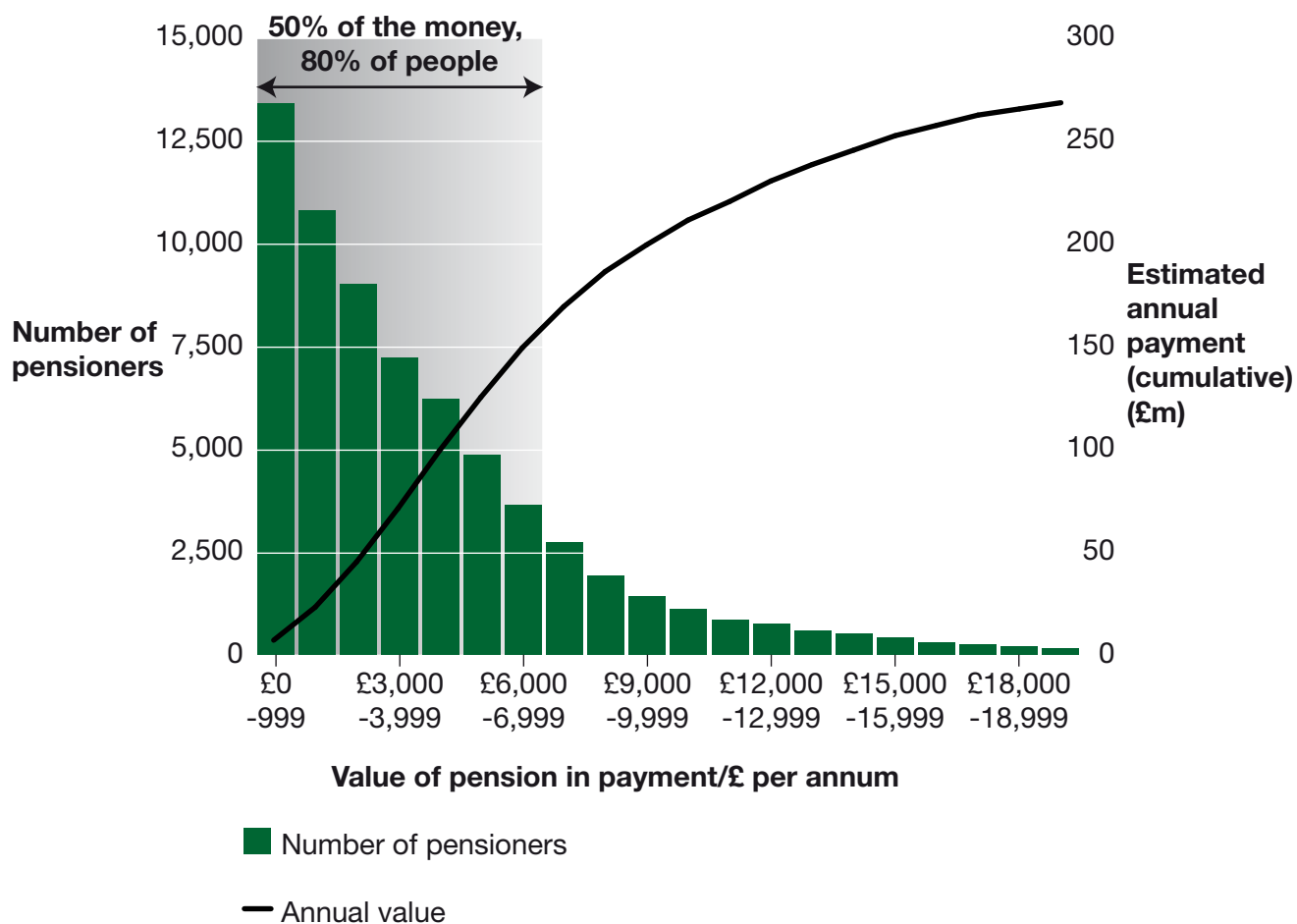
**15** Much of the debate about public sector pensions is about fairness and affordability. The government has faced calls to reform public sector pensions in line with trends in the private sector (Ref. 6, Ref. 7). Reducing the LGPS benefits to match private provision might not substantially reduce total public spending in the long term because of the potential interaction with state benefits (Appendix A).

### Affordability to taxpayers

**16** Cuts in employer pensions, whether the employer is public sector or private sector, will reduce people's independent income in retirement, and result in a burden on the state in the long run, if more people become eligible for means-tested benefits. For private sector schemes, this is an externality. For the LGPS, it is the same taxpayer who funds both occupational pensions and the alternative state benefits. Since most LGPS pensions in payment are quite small, there is a degree of substitution with means-tested benefits for current pensions in payment (Figure 3). Some individuals are not financially much better off with an occupational pension than they would have been if they had opted for the state pension. Means-tested benefits start to taper off as income increases (above £5,100 for a single person). People with higher pensions are less likely to be eligible for state benefits, and some pay tax. Cutting public service pension benefits might save local taxpayer's money in the short term, but this could be eroded in the longer term by increased public expenditure on means-tested benefits. State benefits are funded from national taxation but may be administered by local councils and other agencies.

Figure 3: **Most LGPS pensions are below £7,000**

Profile of pensions in payment for members of the Greater Manchester Pension Fund in 2009<sup>i</sup>



Source: Greater Manchester Pension Fund

**17** Significant changes to the LGPS could also have an impact on other policy areas. An occupational pension is free of the stigma of means testing. It gives its recipients greater financial independence in old age than the equivalent means-tested benefits, some of which are linked to services and change over time. Interaction with state benefits and other forms of pension provision would need to be considered carefully in any reforms of the LGPS benefit structure.

<sup>i</sup> The value of pensions in payment is estimated from the mid point of the income band and excludes the effect of any lump sum payments.

## Fairness for LGPS members on different levels of income

**18** The value of a pension to an individual varies according to their priorities and circumstances. There may be a case for providing employees with more choice over their pension arrangements. Many people who are enrolled automatically into the LGPS decide to opt out, which suggests the current offer does not meet their needs.<sup>i</sup> By doing so, they avoid paying employee contributions (5.5 per cent of pay for the lowest paid workers), but pay higher National Insurance contributions. If the government reforms LGPS benefits, it could affect opt-out rates among the low paid.

**19** Most LGPS pensions are small, reflecting low pay or short service. Over half the local government workforce is part time and nearly three-quarters are women; 47 per cent are women working part time (Ref. 8). Breaks in service also lead to smaller pensions. At the other end of the distribution, there is a 'long tail' of a few people with significantly higher pensions. Proposals to cap pension payments at £50,000 a year would affect few people based on the pattern of current pensions in payment. To obtain a pension worth £50,000 a year, someone retiring in 2010 would need a final salary of £75,000 *and* 40 years' pensionable service.

## Fairness between different generations of employees

**20** A pension scheme provides benefits on a collective basis and this inevitably results in a degree of cross-subsidy between different members. A funded pension scheme minimises the amount of cross-subsidy between different members over time, which is known as intergenerational transfer. But most LGPS funds have not achieved full funding since the early 1990s, which means that there is some inter-generational transfer taking place.

**21** It is a question of judgement whether the amount of intergenerational transfer is too high. The traditional way to avoid the issue is to recover funding deficits over a period around the average term of employment. Although this is simplistic, the idea is to ensure that each set of employees maintains the health of the fund during its working life. Clearly it is important to take account of the reasons for a low funding level when deciding on an appropriate course of action to address it.

<sup>i</sup> For example, opt-out rates in councils in Greater Manchester are 10 per cent for full-time staff and 30 per cent for part-time staff on average.

## Fairness in comparison with private sector schemes

**22** Drawing comparisons between the LGPS and ‘the private sector’ is more complex than often presented in the media. This is because:

- it is difficult to compare the total financial reward packages of different jobs;
- some LGPS employers, mainly those who transferred-in local government staff following outsourcing, are in the private sector; and
- there are private employers outside the LGPS that continue to offer final salary pensions benefits.

**23** Comparing public and private sector jobs must take into account the diversity of terms and conditions of employment in both sectors, and the benefits available to people with differing levels of seniority. Research evidence from the Institute for Fiscal Studies and the Pensions Policy Institute shows that levels of pay across both sectors are broadly similar, taking into account age, education and qualifications. The pension benefits for new entrants to public sector schemes like the LGPS are broadly similar to the benefits offered by private sector defined benefit pension schemes, where those are still available. The value of pensions in the public sector is higher but this arises largely because defined benefit pensions are less likely to be available in the private sector (Refs. 9, 10, 11).

## Fairness in comparison with other public pension schemes

**24** Comparisons across the public sector are more straightforward. The employee benefits for new members of the LGPS, the civil service and NHS are broadly similar. They are less generous than the pensions for uniformed services (Table 3).

**25** Recent reviews of public sector schemes mean that most members have accrued rights under previous rules. For example, most current members of the teachers, NHS, and civil service schemes have a reserved right to retire at 60 because the increase in normal retirement age only applied to new members. The corresponding early retirement benefit in the LGPS was known as the Rule of 85, which allowed members to retire early if their combined age and service reached 85. This has been abolished but most current members have some level of preserved benefit under the Rule of 85.

**26** The rest of this paper looks at the issues that have an impact on the cost of local government pensions to employers. This in turn has wider implications for pension scheme members, people involved in fund administration and governance, and taxpayers.

Table 3: **Public service pension schemes offer different benefits**

Comparison of benefits across the main public service schemes

Scheme	Value as percentage of salary (Ref. 11)	Benefit structure					
		Normal retirement age	Employee contributions <sup>i</sup>	Accrual rate	Lump sum included?	Most recent change to scheme	
Armed forces	38	Final salary	55	Nil	1/70th	3 x annual pension	April 2005
Police	29	Final salary	55	9.5	1/70th	4 x annual pension	April 2006
Firefighters	24	Final salary	60	8.5	1/60th	In exchange for reduced pension	April 2008
Civil service	21	Career average	65	3.5	1/43rd	In exchange for reduced pension	July 2007
Local government	20	Final salary	65	5.5 – 7.5	1/60th	In exchange for reduced pension	April 2008
NHS	19	Final salary	65	5 – 8	1/60th	In exchange for reduced pension	April 2008
Teachers	19	Final salary	65	6.4	1/60th	In exchange for reduced pension	Jan 2007

Source: Audit Commission

<sup>i</sup> The value of salary, pensions and the cost of employee contributions should be considered in the round to work out the total financial reward for a given job.

## Assessing the financial health of LGPS funds

**27** Against the backdrop of declining pension provision in the private sector, public sector pensions look increasingly out of step. This raises the question of whether there is anything fundamentally wrong with the system of pension provision. Has the financial crisis dealt pension funds a terminal blow or can the current issues be managed through the normal operation of the system? This section gives an overview of the financial health of LGPS funds. The complexities of the pensions system mean that it is difficult to gain a consensus on any action that may be needed.

**28** The financial health of a pension scheme is measured using assumptions about the future (Table 4). Different actuarial techniques and assumptions give different answers. The different weighting that fund administrators give to prudence, affordability, stability and stewardship can also lead to different views about a fund's health. The funding levels (the ratio of assets to liabilities) of LGPS funds will have fallen since the last actuarial valuation in 2007. This does not, necessarily, mean anything is fundamentally wrong with the system. Lower funding levels can still be tolerated if there is a robust plan to deal with future risks and liabilities. One of the benefits of a funded scheme is to allow each generation to pay for its own pensions, but there is an intergenerational transfer of wealth if funding levels fall and deficits persist. A key question is whether pension funds have the necessary powers and resources to manage pensions properly in future.

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Table 4: **The health of a pension scheme is measured using assumptions about the future**

Past performance issues	Future assumptions
Has longevity been higher or lower than expected?	Will improvements in longevity continue at the same rate?
Have real investment returns been higher or lower than expected (compared with inflation)?	Are future investment returns expected to be higher or lower than past expectations?
Have employment practices resulted in higher than expected liabilities?	Will employers be more careful to consider the pensions implications of their employment practices in future?
How have changes to the scheme rules influenced the financial health of the scheme?	Are scheme rules expected to change the position in future?

Source: *Audit Commission*

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**29** The assumptions about the future health of a pension fund can be tested against their impact on:

- ability to pay pensions when they are due;
- total liabilities compared with the value of assets in the fund (the funding level);
- the likelihood of achieving full funding within a specified recovery period; and
- the overall cost of providing pensions benefits over the long term.

**30** Maintaining a fully funded scheme would score well against all four of these criteria, but those responsible for pension funds have to balance competing requirements that change over time. During the 1990s, the stock market generally performed well and this was a favourable period for pension funds. The following decade was much more difficult, due to volatility in financial markets and much lower capital growth in asset prices. Pension funds take a long-term view, and cannot simply react to recent events. A pension fund does not always have to be fully funded, as long as there is a robust recovery plan in place to achieve a target funding level, and pensions continue to be paid. Shortfalls do not need immediate action, but they will eventually need to be addressed, for example using cash from employees, employers, taxpayers or from investments.

## Cashflow

**31** The LGPS does not face an immediate crisis. The scheme has a positive cashflow: it can continue to pay pensions and funds can be invested in growth-seeking assets to reduce costs.<sup>i</sup>

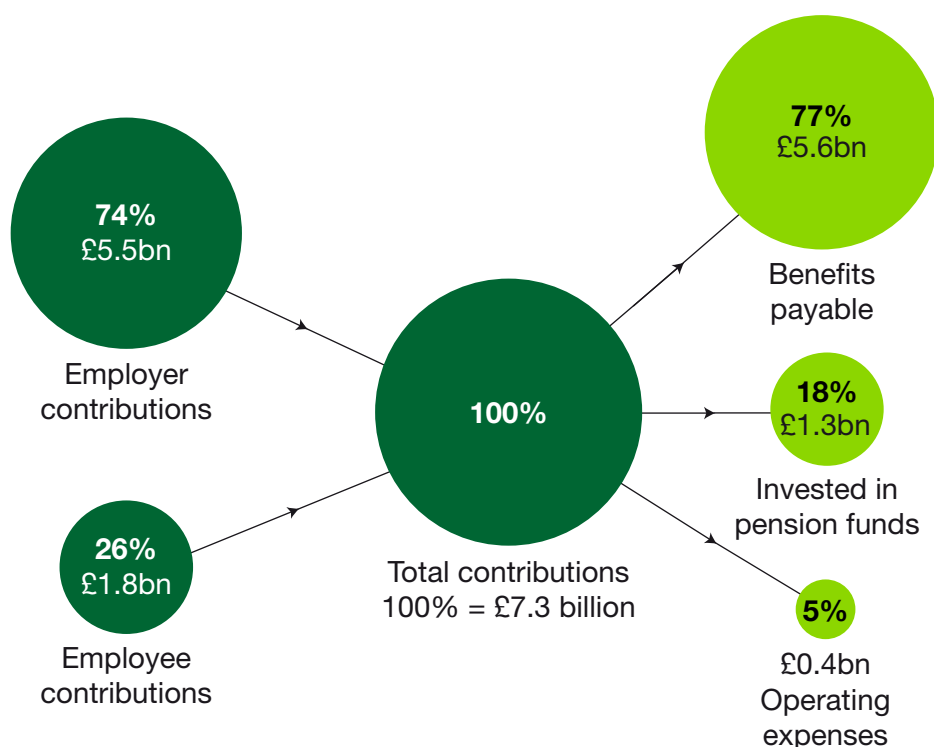
**32** Local LGPS pension administering authorities each have a fund that is used to meet the costs of providing income in retirement. The size of the pension fund means that changes made by employers, such as changes in staff numbers, do not have an immediate impact on ability to pay pensions. The LGPS's statutory basis gives members of the scheme confidence that promised pensions will be paid. The main concern for employers and pension fund authorities is their continuing, long-term ability to pay pensions when they are due.

**33** The amount of money that active members (employees) and employers pay into LGPS funds exceeds the amount that is paid to pensioners (Figure 4). Eventually, when funds 'mature', the cashflow will reverse. When pension payments exceed income from contributions and investments, funds will start to take money out of the fund to pay their pensioners. The diagram also shows that employers currently contribute on average about three times as much as employees, a higher rate than in the past.

**i** A positive cashflow means that pensions can be paid without cashing-in investments, which makes it possible to invest more in long-term growth assets. Positive cashflow does not indicate whether the amount invested is sufficient to meet liabilities in the long term.

Figure 4: **The LGPS has a positive cashflow**

Income exceeded spending across English LGPS funds in 2008/09



Source: Audit Commission analysis of pension fund accounts

**34** Changes to the local government workforce are an important driver of maturity. Cuts to the workforce will speed up the rate of maturation, with implications for funds' investment strategies. A decline in the workforce of 15 to 20 per cent (if achieved mainly by a recruitment freeze) would mean that pension payments could exceed contributions (excluding investment income) by about 2016. But if other assumptions hold, funds will have no difficulty paying pensions in the short to medium term. Assumptions about wage inflation and investment performance have a significant impact on predicted pension funding levels over the long term, but the current size of funds is sufficient to absorb the impact of significant changes to the workforce (Appendix B). In summary, changes to the workforce do have important implications for pension funds, but local funds have sufficient means to meet their most basic obligations – to pay pensions to members when they are due.

## Funding levels

**35** Funding levels are lower than was anticipated in 2007. Asset values had largely recovered to pre-recession levels by 2010, but we estimate the aggregate funding position has declined by about 12 percentage points.<sup>i</sup> Local funds had anticipated positive investment returns of about 6 per cent a year from 2007 onwards that did not materialise in full.<sup>ii</sup>

**36** The valuation of the liabilities, and hence funding levels, is affected by a range of assumptions at the individual fund level (Appendix C). The most influential assumptions are those for investment performance, price and wage inflation, and life expectancy.

**37** Analysis of the 2007 actuarial valuations shows that these individual assumptions can improve the appearance of funding levels by up to 15 percentage points above the estimate obtained using standardised assumptions (Figure 5).<sup>iii</sup> At one extreme, a fund has assumed a future investment return of 4.1 per cent above inflation, while the most cautious fund has assumed only 1.7 per cent above inflation. The estimate of liabilities is highly sensitive to the assumed investment return (the discount rate). The range of assumptions used by different funds in 2007 suggests that some funds might have scope to relax their margins of prudence, given that actuaries expect the long-term returns on investment in 2010 to be similar to expectations in 2007.

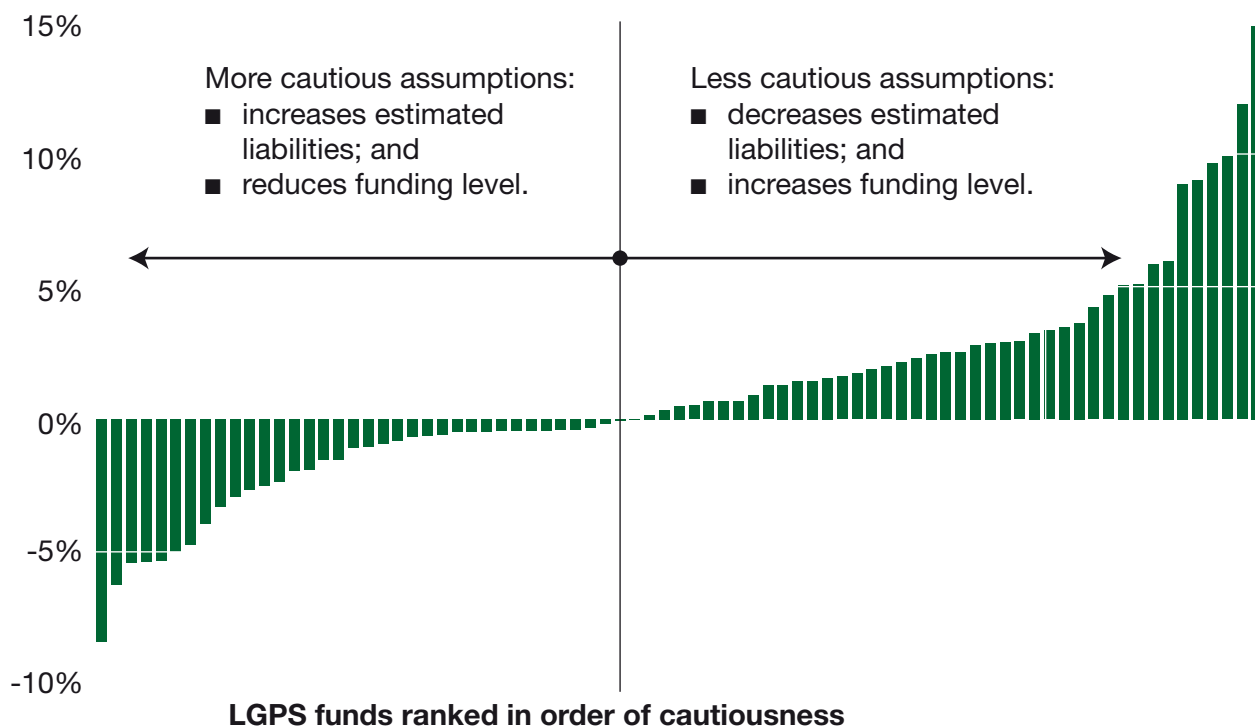
**38** The impact of low funding levels on employer contributions depends on local management decisions about the recovery period. This is the length of time over which the fund expects to recover the deficit. The total impact of the recovery period and the actuarial assumptions can be seen by comparing the actual employer contributions in 2007 with the employer contributions calculated using the standardised actuarial assumptions and a nominal average recovery period of 20 years. The results show that actuarial assumptions and the chosen deficit recovery period can have considerable influence on employer contributions (by up to nearly 20 per cent of pay) (Figure 6). However, most funds are within a much narrower range, reflecting the fact that they make broadly similar assumptions. The distribution is not symmetrical because larger funds are concentrated towards the left hand side of the chart.

**i** This roll-forward estimate is based on individual fund data. It uses the same actuarial assumptions as funds used in 2007, updated to reflect current expected asset values and the recent change to CPI indexation of pensions in payment and deferred pensions.

**ii** Investment returns for LGPS funds from 2007 to 2010 are estimated at 1.4 per cent a year on average.

**iii** The standardised assumptions are shown in table C2 (Appendix C).

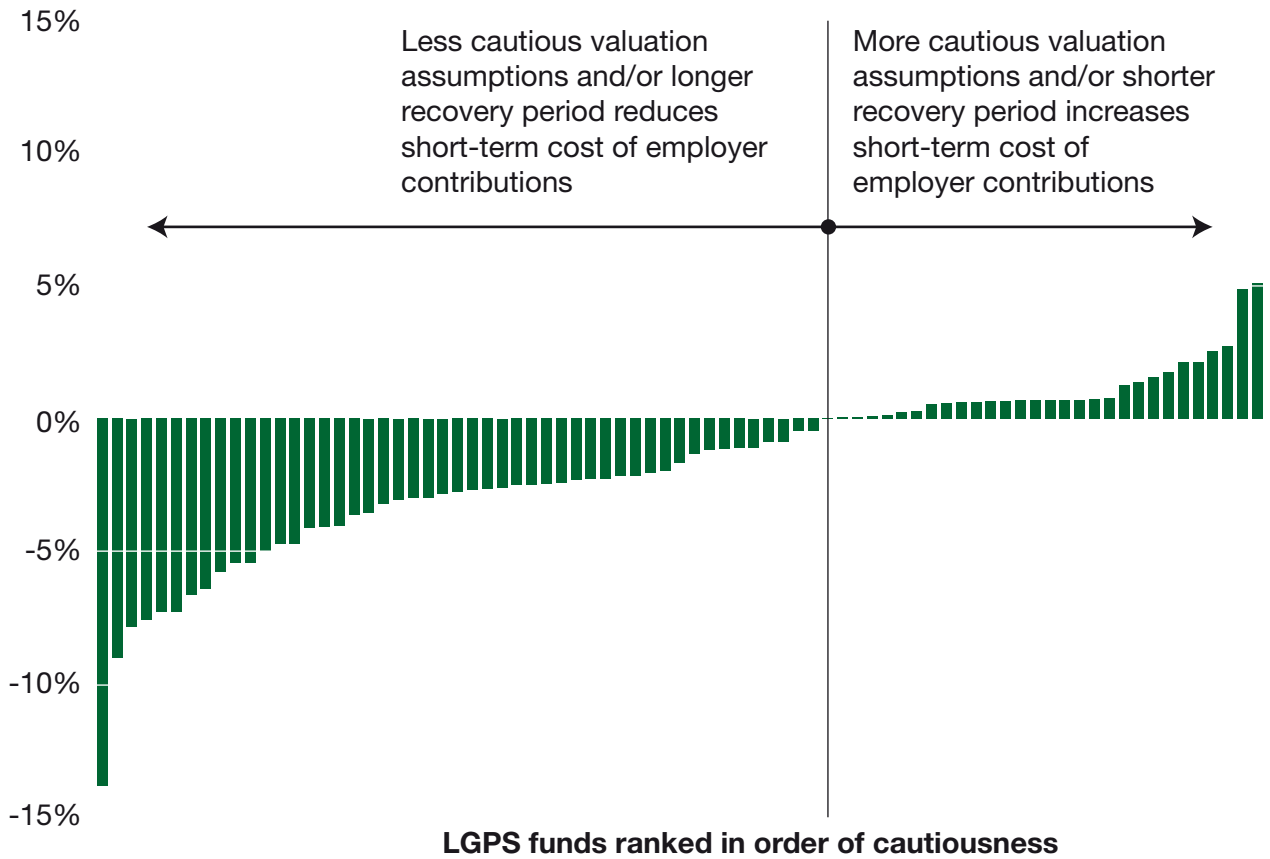
**Figure 5: Local assumptions affect funding levels by up to 15 percentage points**  
Difference between the quoted funding level and the standardised funding level for 2007 actuarial valuation of English LGPS funds



Source: Hymans Robertson

Figure 6: **Employer contributions are affected by actuarial assumptions and the chosen deficit recovery period**

Discrepancy between the fund average contribution rate and the contribution rate calculated using standardised actuarial assumptions and a 20 year recovery period



Source: Hymans Robertson

**39** An update of the 2007 actuarial valuations to take account of the financial climate in 2010 suggests that funding levels would have declined from an average of 84 per cent in 2007, to about 66 per cent in 2010 (Appendix D). But actuaries estimate that recent changes to the indexation of pensions in payment announced in the June 2010 emergency budget could improve this by about 6 percentage points. The combined effect would take funds back to around their 2004 funding position, when the aggregate funding level was about 75 per cent. Given the spread of individual fund values around the average, we estimate the 2010 funding levels for individual funds could vary by up to +/- 20 percentage points.<sup>i</sup> The next valuation of funds will be published towards the end of 2010, and will confirm the actual funding level (which may differ from the estimates in this information paper).

**40** If funds addressed a 12 percentage point decline by simply increasing employer contributions, without phasing in the change or adjusting recovery periods, average employer contributions would have to rise by 5 per cent of the pay bill (Table 5). This is unlikely to be affordable in the current financial climate and funds have a range of measures that could be used to absorb the short-term impact.

Table 5: **Estimated impact of funding levels on employer contributions**

	2007 valuation (%)	2010 estimate (%)	change
Continuing benefits accrual	20	20	nil
Deficit recovery	5	10	+5% of pay
Average employee contributions	6.5	6.5	nil
Average employer contributions	18.5	23.5	+ 5% of pay

*2010 estimate: Hymans Robertson analysis*

**41** A further complication in understanding funding levels is that there are two calculations: the triennial actuarial valuation, and the annual valuation of pension assets and liabilities for inclusion in the local authority’s published annual accounts. The actuarial valuation is conducted every three years at the pension fund level whereas the annual accounts valuation is an estimate of the assets and liabilities for individual employers.

<sup>i</sup> The modelling was intended to show the impact of actuarial assumptions in general, not predict the value of individual funds. The estimate for 2010 is based on the same actuarial assumptions as in 2007, but individual funds may use different assumptions in 2010.

## Valuations for annual accounts

Since 2000, UK accounting standards have required employers to include pension scheme assets and liabilities on their balance sheet (Ref. 12). In the private sector this has acted as a strong incentive to reduce unfunded liabilities. With any defined benefit pension scheme, the funding level fluctuates with, among other things, asset prices. This volatility can be reduced by investing in low-risk, low-return assets but a low rate of return on investments contributes to rising pension costs. A defined contribution scheme does not have the problem of unfunded liabilities, so many private sector pensions have switched from defined benefit to defined contribution arrangements (Ref. 13).

The annual accounts valuations are also a concern for local government employers. The impact is not the same as in the private sector, since local authorities are not subject to scrutiny by investors and analysts. The annual accounts valuations, however, do provide information for employers to compare fund performance between the actuarial valuations. There is always some year-to-year volatility because the valuation of assets depends on the performance of the financial markets and that of liabilities depends on the movements in interest rates, inflation rates and assumptions on longevity.

**42** Regardless of the assumptions and valuation techniques used, it is clear that funding levels will be substantially lower in 2010 than they were in 2007. There are, however, arguments that this is not as serious an issue as it might appear.

- The funding level is a snapshot in time and is affected by the performance of financial markets, which have been very volatile over the last decade including the recent financial crisis. Pension funds take a long view of investment and some element of mispricing (up or down) is a normal feature of fund valuation. The total pension liabilities are not due for payment immediately: they will be paid out over an extended period of time, beyond the typical recovery period of 20–25 years.
- Some funds and local employers may respond to current deficits by local action such as increasing employer contributions to pension funds. Some may also reduce their estimated liabilities by reducing the margin of prudence in their actuarial assumptions. As a rule of thumb, a 0.5 per cent change in the expected return on investment would affect pension contributions by about 5 per cent of pay.
- A proportion of the deficit has resulted from increased longevity, and the effect of further increases will be mitigated in future through the government's cap and share mechanism.

**43** In summary, low funding levels do not represent an immediate crisis because there are ways of managing the impact on the public purse. But the evidence is that funds are gradually building up larger unfunded liabilities. Some funds and individual employers are in a better position than others to cope with this issue, but the overall trend affects all funds. This suggests LGPS may not be sustainable in its current form and the scheme rules would need to be changed to give employers more flexibility to respond.

## **Can funds return to full funding within the planned recovery period?**

**44** There are four main change options for LGPS funds' recovery to full funding and for each there are possible obstacles.

### **Spreading recovery over a longer period**

**45** Spreading recovery over a longer period defers costs into the future. Before 2004, fund recovery periods would have been lower as they were based on the average future working life of the fund's active members (normally about 12 years). In 2004, the governance rules on recovery periods were changed because of the introduction of funding strategy statements (FSS). LGPS funds must have regard to CIPFA guidance on FFSs (Ref. 5, regulation 35), which allows longer recovery periods where these are 'prudentially appropriate', and where councils might otherwise face the prospect of a significant increase in council tax or cuts in services (Ref. 14). LGPS funds have increased recovery periods, most of which were between 20 and 25 years in 2007. Recovery periods could extend further for local government and scheduled bodies such as police authorities, but this is not an option for admitted bodies such as contractors. Private sector employers must have shorter recovery periods as they face the risk of insolvency.

### **Getting higher investment returns**

**46** LGPS funds would have to get an average 7.5 per cent return on investments to recover estimated 2010 deficit over 20 years. This is a demanding rate of return in comparison with the 6.2 per cent average return assumed by LGPS funds in 2007 and the 4.5 per cent return offered by gilts. If funds aim for a higher rate of return than they achieve in practice, this would not achieve anything worthwhile. It would simply conceal the true extent of the unfunded liabilities in the short term. Although local government pension funds are in a good position to target high investment returns, because they should be able to tolerate higher risk than private sector funds, they are unlikely to have the appetite for more investment risk at the current time.

**47** All LGPS funds assumed a fairly high investment return (discount rate) in their 2007 actuarial valuation. They are already likely to be operating at the highest level of investment risk they are comfortable with managing. Committees are open to scrutiny and their advisers – council officers, investment consultations and actuaries – may have different views about risk. To take advantage of a higher risk strategy, funds would have to develop greater expertise to support a confident, active approach to investment risk (Appendix E).

### **Reducing liabilities**

**48** Employers can reduce liabilities by constraining pay inflation, through annual pay awards and pay progression. Pay restraint, though, has a limited impact on containing pension costs. It would not immediately affect pensions in payment, which follow price inflation. Action by a single employer could weaken its ability to recruit and keep staff in the medium to long term.

**49** The employers' liabilities could also be managed by changing the balance between employer and member contributions, through new cap and share arrangements, for example, or by making the scheme benefits more relevant to work and career choices. Either of these changes would require amendments to the national regulations.

### **Reducing operating costs**

**50** Funds may be able to achieve savings on fees and administration costs at the margin, but these are small in comparison to fund investments. The amount of money spent on administration and management fees annually is about 5 per cent of total pension contributions. Savings in these areas would build up to a substantial amount over the long term, but would not make a significant difference to the speed of deficit recovery.

## **The overall cost of providing pensions**

**51** The default response to address funding deficits is to increase employer contributions. If the cost increase is prohibitive for employers they could extend the recovery period. Although the latter is more affordable in the short term, the long-term cost is higher. A comparison can be drawn with a mortgage. A 10-year mortgage has higher monthly payments than a 25-year mortgage, but is cheaper in the long run if you can afford it. However, most people opt for a 25-year mortgage because they have other priorities. Mortgages and pensions are basically just financing mechanisms and people choose the term that best suits their needs, which may not be the cheapest.

## Is there a consensus for change?

**52** Those responsible for pension schemes face a considerable challenge. Investment performance in the years leading up to 2009 has been lower than expected. Financial market performance was unusual with a loss of confidence in financial services following the credit crunch and world financial crisis.

**53** But, despite press commentary about the affordability of public sector pensions in the current economic climate, there is no immediate crisis for LGPS funds. The funds are likely to keep a healthy cashflow for many years to come, even though current funding levels are estimated to be low.

**54** Employer costs are likely to rise over the next three years following the 2010 valuation; the employers recognise this (Ref. 15). If longevity continues to increase, then liabilities and costs will also increase. Cap and share would reduce the impact, but it will only influence future accruals and will not affect the LGPS before the next valuation in 2013.<sup>i</sup>

**55** While there is concern about pension funding issues among some employers and in the press, the response from those responsible for administering pension funds is measured. This may be because:

- Pension fund authorities' main concern is preserving pensions in payment, where there is no problem. The risk of insolvency is long term and theoretical.
- Pension costs are predictable and incremental change is possible. Most local government employers can use their medium-term financial plans to phase in change. A few employers such as contractors with staff in the LGPS do face sharp cost increases, and this is a difficult situation to resolve.
- Pensions costs for council staff are small in comparison with other areas of council spending, particularly as many services are not provided directly by council staff. For local authorities, although the cost of pension contributions is typically around 15-20 per cent of pay, staff pay is only around one third of the total expenditure. Pensions are not necessarily high on councils' agenda because the governance structure of the LGPS means the individual employers are limited in what they can do to influence pension costs.
- Councils continue to see pensions as an important tool in recruitment and retention.

<sup>i</sup> The previous government reiterated its commitment to cap and share arrangements for public sector pensions in Budget 2010. Discussions about the implementation of cap and share within the LGPS were continuing when this paper was written.

**56** The evidence on the impact of pensions on recruitment and retention is mixed. Pensions are more likely to appeal to older employees while younger employees may not understand the true value of pensions or may have different priorities (Refs. 16 and 17). The current benefit structure gives greater reward to people with long service whose salaries have increased during their career. This does not reflect the careers of most local government workers, many of whom are part time and low paid, and may benefit more from a career-average system (Appendix F). Recent changes to the rules of the scheme acknowledged the potential inequity in the system and set lower contribution rates for lower paid workers.<sup>i</sup>

**57** There is no current, accepted benchmark for the affordability of employer contributions as a percentage of pay. The proposals for cap and share will, however, effectively define an affordability limit. The average employer contribution in 2010 is under 20 per cent but varies between funds and employers. Other large public sector schemes already have risk sharing arrangements, but they each have different thresholds ranging from 14 to 20 per cent for different schemes (Ref. 19).

<sup>i</sup> From 1 April 2008, active members of the LGPS earning less than £18,000 saw a reduction in their contribution rate (Ref 18). Due to uprating, the lower rates now apply to members earning less than £18,900.

# Choices

**58** Councils and their pension fund administering authorities have limited powers and resources to address the long-term costs of pension provision. There are various options for reform. Here we consider six possible changes at the national level that could allow councils to provide pensions on a more sustainable basis (Table 6). The rest of this chapter reviews them in more detail.

Table 6: **From incremental to radical: six possible reforms**

Reform	Implications
Change employee benefits and contribution rates	Straightforward in theory but difficult to negotiate in practice No change to governance
More local control over pensions benefit (choice of different schemes, for example)	More complexity to manage More local control
Improve risk-adjusted investment returns with active local management	Difficult to implement through current governance arrangements
Higher net investment returns through fewer, larger funds (or a single fund)	Radical change Less local control over investments
A permanently lower funding target (eg. 75%)	Likely to be controversial because of previous experience
Locally managed unfunded scheme, as in police and fire	Radical change – releases cash but does not make pensions more affordable in the long run

Source: *Audit Commission*

## Change the benefit package

**59** All pension reforms are likely to be controversial, but reducing the value of the benefits package to members has a straightforward impact on costs. Changing the benefit structure would be an opportunity to adjust the share of costs and benefits borne by employers and employees. It could also change the distribution of benefits among employees to reflect the current workforce. There are many different ways change could be implemented, but four possible options are:

- increasing employee contributions;
- raising the retirement age;
- career average benefits; and
- conditional indexation of benefits.

**60** Increasing employee contributions is one of the measures that private sector pension funds often use to improve the long-term funding position. There may be further scope to do so in the LGPS, although changes would have to be introduced carefully to avoid increasing opt-out rates. The LGPS has a schedule of employee contributions in salary bands, so the rate could be increased by a few percentage points for higher earners who would typically have longer service and would be less likely to opt out.

**61** Raising the normal retirement age and reducing the accrual rate to keep the pension payment the same as before would reduce future liabilities and reduce substitution by state benefits. People who wanted to retire at the current normal retirement age of 65 could still do so under flexible retirement policy (at an actuarially reduced rate).

**62** Career average benefits would change the distribution of benefits among members. With other changes they could lessen the impact of reducing the total pension benefit.<sup>i</sup> A career average revalued earnings (CARE) system is more complicated than the current final salary arrangements but could be a fairer distribution and would give members more certainty over their final LGPS pension.

**63** Conditional indexation of benefits would mean breaking the link between pensions in payment and prices. Some private sector pension funds operate on this basis, which allows liabilities to be trimmed in relation to the fund's ability to pay them. Conditional indexation can be implemented through a formula or through an annual decision, with the pension rise depending on the financial health of the pension fund. This change would share investment and other risks with members (employees and pensioners). Conditional indexation of benefits could be implemented by changing the scheme rules to affect all accruals after a certain date. It would be more difficult to apply to benefits already promised, but it might be possible to gain agreement, if members were compensated financially.

### **Allow more local flexibility**

**64** Under the present arrangements, LGPS pension funds have limited discretion over pensions. All LGPS pensions are ostensibly the same, as defined in law. If the core LGPS benefit package was reduced in value, LGPS fund authorities could be given discretionary powers to provide additional pension benefits on top of the core, in exchange for additional employee contributions. The discretion could also be linked to employers' development of a total reward approach to pay and pensions that suited local employment markets.

<sup>i</sup> A career average revalued earnings (CARE) basis relates the final pension to employees' salaries in each year of their career, indexed with inflation. Under this system the value of a pension is proportional to the employee's contributions throughout their career.

**65** Pensions could remain transferrable to other local government employers if local choices operated within national rules. More local flexibility would add administrative cost but the new arrangements could add value if they resulted in a pension system that better met the needs of local employers and employees.

## Encourage funds to seek higher returns

**66** If funds are already operating at the highest risk they are comfortable with, it would be irresponsible to encourage them to seek higher returns unless there are other actions to manage risk. The government and professional bodies are already making efforts to improve the quality of governance and the level of technical support provided to investment committees, so local funds understand and manage their risks better.

**67** Funds could take more advantage of their constitutionally permanent status to invest in less liquid assets that are likely to grow in value over the long term. They could focus their efforts on a more active approach to asset allocation, rather than spending time on issues such as monitoring fund manager performance.

## Combine funds

**68** Fewer, larger funds should have greater capacity to develop and oversee more thoughtful strategies for balancing risk and reward on behalf of local authorities. Combined funds should be able to attract the specialist staff needed to ensure capital growth. They should also achieve lower fee rates for externally managed investments.

**69** Larger LGPS funds performed slightly better than average over recent years to 2009, though this was not the best year to draw comparisons because of the financial downturn and the extreme volatility of financial markets around this time (Appendix G). Further analysis is necessary to assess the strength of the case for combining funds. Any plans to do so would also have to deal with issues such as local influence over employer contribution rates. In 2006, the Audit Commission identified several options for LGPS funds in London to take advantage of the economies of scale enjoyed by larger funds. Although there are some examples of shared services in London, there is potential to go further (Ref. 20).

**70** A single LGPS fund could be like the National Civil Pension Fund in the Netherlands. This is similar in size to the total of all the English LGPS funds. Like other Dutch pension funds, it targets a funding level significantly above 100 per cent: its current recovery plan aims to reach 125 per cent by 2022 (Ref. 21). Higher funding levels are a buffer against fluctuations in asset values, and give the required level of confidence that the funding level will stay over the 105 per cent minimum requirement (Ref. 22).<sup>i</sup> A single fund for all English local authorities and other scheduled bodies could have a lower funding target, to reflect current LGPS practice and financial realities.

### **Move to a lower funding basis permanently**

**71** The positive cashflow position and constitutional permanence of local government could be used as an argument for a permanent partial funding of LGPS. This is on the basis that the scheme will never be wound up and therefore some proportion of the funds will never be required. The government proposed a new approach to measuring solvency in 2009, anticipating lower funding levels. A lower funding target of 75 per cent was tried for a short period in the early 1990s. Once taken, though, this is a step that cannot easily be reversed. Most funds have not recovered from the years with a reduced target. Intentionally reducing the scheme's funding target would lock in an element of intergenerational transfer of wealth through the pensions system.

**72** Given the fact that public service pensions can be provided on a totally funded or unfunded basis, there is no 'ideal' level of funding in principle. The pension funds absorb risk, so the amount of funds required depends on issues such as how much you expect the local government workforce to change. Moving to a lower funding basis would mean funds becoming more directly dependent on central government, if it assumed responsibility for a proportion of the pension liability (the proportion that would otherwise have to be covered by funds that would never be liquidated in practice).

<sup>i</sup> Another feature of the National Civil Pension Fund is that indexation of benefits is conditional on funding levels. Indexation is suspended below 105 per cent funding, there is partial indexation on a sliding scale between 105 and 130 per cent funding, full indexation at 130 per cent, and catch-up indexation when funding exceeds 135 per cent (Refs. 23, 24).

**73** Although moving to a lower funding target might sound like an attractive way out of the present difficulty, funds rely on high investment returns to reduce costs. A lower funding basis would theoretically increase the cost of pensions, so there would still need to be a change to the benefit structure (or other measures) to ensure long-term sustainability.<sup>i</sup> Dependence on government would follow if it provided a partial subsidy of pensions in payment to reflect any loss of investment income that arose from moving to a lower funding basis. In practice, the partial funding option is no more sustainable in the long term than the current system, but it could be seen as an expedient measure for funds that cannot afford to recover funding levels to the 100 per cent target in the current financial climate; it could also be the start of a move to an unfunded LGPS.

## Move to an unfunded basis

**74** The LGPS could be restructured over time to operate similarly to the police and firefighters' schemes, which are funded directly from taxation and administered locally. This option would not address the fundamental issue that the benefits package has gradually become more generous because of increasing life expectancy. It would remove the investment risk from local administrations but also the potential benefits of investing in growth assets. The unfunded public sector schemes rely on GDP growth to remain affordable, and in this sense, risk is transferred to central government.

**75** The main advantage of this approach is consistency across all public sector schemes. This would involve significant change and costs, and may throw up difficult legal issues. The value of LGPS funds appears on local accounts and therefore is already counted as public money. Transferring funds from local to central government would have no effect on the national debt. The financial case for moving to an unfunded basis depends on balancing the costs of fund management and the rate of return achieved, compared to alternative uses for the money. LGPS funds should be able to achieve a better long-term return on investment than the cost of borrowing to government, so this option is not compelling.

<sup>i</sup> Many funds have a low funding position currently, so moving to a lower funding target would not increase current costs in practice.

## Conclusion

**76** Pensions are a major financial issue for local government but do not represent an immediate crisis. Pension costs affect how much money is available to fund services and can influence council tax levels. This report focuses on the affordability of pensions at a time when all services are under financial pressure.

**77** The local government pension scheme is, in many ways, in a better position than other public sector pensions. It is one of the few public sector schemes with a pension fund, and the value of investments has recovered since the low point in early 2009. However, current asset levels are, on average, about 15 per cent lower than was anticipated at the last valuation in 2007. This has led to higher unfunded pension liabilities which must be addressed.

**78** There is not an immediate crisis. But, with a background of costs gradually increasing and deficit recovery being pushed further into the future, there is a need for action at two levels; nationally and locally.

**79** Nationally, the Commission believes that the government should consider:

- reviewing employee benefits. For example, a change that would make quick savings would be to raise the normal retirement age and reduce accrual rates;
- raising employee contributions. The government's cap and share proposals will shift the cost of increased longevity onto employee contributions in future, but there is also an argument to increase the base contribution rates. Increases could be tapered to reduce the impact on low-paid members;
- giving more discretion to local pension funds to adjust benefit structures. For example, employers could be allowed to adjust benefits and contributions and link different pension benefits to a total reward approach. With legal protection for deferred pensions and pension transfer values, the case for a uniform national scheme is weaker than when the LGPS was designed.

**80** Locally, pension funds can take action to manage their liabilities. But this needs to go further than simply adjusting the actuarial assumptions. Pension funds need to seek opportunities to improve performance and reduce costs in areas such as investment performance and fees rates for externally managed investments. Funds should also look at improving skills and strategic capacity in pursuit of better, long-term risk-adjusted returns.

Employers should follow good business practice by ensuring that pension costs are minimised and that the benefits of the scheme are used to best advantage. In practice, this means controlling wage costs and promotional rises, managing early retirements carefully and encouraging flexible retirements where these are supported by a good business case. This paper and the appendices provide information to inform local discussions.

**81** More radical reform is sometimes attractive in times of crisis, but is not likely to serve local government well in the short term. The costs of radical changes, such as merging funds or changing the scheme to a permanently lower funding basis, might outweigh any benefit. Incremental reform, in the way we have outlined here, is the most obvious way to put the LGPS on a more secure long-term footing.

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## Glossary

<b>Accrual rate</b>	How quickly pension benefits build up over time. The LGPS accrual rate of 1/60th means that for each year of employment, the pension increases by 1/60th of final salary.
<b>Actuarial valuation</b>	This is carried out every three years in the LGPS. An actuary uses their professional judgement to estimate assets and liabilities.
<b>Actuary</b>	Professional who specialises in evaluating probabilities and advising on financial risks.
<b>Assets</b>	The result of investing contributions. May be held in shares, bonds, cash, and other forms of wealth, both in the UK and overseas.
<b>Benefit accrual</b>	Pension rights (the value of the pension) building up over time.
<b>Cap and share</b>	Arrangement where there is a limit to the maximum rate of employer contributions (the 'cap'). Above this limit cost increases will be shared between employers and employees. Details not yet settled for the LGPS.
<b>Employee contribution</b>	The employee's share of paying the cost of pensions, usually expressed as a percentage of the employee's salary. It is deducted from the salary by the payroll department.
<b>Employer contribution</b>	The employer's share of paying the cost of pensions. It is calculated as a percentage of the employee's salary. It is an extra cost of employment on top of wages.
<b>Final salary</b>	Salary on retiring or finishing employment. In pension schemes like the LGPS, pension payments are directly linked to the final salary.
<b>Funding level</b>	One of the outputs of an actuarial valuation. How assets compare with liabilities, as a percentage. If assets and liabilities are equal then the funding level is 100 per cent and the pensions are fully funded.
<b>Funding deficit</b>	If the funding level is less than 100 per cent then there is a deficit. This is the number by which assets are lower than liabilities.
<b>Future service cost</b>	The cost of benefits being accrued from now on. Put another way, the contributions needed to keep assets increasing as fast as liabilities.
<b>Indexation</b>	Increases in payments to take account of inflation. This applies to pensions once they start being paid. Indexation also applies to the pensions of deferred members during the waiting period.

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<b>Intergenerational transfer</b>	Passing something between different age groups. For example, intergenerational transfer of wealth occurs if pensions in payment are subsidised using current contributions to the scheme.
<b>Liabilities</b>	Estimated present value of the pension payments that a fund will have to make in the future because of benefits built up so far. This figure depends on inflation, what the final salaries of current employees will be, how long they will live beyond 65, and so on. These are not knowable in advance and must be predicted. The future pension payments are discounted by the assumed rate of return on investment, which allows direct comparison of assets and liabilities.
<b>Members</b>	People who are benefiting or will benefit from the pension scheme. Members belong to three different groups: <ul style="list-style-type: none"><li>■ active members (current employees, currently paying in);</li><li>■ pensioner members (retired employees who are receiving pensions); and</li><li>■ deferred members (people who are no longer paying in but are waiting to claim their pension. Many will be former employees below retirement age who now work outside local government).</li></ul>
<b>Normal retirement age</b>	Age at which members can claim their pension without any adjustment. This has always been 65 for the LGPS. People retiring earlier than 65 have their pensions reduced because they will be paid for longer. (Pensions can be paid as early as 55 with the employer's permission, or from 60 by right.) People starting to receive their pensions later than 65 will have the payments increased because they will be paid for fewer years.
<b>Past service cost</b>	Only exists where there is a deficit. Contributions needed to allow assets to catch up with liabilities.
<b>Pension benefits</b>	The main benefit is regular pension payments following retirement. Other benefits may include a tax-free lump sum on retirement, pensions for spouse or children after death.
<b>Recovery period</b>	The period over which the pension fund plans to take action to move back to the target funding level (for example by requiring higher contributions). The target funding level in the LGPS is currently 100 per cent. Recovery plans are also assessed by the scheme actuary.
<b>Rule of 85</b>	An exception to the normal retirement age within the LGPS. It allowed retirement before 65 without reduced pension for people whose combined age and years of service came to 85 or more. Abolished in 2008

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## Research Methods

Research for the study was carried out between July 2009 and March 2010. The methodology was primarily desk-based, involving an analysis of data from all 79 LGPS pension funds in England obtained from actuarial valuations and pension fund annual reports and accounts. The collected data covered pension fund performance, administration costs, pension contributions, actuarial assumptions and so on. To supplement the information from local pension fund auditors, the study team undertook field visits to three pension funds (Greater Manchester, Havering and the London Pension Fund Authority) and consulted key stakeholders.

We are grateful to the officers and members from the councils and our stakeholders who took part in our study and who gave up time to be interviewed and respond to queries. We are also grateful for the assistance of Hymans Robertson and PwC. Hymans Robertson, a firm of consulting actuaries, provided technical support, actuarial calculations and statistical analysis. PwC provided a third party review of the methodology and analysis, including the techniques used to compare actuarial assumptions on a consistent basis.

Phil Hall project managed this study supported by Cameron Paton, Ben Clarkson, Evanna Rees and Michael Cowell. Steve Warren provided advice on audit policy and accounting issues. Michael Hughes was the Director of Studies and Katie Smith the Head of Studies.

The inferences and conclusions expressed in this report are entirely those of the Audit Commission.

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