

PENSIONS COMMITTEE - 22 SEPTEMBER 2006

NEW LOOK LOCAL GOVERNMENT PENSION SCHEME 2008 – CONSULTATION ON OPTIONS

SUMMARY

This report considers the Council's response to the Government's consultation paper 'Where Next? – Options for a new-look Local Government Pension Scheme in England and Wales' in order to meet the deadline for responses of 29 September 2006.

RECOMMENDATIONS

That:

- (1) Option A be agreed as the basis of the Council's response to the consultation exercise on options for a new look LGPS, and
- (2) the Council's response in Appendix 2 be agreed for submission.

1. Introduction

The Government published a consultation document at the end of June 2006 that sets out various proposals for creating a new-look Local Government Pension Scheme (LGPS) from April 2008. No specific option is being recommended - the consultation is informal and aims to promote debate and to build consensus around the best way forward for the scheme in the future. The development of a new-look scheme is taking place alongside reforms to other public service schemes and to the state pension system.

Both final salary and career-average options are considered, and each option also includes increased death in service benefits, co-habitees' pensions, as well as new, two-tier ill health pension provisions. Half of LGPS members are now estimated to work part-time and 72% of members are female. The diversity of the workforce and extended and more flexible working lives require a modern, equality-proofed pension scheme that is attractive to employees and employers across the range of the workforce and in and around local government. It must also remain affordable to employers and employees, and to the taxpayers who underwrite its pension promise.

2. The Four Options

The consultation paper starts by working out a benchmark cost against which to compare each option for the new look scheme. The benchmark cost reflects the cost of the current scheme less 50% of the savings from the removal of the Rule of 85 (after adjusting for some additional protection for existing staff).

Having arrived at a benchmark cost of 20.9% the consultation paper then offers four possible costed options for a new look Local Government Pension Scheme:-

- A** An updated current scheme, which retains its final salary aspect;
- B** A new, final salary scheme with an improved accrual rate;
- C** A new, career-average scheme with an improved accrual rate; and
- D** A new, hybrid arrangement, based on a career-average core with a final salary option.

These options, their comparative costs and other proposed improvements to the scheme are considered in more detail in the summary of the consultation paper attached as Appendix 1.

3. The Preferred Option

Option A has the least impact on existing scheme members and has the lowest estimated costs of any of the four options, 19.4% of payroll (total of employers' and employees' contributions). It is the only option that is estimated to cost lower than the benchmark cost for a new scheme. The government also seeks to set an appropriate employee rate under the new-look scheme to ensure affordability for employees and for scheme employers. Under Option A an average employer rate could be between 14.5% and 13% depending on the level at which employee contributions are set. This should ensure, if this option is finally chosen by the Government, that Bexley Council's employer contributions would reduce or at the very least be maintained at the level of employer contributions set under the 2004 valuation. Actual contribution rates will, of course, also depend on the investment performance and the returns on corporate bonds used to calculate liability values.

This would also be the simplest and cheapest option to administer and to communicate to employees, being essentially the same as the current final salary scheme. Changes to the LGPS made over the last couple of years, and news reports about the pension crisis, have created a feeling of unease about further changes to what is a good quality final salary scheme. To alter the scheme from a final salary scheme would remove one of the main perceived benefits of the scheme. Changes proposed to the scheme in respect of the 'Rule of 85' have already resulted in industrial action by Bexley employees. Subsequently any move from a final salary scheme to a significantly different scheme is also likely to create industrial relations difficulties. The current final salary scheme is considered a valuable recruitment tool and a key part of the Council's remuneration package.

Therefore, Option A, which not only retains the final salary aspect of the scheme but also involves the lowest cost, is proposed as the preferred option. Options B, C and D all offer higher accrual rates (the rate at which pension benefits are earned) and therefore cost more than option A. Full details of the accrual rates are included in Appendix 1.

4. The Response

The DCLG provided set questions that they felt were particularly relevant to the successful development of the scheme and these have been used as a basis for Bexley Council's proposed response attached as Appendix 2. The response is based on supporting the preferred option – Option A – for the reasons given in section 3 above.

Comments on the proposals that have been put forward for two tier ill-health provisions for the LGPS to come into effect on 1 April 2007, one year in advance of the new look scheme were also sought as part of this consultation. There will be a further statutory consultation on those proposals in the autumn of 2006. Bexley Council's proposed response includes support for the proposals as an improvement on the current "one size fits all" arrangements as they recognize varying levels of ill health and that benefits should be awarded accordingly. The proposals apply for each of the four options in the new look scheme.

Proposals for other possible improvements to the scheme were also considered in the consultation paper and Bexley Council's response therefore also includes support for extensions to the current flexible retirement provisions as they are cost neutral, and support for an increase to the employee rate.

Unless there is a significant increase in employee contributions, it could be argued that the changes do not fundamentally address the future cost of the LGPS.

It is therefore suggested that this be agreed as the Council's response to the consultation.

5. Equal Opportunities/Access Issues

The proposed response has been compiled with due consideration to all affected employees regardless of race, gender, age, disability, or level in the organisation.

6. Summary of Financial Implications

The proposed response supports the option that is expected to produce estimated reductions in total costs of 1.5%, compared to the estimated average cost of the current scheme. The new look scheme is intended to operate from April 2008 so should be decided in time for the impact on Bexley's scheme contributions to be determined by the Council's actuary following the next valuation as at 31 March 2007. The actual impact on the Council's financial plans will depend on a number of other factors and will not be known until the valuation has been completed.

7. Conclusion

The consultation focuses on redistributing half of the saving from the removal of the Rule of 85 whilst retaining the final salary aspect of the existing scheme or providing a better accrual rate than other options considered. Unless there is a significant increase in employee contributions, it could be argued that the changes do not fundamentally address the future cost of the LGPS.

Local Government Act 1972 – section 100d

List of background documents

DCLG consultation paper "WHERE NEXT? - OPTIONS FOR A NEW-LOOK LOCAL GOVERNMENT PENSION SCHEME" – June 2006

Pensions Committee 20 July 2006 - Local Government Pension Scheme (LGPS) – Annual Report on Early Retirement 2005/06

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APPENDIX 1

The Department for Communities and Local Government published a consultation document at the end of June 2006 "**WHERE NEXT? - OPTIONS FOR A NEW-LOOK LOCAL GOVERNMENT PENSION SCHEME**" requesting responses from interested parties by 29th September 2006.

The document sets out various options for a new-look Scheme from April 2008, insisting that the scheme be

- Affordable and viable;
- Fair to taxpayers, who ultimately guarantee its pension promise;
- Attractive to existing and future scheme members, and to employers;
- Regarded and valued as an integral part of the overall remuneration package for employees in an increasingly diverse workforce; and
- Deliver an appropriate defined benefit, index-linked income in retirement for its members.

The consultation paper starts by working out a benchmark cost against which to compare each option for the new look scheme:-

Benchmark costs	Existing¹	New²
The scheme before the removal of the rule of 85 and commutation	22.2%	19.4%
The scheme after the removal of the rule of 85 and commutation	20.0%	17.6%
Savings from the removal of rule of 85 and commutation	2.2%	1.8%
(The scheme as assumed by many funds at the 2004 valuation)	20.3%	17.9%
A target benchmark cost for the new-look scheme		
Benchmark cost after adding back 50% of the savings from the rule of 85 and commutation and subtracting 0.2% for additional protections or phasing.	20.9%	18.3%

¹ "Existing" refers to the existing members cost as a percentage of pensionable payroll.

² "New" refers to the new entrant cost as a percentage of pensionable payroll.

The four basic options put forward for the Scheme are

- A An updated current scheme, with additional benefit improvements;
- B A new, final salary scheme with an improved accrual rate;

- C A new, career-average scheme with an improved accrual rate; and
- D A new, hybrid arrangement, based on a career-average core with a final salary option.

The options have been costed by the DCLG on the basis that 50% of the assumed savings from the removal of the 85-year rule, and the introduction of increased commutation of pension into lump sum are re-cycled into the Scheme to provide benefit improvements.

SCHEME IMPROVEMENTS

All of the options include the following scheme improvements the cost of which is shown below as an increase or reduction to current costs under the scheme (as at 1 October 2006). These costs have already been included in the total estimated costs for each of the options by the DCLG. The total estimated costs for each option are stated later in this summary.

- Increase of lump sum grant for death in service from 2 times final salary to 3 times
Impact: An increase in costs of 0.3% of payroll (0.2% for new members)
- The introduction of two tiered ill health benefits which enhance benefits for the seriously ill but dilute benefits for those deemed fit for work other than their current jobs.
Impact: A reduction in costs of at least 1.0% of payroll (0.7% for new members)
- The improvement of partners pensions as a result of a higher basic pension (options B, C and D only)
Impact: An increase of no more than 0.3% of payroll (0.2% for new members)

OPTION A An updated current scheme, with additional benefit improvements

This is a final salary scheme with an accrual rate of 1/80 of final salary, with a tax-free lump sum of 3/80 of final salary. The total cost of this scheme is estimated to be 19.4% of payroll (17.3% for new members).

OPTION B A new, final salary scheme with an improved accrual rate

This is also a final salary scheme but with an accrual rate of 1/60 of final salary, and with no automatic lump sum. The total cost of this scheme is estimated to be 20.9% of payroll (18.6% for new members).

OPTION C A new, career-average scheme

This is a career average scheme with two alternative methods for calculating benefits. The first would be to revalue each years pay in line with the Retail Price Index (RPI) and apply an accrual rate of 1.85%. Alternatively, each years' pay could

be increased by RPI plus 1.5% with an accrual rate of 1.65%. The first option is estimated to cost 20.6% of payroll (17.7% for new members) whilst the second would be marginally less costly at 20.5% (but 18.1% for new members). This option costs more than the final salary scheme as a higher accrual rate is assumed.

OPTION D A new, hybrid scheme

This would be similar to Option C, but would provide members with the opportunity to pay additional contributions to obtain final salary linked benefits. The basic cost would be the same as for Option C, however scheme members electing to receive final salary based benefits would need to pay around 3% in additional contributions.

OTHER POSSIBLE DEVELOPMENTS FOR THE NEW SCHEME

With the exception of partners' pensions, the DCLG is also asking for views on proposals for the following possible developments for the new look scheme.

Partners Pensions

The consultation paper does not advocate the immediate introduction of co-habitee's pensions, but recognises that these may need to be considered following conclusion of the government sponsored Law Commission consultation: "Cohabitation: The Financial Consequences of Relationship Breakdown". It is pointed out that under Options B, C and D, where basic individual pensions are higher, current partner pensions are subsequently increased.

Increased Flexibility for early retirement

Proposals include:

Allowing members to pay additional contributions to offset the reductions in benefits resulting from early retirement.

Remove the requirement to obtain employers consent for flexible retirement from age 50 (increasing to 55 by April 2010)

Remove the requirement for employees to reduce hours or grade for taking flexible retirement

Benefits accrued after age 65 to be actuarially uplifted to account for late retirement

Two-tier ill health retirement

Aimed to widen the range of ill health benefits an employing authority is able to award, the top tier would cover members permanently unable to perform the duties of their local government employment and unlikely to secure gainful or regular employment again. The second tier would cover members judged capable of undertaking other regular employment.

Those covered by the top tier would receive immediate benefits with service enhanced by 50% of potential service to age 65 (possibly higher if justified on

compassionate grounds). Employers would be given the ability to review and if appropriate to withdraw the enhanced benefits

Those covered by the second tier would receive immediate unreduced benefits, but these would not be enhanced. It is expected that 85-95% of ill health retirees would fall within the second tier. The second tier might also be split into categories offering a different level of benefit ranging from immediate payment of enhanced benefits to immediate payment of deferred benefits for a fixed period only (e.g. 2 years).

Employer and Employee Contribution Rates

In order to “equality-proof” the new Scheme, tiered employee contributions could be considered. These would be particularly appropriate to Options A and B, as final salary schemes tend to disproportionately reward high earners.

It may also be appropriate to consider future cost sharing between employers and employees. Effectively this means introducing some mechanism by which variations in the ratio between employer and employee contributions are limited.

Existing Members in the new-look Scheme

It is intended that the new Scheme be available to all new and existing scheme members from 1st April 2008. All membership from April 2008 would be accrued under the terms of the new-look scheme. Three methods have been proposed for treating pre April 2008 membership

- A Award an actuarially calculated period of membership to existing members
- B Award a period of membership greater than that calculated in A to existing members
- C Treat pre April 2008 membership as a deferred benefit under current scheme rules, but based on final pay at retirement.

Scope of Scheme Employers discretions

It is suggested that employers could be enabled to provide specific additional benefits over and above the main Scheme benefit package, where this would not conflict with other equality and discrimination requirements.

A response from Bexley Council

QUESTION	RESPONSE
<p>THE FOUR OPTIONS <i>Relevant Chapters of Consultation document: 1-6</i> C1. Which of the four options, or variations on them, would you support and which would you oppose? Why?</p> <p>C2. Bearing in mind the criteria for evaluation, and Chapters 1-4, which Option would you recommend be taken forward for the new-look scheme?</p>	<p>We would support Option A because it has the lowest estimated costs which is an important factor to us as an employer. It also has the least impact on administration costs, and on existing scheme members which is important in order to maintain good relations with employees. We consider a final salary scheme very valuable as part of the overall remuneration package aiding recruitment and retention.</p> <p>We would not support Option B because it increases the accrual rate above the current 1/80th, the cost of which is not to be offset solely by compensating savings, and does not provide an automatic lump sum. Recent changes have been made to the current scheme to encourage members to take the maximum 25% of value of pension benefits as a lump sum. It was anticipated that 50% of members would do this and this would produce savings by reducing anticipated long-term liabilities. Our experience so far is that employees prefer to maintain the highest possible long-term pensions. With increasing pensioner longevity therefore this option does not seem the most affordable in the long term for employers although attractive to employees.</p> <p>We would not support Option C or D as they would require considerable changes to current systems to administer involving us as an employer in potentially substantial additional costs (as yet unidentified). They will also be complicated to explain to scheme members.</p> <p>It is recommended that Option A be taken forward.</p>

A response from Bexley Council

QUESTION	RESPONSE
<p>FLEXIBLE AND EARLY RETIREMENT <i>Relevant Chapters of Consultation document: 2, 3, 7</i></p> <p>C3. Which of the five possible extensions to the current flexible retirement provisions, or variations on them, would you support and which would you oppose? Why?</p>	<p>Allowing scheme members to make extra contributions to offset any reduction to their pension if they retire early, removing the requirements to obtain employer consent to taking their benefits and to take a reduction in hours/grade, and uplifting benefits for late retirement are all supported as all are cost neutral.</p> <p>Current amendments to the regulations already allow flexible retirement from age 50 and it is accepted that the minimum retirement age for the scheme must rise to age 55 by 2010.</p> <p>None are opposed.</p>

A response from Bexley Council

QUESTION	RESPONSE
<p>EMPLOYEE AND EMPLOYER COSTS <i>Relevant Chapters: Chapters 1-6, 11</i></p> <p>C4. What should the average employee contribution rate be in the new-look scheme?</p> <p>C5. Should the employee contribution rate be tiered, so that a lower contribution rate would be payable on pensionable pay below a certain cut off point? Would this depend on which Option was implemented, and if so, how and why?</p> <p>C6. What would an affordable employer contribution rate be in the new-look scheme, in relation to the employer rates being paid by scheme employers for future service costs under the current scheme?</p>	<p>In a previous consultation exercise we supported in principle an increase in the employee contribution rate to 7% but were concerned about potential salary increase demands counteracting the benefit of that increase by increasing scheme liabilities. In Annex 1 it is suggested that for every Option except for Option B an increase to 6.6% would produce employer savings against the levels of employer contributions set in the 2004 valuations. As we have chosen Option A as our preferred Option we would support an increase to 6.6% which could produce a saving of 1.5% according to the illustrations if that Option is chosen. Such an increase should not make the scheme suddenly unattractive or unaffordable to employees. We would however not be against an increase to 7% if the chosen Option is not A.</p> <p>A tiered contribution rate is not supported because it will require considerable changes to current systems. This will involve us as an employer in potentially substantial additional costs (as yet unidentified). Although it is appreciated that lower paid employees who do not pay tax do not benefit from tax relief on contributions, the scheme should not be a vehicle for correcting what may be seen as unfairness in the national tax regime. It would also introduce 'cliff edge' problems.</p> <p>An employer contribution rate of no more than 13%.</p>

A response from Bexley Council

QUESTION	RESPONSE
<p>TWO-TIER ILL-HEALTH PENSION PROVISIONS <i>Relevant Chapters: 8</i> T7. Do you support or oppose the proposal to move to a two-tier basis for ill health pension provision? Why? The following additional questions might be relevant: a. What criteria should be used to define “regular employment”? b. By what percentage of prospective service should a member’s accrued service be enhanced? c. Should employers’ retain the discretion to award up to 100% enhancement? d. What criteria should be used to judge “capability to undertake other regular employment?” e. Do you agree that ill-health retirements under the second tier should not receive any enhancement? f. Should the immediate payment of unreduced benefits be: subject to review, subject to abatement in the event of improvement, not subject to review, but payable for a fixed period of time or not subject to review, and payable until death? g. In the case that the second tier is to be subject to review, should it be divided into different categories according to extent of incapacity and prospective opportunities, with each category subject to different review procedures? h. Should any movement to the top tier be allowed? i. Should a scheme member be able to apply for ill health retirement j. How should ill-health retirees be assessed? T8. Do you have proposals for alternative two-tier ill health pension provisions?</p>	<p>A two-tier basis for ill health provision is supported because it recognizes that there are varying levels of ill health and that benefits should be awarded accordingly. a. The example quoted used by the Firefighters’ schemes for defining “regular employment” of being “not less than 30 hours per week on average over twelve month period” could be suitable for those who had been full time employees. However significant numbers of Local Government employees are part time so it would seem more appropriate to use instead a relevant percentage of contractual hours perhaps 80 – 85% for consistency and fairness. b. 50% of prospective service to age 65 would provide a reasonable benefit for most employees who fall into the top tier. c. No because it would be difficult to ensure consistency and fairness when making awards. d. Criteria should be the same as under the current scheme, i.e. permanently incapable until age 65. e. Yes because they are still capable of undertaking other “regular employment”. f. It would be preferable to avoid a review process to ensure consistency and ease administration and this would be reasonable if a two-tier system were adopted where it is anticipated 85 – 95% of ill health retirements would fall into the lower tier and attract only unreduced benefits with no enhancements. g. Once a level of benefit has been awarded it should remain in payment for life. Any review process is not supported. h. No because this could lead to numerous appeals from members seeking to be placed in the higher tier and our view is that the decision once made should not be subject to review. i. No because we consider this would weaken employee re-deployment and DDA obligations to make every effort to keep people working. j. No view. No</p>

A response from Bexley Council

QUESTION	RESPONSE
<p>EXISTING SCHEME MEMBERS IN THE NEW-LOOK SCHEME <i>Relevant Chapters: 13</i> T13. Which of the possible three transfer methods would you support and which would you oppose? Why?</p> <p>T14. How should protections for existing scheme members from the removal of the 85- year rule be dealt with in the new-look scheme post 1 April 2008?</p> <p>T15. Do you have proposals for alternative methods of transfer?</p> <p>T16. Bearing in mind the criteria for evaluation, which method would you recommend be taken forward for the new-look scheme?</p>	<p>We would support Method C treating all accrued service of existing scheme members as at 31 March 2008 as a benefit payable on retirement, under the terms of the current scheme, based on final salary at retirement, because benefits have already been funded and it does not change the expectations of existing members.</p> <p>Method (ii) is supported because it is not viewed as having a cost impact on the new scheme. It is our understanding that it provides protection on a similar basis to the protection given by the amendment regulations that came into force from October 2006 under the current scheme.</p> <p>No</p> <p>Method C for the reasons given above.</p>
<p>SCOPE OF SCHEME EMPLOYERS' DISCRETIONS <i>Relevant Chapters: 14</i> T17. Do you support or oppose the idea of the introduction of a discretionary opt-in for scheme employers to provide additional specific benefits to scheme members a future cost sharing mechanism into the LGPS? Why?</p>	<p>Oppose the idea as the scheme is a national scheme and should retain a standard benefit package.</p>