Department for
Communities and Local Government

Where next? –

Options for a new-look Local Government Pension Scheme in England and Wales

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Foreword

1. I see this document as a crucial step in the development of the Government's proposals for sustainable and affordable solutions to the challenges facing the Local Government Pension Scheme (LGPS) in England and Wales.

2. The Scheme is recognised by all stakeholders as a key component of the reward package available to workers in and around local government. Scheme employers greatly value the LGPS and now wish to see it secured on a sustainable and affordable basis. So too do scheme members. A degree of consensus is emerging around the need to reform the Scheme, both to ensure it meets the challenge of a changing and more diverse workforce and adapts to increasing pensioner longevity. It must also remain fair to taxpayers who underwrite its benefits and its pension promise.

3. The development of a new-look LGPS is taking place alongside reforms to other public service schemes and to the state pension system. A White Paper on Pensions Reform, *Security in retirement: Towards a new pensions system,* was published on 15 May. The Teachers', Civil Service and NHS pension schemes are each completing, or are in the process of developing, new schemes.

4. Against this background, a number of costed options are now put forward in this document for a new-look Local Government Pension Scheme in England and Wales to apply to its existing and future workforce from April 2008. These options take forward the principles and propositions first consulted on in *Facing the Future* in October 2004. They have been developed in conjunction with LGPS stakeholders over the last six months.

5. The Government now seeks the views of all LGPS interests on these options by 29 September, in order to build a consensus around what affordable, viable, fair and equality-proofed reforms can be delivered for 1 April 2008.

Phil Woolas MP
Minister for Local Government and Community Cohesion

Executive Summary

1. The Government's policy for the Local Government Pension Scheme (LGPS) in England and Wales can be summarised as follows. The Scheme should be:

   a. **affordable** and **viable**;

   b. **fair** to taxpayers, who ultimately guarantee its pension promise;

   c. **attractive** to existing and future scheme members, and to employers;

   d. regarded and valued as **an integral part of the overall remuneration package** for employees in an increasingly diverse workforce; and

   e. able to deliver an appropriate **defined benefit**, **index-linked income** in retirement for its members.

2. At this stage, Ministers have agreed to invite consultees views on four options for the new-look scheme. These options were developed in conjunction with LGPS interests over the past six months, and build on the responses received to the October 2004 Green Paper *Facing the Future – Principles and Propositions for a new-look Local Government Pension Scheme in England and Wales.* The four options 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; and

   D. A new, hybrid arrangement, based on a career-average core with a final salary *option*.

3. Options B-D have been designed to have an indicative benchmark cost of around 20.9% for existing members. This is because, within the costing methodology adopted, 20.9% represents a scheme cost in which 50% of the savings from the removal of the 85 year rule and commutation are recycled, once the additional protections for existing scheme members from the removal of the 85 year rule are taken into account. DCLG is currently consulting on these extensions, but we assume, for the purposes of this consultation, that they are implemented. Option A is a somewhat lower cost option, at 19.4% for existing members.

4. These benchmark costings are not intended to provide a funding recommendation for the scheme, nor a representative or average scheme cost. This is because it is not considered appropriate to produce average or representative costings centrally for a Scheme which is run by 89 separate funds in England and Wales, each with their own profile and individual challenges. Funds will take different approaches to valuing their individual assets and liabilities, and will make different recommendations for contribution rates to employers.

5. Instead, the Department developed an approach for costing options for a new-look scheme in discussion with the Government Actuary's Department (GAD). This has also involved LGPS fund actuaries and actuarial advisors to main LGPS stakeholders. The costings have been developed in consultation with and have been made available to LGPS working groups. This approach allows for valid comparisons to be made, based on the differences between the cost of the current scheme and the costs of the new-look scheme options.

6. Funds and scheme employers are now strongly encouraged to use these to assess the likely impact on their costs, should any of the options detailed here apply from 2008. This data will be important to the Department and to stakeholders in assessing range of local cost implications of the options for funds, employers and employees. In order to ensure the Scheme's affordability, employees' and employers' contribution rates must be acceptable to all parties and an appropriate mechanism for sharing of future cost pressures should be considered.

7. The responses received to this consultation will be carefully considered before Ministers decide on which proposal to conduct a statutory consultation, in the form of draft Scheme regulations, later this year. It is intended that the new-look scheme will be available to all new entrants *and* existing scheme members from 1 April 2008. The mechanics of how the accrued rights of existing scheme members in the current scheme will be transferred or protected remain to be discussed with stakeholders. However, the objective would be to have one local government scheme for all members and therefore a fair means to transfer existing scheme members to the new-look scheme must be developed.

8. The four options represent the range of views from across the scheme and from scheme interests. The priorities and perspectives of scheme employers are important, as the LGPS provides for their employees. So too are those of LGPS members, who benefit in retirement from choosing to save **now**. It is also important to value and take account of the views of those employees who currently choose not to join the Scheme, and to focus on how their needs can be provided for in the reforms. Finally, the views of the taxpayer, through their representatives, need to be taken into account during the consultation process and beyond.

9. Response templates can be found at Annexes 2 and 3.

Chapter 1

The Departmental and regulatory position

1.1 This consultation stage in the development of new-look LGS considers costed options from which it is hoped that the basis of specific regulatory proposals to reform and modernise the LGPS in England and Wales will emerge. Ministers have indicated consistently throughout this reform process that they wish to develop a modern, flexible LGPS which can better serve the needs of local government and its workforce, as well as being affordable and viable for stakeholders.

1.2 Given their stewardship and regulatory responsibilities for the Scheme, Ministers have confirmed that they wish to see local authority employees, and other LGPS members, enjoy the benefits of a good quality pension scheme. To achieve that, the LGPS must be regulated on the basis of fairness and affordability, and be proportionate in terms of the balance between the level of benefits which are provided for its membership, and the costs incurred by its providers. Finally, of course, the Scheme itself is under-pinned by taxpayers who ensure its pension promise.

1.3 The LGPS in England and Wales has developed considerably since the early part of the last century. Its rules are now defined in regulations made under section 7 of the Superannuation Act 1972. It is defined also for the purposes of the Pensions Schemes Act 1993 as a statutory, public service pension scheme.

1.4 The Scheme is sponsored by the Department for Communities and Local Government (DCLG), which is responsible for its stewardship and maintaining its regulatory framework. However, within that framework, it is administered, managed and funded at local authority level.

1.5 In defining the policy framework, as a prelude to discussing the possible architecture of options for a new-look Scheme, it may be helpful to state the basis for the Scheme's new arrangements to be set out in new regulations, made under powers in the Superannuation Act 1972. They should be:

- **comprehensive** in their overall provision;
- **flexible and responsive** to the needs of stakeholders, in terms of the balance between provision and cost;
- **efficient and cost effective** in terms of delivery;
- **fully transferable** and;
- **provide the continued security** of an inflation-proofed pension promise for all Scheme members.

Chapter 2

Increasing longevity and reform of the state pension system

2.1 Today's population can expect to live for longer than ever before. Longevity brings advantages and disadvantages, depending on one's perspective. Men and women are living longer in general but these personal and social gains produce implications for society, governments and policy makers. Pension provision, driven as it is by the combination of time, costs and long term promises does not escape. Inevitably, there is a need for a proper balance between reasonable expectation and viable provision. In the LGPS, a funded public service scheme which is underwritten by the taxpayer, this is a fundamental requirement to the upheld in any reform process.

2.2 Societal changes impinge on that process. Expectations, lifestyles, social patterns of behaviour have fundamentally changed since the LGPS was first introduced and indeed have accelerated over the past two decades. Working lives have altered with more variation than ever in each adult's lifetime as between work, study, caring, career breaks and semi-retirement. Multiple employments are far more common-place. The role of women in the workforce, and especially so in local government has seen very significant increases, including high proportions in part-time employment.

2.3 Perhaps most fundamental of all is the need to deal with the challenge of an ageing population and consequently the dramatic increase in dependency ratios. The Department for Work and Pensions (DWP) White Paper on Pensions Reform – *Security in retirement: towards a new pensions system* (cm 6841), published on 25 May, helpfully summarises the position. In particular, it states (paragraph 18) that:

"we are about to experience a dramatic acceleration in the dependency ratio – the balance between the numbers of people of working age and those over State Pension Age. Rising longevity means this is on a long-term upward trend. However, with the large cohort of baby-boomers born just after the second world war swelling the workforce, this ratio has been artificially depressed in recent decades. As that generation goes through to retirement, we will rapidly catch up with the long-term trend."

2.4 To emphasise the point, the White Paper points out that the pensioner population in 1950 stood at 19 per cent of the working age population. Today the figure is 27 per cent. By 2050, once the ratio has caught up with the underlying trend, it might be 47 per cent. This demographic shift, the White Paper suggests, will transform the context for pensions policy.

2.5 In addressing the challenges described in the White Paper, the Government has set five tests for its reform package. Any reformed pension system must:

- **Promote personal responsibility;**
- **be fair;**

- **be simple;**
- **be affordable;** and
- **be sustainable.**

2.6 In taking these five tests forward, the White Paper clarifies the Government's reform proposals for State pensions and personal provision in the following ways:

Making it easier to save for retirement: Automatic enrolment in the new Personal Accounts system is not targeted at employees who already have access to good quality workplace pension schemes like the LGPS. DWP will be consulting later this year on an exemption test for employers who offer such schemes.

Providing a solid foundation on which people can save: The Second State Pension is estimated to become flat-rate by 2030. The basic State Pension will be re-linked to average earnings during the next Parliament.

Making the state pension fairer and more widely available: Qualifying requirements and the way in which women, carers and other groups build entitlement to the state pension are being adjusted.

Supporting and encouraging extended working lives: The state retirement age is proposed to rise in line with gains in average life expectancy. The state pension age for women is already due to rise from 60 to 65 between 2010 and 2020, and there will now be a subsequent rise for both men and women from 65 to 68 between 2024 and 2046.

Streamlining the regulatory environment: Contracting out is to be abolished for defined contribution schemes. The long-term future of contracting out for defined benefit schemes will be subject to ongoing review.

2.7 The White Paper's intentions, therefore, are designed to make a difference to the retirement prospects of everyone and to achieve a new balance between individuals, their employers and the State. Measures to protect the current pensioners will remain and steps will be taken to ensure all pensions will share in rising national prosperity. Legislation is proposed for the second session of this Parliament.

2.8 These proposals, inlcuding the rising state pension age, clearly provide a relevant context to the reform of the LGPS, and will need to be taken into account as the development of a new-look LGPS progresses.

Chapter 3

A changing workforce in and around local government

3.1 Consultant actuaries, Hymans Robertson LLP, produced, in September 2005, a demographic study for the then Office of the Deputy Prime Minister, entitled *Local Government Pension Scheme in England and Wales: Review of Demographic Patterns*. This review included an analysis of changes in employee membership structure, drawing on the experience of six LGPS funds particularly between the 2001 and 2004 valuations. The report found that the membership of the LGPS had changed significantly since the existing benefit structure was introduced in the early 1970's. This had become particularly apparent since all part-timers were allowed to join in 1993.

3.2 The LGPS now demonstrates characteristics of substantive divergence. In a Scheme of this size, covering up to 1/12 of the labour market and with such a wide variety of jobs and professions such divergence, reflecting national employment trends, should not perhaps be a surprise. This diversity provides a strong case for the benefit structure evolving in order to suit a wide range of needs fairly. An ageing working population and a substantially increasing pensioner population (relative to the working population) also means that retaining older workers in employment will become increasingly important. The following main trends were identified:

3.3 **Part-time working:** 72% of the current employee membership is female, with 57% of female workers working part-time. Almost half the employee members work part-time, and will therefore be building up benefits in retirement on the basis of a part-time salary.

3.4 **Length of service:** The average length of service for members leaving active status in the LGPS has reduced from 8.1 years in 1992-95 to 6.3 years in 2001-04. This means that scheme members, over the course of their careers, are likely to build up pension provision in other schemes as they change employers. Short serving scheme members are not likely to expect to draw the majority of their retirement income from the LGPS. Indeed 75% of pensions in payment in 2004 were less than £5,000 a year. Additionally, women tend to be in receipt of lower pensions than men, primarily due to a combination of their shorter service, part-time working patterns and lower pay.

3.5 **Salary distribution:** Although average annual Full Time Equivalent (FTE) pay for women and men at 31 March 2004 was found to be some £16,400 and £20,800 respectively, analysis of the distribution of women's pay in particular shows that the distribution is skewed with large numbers of women being paid less than the average, and small numbers of women being paid significantly more. In other words, there is a bunching around lower annual pay levels, between the ranges of £10,000 – £17,000.

3.6 **Pensioner longevity:** For men retiring at 65, based simply on LGPS population mortality, the average period that a pension is expected to be in payment has risen from 12.2 years to 16.0 years since the early 1970's, an increase of some 31%. For women, the rise is from 16.1 years to 19.0 years, a rise of some 18%.

Chapter 4

Equality proofing

4.1 The demographic study by Hymans Robertson also provided some evidence that LGPS pensioners with larger pensions tend to survive for longer in retirement. This should not, in itself, be surprising: a number of studies have shown a definite correlation between wealth and longevity.

4.2 A final salary scheme such as the LGPS also tends to focus benefits on long serving staff, and particularly those who progress up the earnings scale whilst in employment. While it is not the role of a pension scheme to redistribute wealth, in order to equality proof the LGPS, a smoothing of these differences, whilst maintaining mutuality across the pension scheme, seems a reasonable objective. These steps seem necessary, given the diverse nature of the modern LGPS workforce as outlined in Chapter 3. They might also serve to meet the needs of those potential scheme members who have already or who might in future choose not to join the LGPS.

4.3 The Prime Minister's Foreword to the Department for Work and Pensions (DWP) White Paper on Pensions Reform – *Security in retirement: towards a new pensions system,* states that "we need to put in place an affordable and sustainable pension system which…encourages people to save for their retirement". To ensure the new-look LGPS is attractive and affordable **across the whole diverse range** of a modern workforce – including school dinner ladies, town planners, teaching assistants, roadsweepers, accountants and chief executives, with their different salaries, periods of scheme membership and progression prospects seems a necessary objective.

4.4 A good quality, workbase pension is, for many individuals, a key componant of their retirement income. The reform of the LGPS will secure its status as a good quality, defined benefit pension scheme, but the reforms must also be equality-proofed, and must remain attractive and affordable to employees and employers and fair to the taxpayer who underwrites its pension promise.

4.5 In Chapter 6, four options for the new-look scheme are presented. Some of these options retain and build on the final salary structure of the LGPS, but others are based on a career-average structure. While a final salary structure tends to focus benefits on long serving staff, and particularly those who progress up the earnings scales whilst in employment, a career average structure tends to redistribute benefits back towards the shorter serving staff or those with lower career salary growth. This would, therefore be one equality-proofed option for a new-look scheme that is attractive and provides benefits fairly across the whole diverse range of the modern workforce.

4.6 Consideration must therefore also be given to how the final salary options could be equality-proofed, in the context of the diversity of the modern workforce. Lower cost entry points are one possibility, to make a final salary structure more attractive to those whom it does not tend to benefit as much as long serving staff, and particularly those who progress up the earnings scales whilst in employment. However, any reduction in contribution rate for one part of pensionable earnings will need to be mirrored with an increase in contribution rate for another part, in order to generate the required average employee contribution rate, other things being equal.

4.7 The merits for one element of the workforce of a *tiered contribution structure* must therefore be weighed against the downside for another element. Such a structure would be necessary, were a final salary scheme to be implemented, and it could be considered to be desirable also in the case that a career-average scheme is to be implemented. In Chapter 11, consideration is given to exploring possible tiered structures.

Chapter 5

Arriving at a target benchmark cost

5.1 The LGPS has had a normal retirement age of 65 since the 1920s. However, the 85 year rule currently allows scheme members whose age plus service equals 85 to retire from 60 (of from 50 with employer consent) on an *unreduced pension*. Any scheme member can retire from 60 (or from 50 with employer consent), but if they do not satisfy the 85 year rule, they will face a reduction in their pension to reflect the fact that it is coming into payment earlier than expected and is also likely to be in payment for longer than expected.

5.2 The 85 year rule was removed from 1 October 2006 by the *Local Government Pension Scheme (Amendment) Regulations 2006,* which were laid in Parliament on 30 March 2006. These regulations also introduced protections for those existing scheme members closest to retirement, who would be 60 and satisfy the 85 year rule by 31 March 2013 and who would therefore not have time to make alternative arrangements. The new-look scheme options do not assume any 85 year rule rights, except for those existing scheme members who satisfy the 31 March 2013 protections.

5.3 As many consultees will be aware, the 85 year rule was previously removed from 1 April 2005, but these regulations were subsequently revoked, so the rule was effectively reinstated to the scheme. Chapter 15 contains descriptions of the Scheme's benefit package over the recent period of changes. These variations on the current LGPS have also been costed on this same basis as the new-look scheme options, in order to allow respondees to compare the relative costs of the options with the current scheme.

5.4 Within the methodology of *benchmark* costings, carried out by the Government Actuary's Department (GAD) (this methodology and approach is outlined in Chapter 9), and by comparing the cost of the scheme at 30 March 2006 (when the 85 year rule was in place but increased commutation was not) with the cost of the scheme at 1 October 2006 (when the 85 year rule will not be in place, but increased commutation will be), it is possible to arrive at a representative figure for the cost of a new-look scheme in which 50% of the savings from the removal of the 85 year rule and the introduction of increased commutation are recycled.

5.5 Chapter 10 shows that, on this basis, some 1.1% (0.9%)[1] would be available for recycling into the new-look scheme, giving an indicative new-look scheme cost of some 21.1% for existing scheme members and 18.5% for new entrants. The trades unions and local government employers reached an agreement, detailed in their joint statement of 11 April 2006, to develop the new-look scheme on this basis. We have viewed these indicative costings as a target cost for the new-look scheme, and have developed the options accordingly.

1 All costings in this paper are presented in terms of the percentage of pensionable payroll, as:
existing member cost % (new entrant cost %)

The draft Local Government Pension Scheme (Amendment) (No.2) Regulations 2006

5.6 DCLG is conducting a consultation from 26 May to 3 July 2006 on proposals to provide additional affordable and legal additional protections for existing scheme members from the removal of the 85 year rule. These proposals were put to the Department following joint discussions between the local government employers and the trades unions. Subject to the outcome of the consultation exercise, amending regulations will be made and laid by the summer Recess in order to implement these changes from 1 October 2006.

5.7 It is important to obtain the cost of these additional protections, and to take account of how this cost would be likely to impact on the cost of the new-look scheme, should the proposals be implemented. Chapter 15 outlines costings from the Government Actuary's Department (GAD) which show that the target costings should be **reduced** by 0.2% in the case that these proposals for additional affordable and legal additional protections are be implemented. This document has been prepared on the basis that they will be, and therefore the target benchmark scheme costs for the new-look options should be adjusted to 20.9% for existing scheme members and 18.3% for new entrants, as is illustrated in Chapter 10. The four options contained in this paper have been designed with reference to this **adjusted target benchmark cost.**

Chapter 6

Four options for the new-look scheme

6.1 The LGPS has a varied membership, with a complex set of needs to meet, within an affordable package which is fair to taxpayers. The reform of the Scheme must take this into account. The Department is, sensitive to the needs and perspectives of different LGPS interests and four costed options have therefore been designed to allow for the full range of views. Each of the four options would deliver the Government's policy for the Local Government Pension Scheme in England and Wales.

Core structures

6.2 The four options detail different *core structures* for the new-look LGPS, which have a normal retirement age of 65. Options A and B retain the *final-salary* nature of the Scheme, in which a pension per annum is paid to scheme members from the normal retirement age of 65 as follows:

Pension p.a. = (Accrual rate) x (No. years membership) x (Final salary)

6.3 The accrual rate defines the proportion of final salary which the member builds up (or *accrues)* for each year of their membership of the pension scheme. For the LGPS, the accrual rate is currently $1/80^{th}$, i.e. members build up pension rights payable per annum in retirement at a rate of $1/80^{th}$ of their final salary per year of scheme membership. This pension is then increased in line with inflation (RPI) in retirement.

6.4 Option C has a *career-average* structure, in which scheme members build up entitlement to a pension in retirement based on their salary *in each year of membership*, not just on their final salary. Pension per annum is paid to scheme members from the normal retirement age of 65 as follows:

Pension p.a. = (Accrual rate) x (Year 1 Salary) x (Re-valuation index)

+ (Accrual rate) x (Year 2 Salary) x (Re-valuation index)

+ ... + (Accrual rate) x (Final Year Salary) x (Re-valuation index)

6.5 The member's benefits in retirement are therefore the sum of each year's accrual indexed according to the chosen revaluation index, which effectively revalues the benefits accrued in each year of service according on a certain basis. Option C1 revalues each year's benefits in line with price inflation, and Option C2 revalues each year's benefits in line with a measure of wage inflation. As a greater revaluation index is more expensive (as it gives more value to each year's benefits), the accrual rate for Option C2 is lower than that for C1.

6.6 Option C1 provides each member with an element of pension (1.85%) for the pay received in each year, which is fixed in real terms for each year (by RPI revaluation). Deferred members benefits are increased in line with RPI also – there is therefore no difference in revaluation between active members and deferred members. Option C2 provides members remaining in service with increases to their benefits in line with wage inflation (taken to be RPI + 1.5%). They therefore receive a more favourable revaluation than deferred members.

6.7 Under the current final salary structure, benefits are paid according to final salary. Options C1 and C2 will affect existing scheme members differently in relation to the current scheme, depending on their circumstances. As option C2 is someway between Option C1 and a final salary scheme, Option C2 could be considered to have less of an effect of the change on existing scheme members than Option C1.

6.8 Any implications of the 1993 Pensions Act for the treatment of leavers from the LGPS would need to be considered further in the event that Option C2 was to be taken forward.

6.9 Option D builds on Options C1 and C2, but would also offer scheme members a *one-off* choice of making extra contributions to obtain final salary linked benefits in retirement. There would be no extra contribution from the employer.

The additional benefit improvements

6.10 Options A-D would also provide an increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees, and better targeted ill-health pension provision on a two-tier basis. The proposals for two-tier ill health pension provision are detailed in Chapter 8.

6.11 These improvements would provide better security for scheme members and their dependants in the event of death or inability to work due to serious ill-health retirement. The four options have therefore been costed to include all three of these additional benefit improvements. However, two points are worth bearing in mind from the outset: firstly, that were partners' provisions to be reduced for married, civil and cohabiting partners, this would reduce the cost of the options, and secondly, that the Law Commission are due to make a final report to the Government on reform of the law surrounding relationship breakdown in August this year.

6.12 **Partners' pensions:** This consultation paper on options for the new-look scheme makes no proposition that partners' benefits should be reduced in the LGPS at this stage. However, as more women enter the workforce, and more households draw on more than one income, the need to provide partners' pensions reduces, as long as both partners have access to a good workplace based pension scheme, and are able to build up enough entitlement.

6.13 Additionally, it should be pointed out that where the accrual rate in the scheme is improved, most noticeably in Option B, the long term survivor benefits for partners are also improved, as these are set at 50% of pension entitlement. Therefore, this represents an additional benefit improvement, which might be valued at about 0.4% (0.3%). Were this not to be provided, the cost of the Option would fall.

6.14 **Cohabitees pensions:** The Law Commission published, on 30 May 2006, Consultation Paper No 179, *Cohabitation: The Financial Consequences of Relationship Breakdown,* having been tasked by the Government to consider how any reform of the law of this area could be carried out. The paper considers the case for allowing cohabiting couples to "opt-in" to a scheme imposing enforceable financial obligations on the parties in the event of their separation.

6.15 The consultation is open until 30 September 2006, and a final report is expected by August 2007. The introduction of cohabitees pensions into the LGPS may need to be reconsidered in light of any resulting change in the law, as it is clearly desirable that any provision be compatible and aligned with any reform in law in this area which may emerge. However, for the purposes of this paper, we proceed to cost the introduction of cohabitees benefits, according to the same principles and criteria as have been adopted for the Civil Service Pension Scheme.

Evaluation of the four options

6.16 Having considered the general aspects of the options, each option is now considered in turn, its associated cost is outlined and it is evaluated against the following specified criteria:

Cost – is the option affordable for employees and employers? This is dealt with in more detail in Chapters 11 and 12.

Effect on existing scheme members – how will the future accrual of existing scheme members be affected by the new options? This is dealt with in more detail in Chapter 13.

Attractiveness to employees – does the scheme encourage saving and encourage working later in life? This is also considered in Chapters 2, 3 and 7.

Design – is the option fit for the modern and future workforce in and around local government? This is also considered in Chapters 3 and 4.

Attractiveness to employers – would the option help employers to recruit and retain staff? The related issue of a discretionary approach for scheme employers is raised in Chapter 14.

6.17 The four options in this paper have been costed according to the approach outlined in Chapter 9. The benchmark costings used to evaluate the four options (summarised in Chapter 10) are drawn from this approach, and have been designed with reference to an adjusted target benchmark cost of 20.9% (18.3%), as detailed in Chapter 5. This adjusted benchmark cost represents the cost of a scheme in which 50% of the savings from the removal of the 85 year rule and commutation are recycled into benefit improvements, when the proposals for additional protections for existing scheme members as contained in the draft *Local Government Pension Scheme (Amendment) (No.2) Regulations 2006* are taken into account.

OPTION A: An updated current scheme, with additional benefit improvements

Core structure: The current LGPS – a final salary scheme with an accrual rate of 1/80th of final salary per year of membership, an automatic tax-free lump sum on retirement of 3/80th of final salary per year of membership.

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health benefit provision on a two tier basis.

Benchmark cost: On the basis of the costing methodology applied, this Option would cost a total of 19.4% (17.3%) of pensionable pay, i.e. 0.6% (0.3%) **less than** the scheme at 1 October 2006.

Core structure	Death benefit	Cohabitees pensions	Two-tier ill health	Total cost
20.0% (17.6%)	0.3% (0.2%)	0.2% (0.2%)	–1.0% (–0.7%)	**19.4% (17.3%)**

Evaluation against criteria:

1. This is a lower-cost option than Options B and C. The reduction in costs generated by the move to two-tier ill health pension provision actually means it costs less than the scheme at 1 October 2006 (i.e. without the 85 year rule), despite the improvements to death in service benefits and cohabitees pensions. This option would therefore, other things being equal, require a lower contribution rate for employers and/or employees than would be the case for Options B and C.

2. A final salary scheme is a valuable recruitment and retention tool for scheme employers, as it tends to focus benefits on long-serving staff, particularly on those who progress up the earnings scale whilst in employment. It is an especially attractive option for these individuals, both currently and in the future.

3. Should this option be implemented, consideration will need to be given to a *tiered employee contribution rate,* which would encourage short-serving, low progressing staff to join the scheme and would ensure the scheme catered fairly for the modern workforce.

4. Retaining the current structure will minimise the effect of the change on existing scheme members. However, the introduction of a tiered employee contribution rate would affect employees' take-home pay immediately, as this might be increased or decreased in comparison with the contribution rate they currently pay, depending on the salary of that person.

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

Core structure: Retains a final-salary structure, but moves from a "$1/80^{th}$: $3/80^{th}$" structure to a $1/60^{th}$ accrual rate, with no automatic tax free lump-sum on retirement.

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health pension provision on a two tier basis.

Benchmark cost: On the basis of the costing methodology applied, this Option would cost a total of 20.9% (18.6%) of pensionable pay, i.e. 0.9% (1.0%) more than the scheme at 1 October 2006.

Core structure	Death benefit	Cohabitees pensions	Two-tier ill health	Total cost
21.5% (18.9%)	0.3% (0.2%)	0.3% (0.2%)	–1.1% (–0.8%)	**20.9% (18.6%)**

Evaluation against criteria:

1. It is difficult to compare the value of the current $1/80^{th}$:$3/80^{th}$ structure to one in which there is no automatic lump sum. However, on the basis of assumptions consistent with those underlying these benchmark costings, the current structure is approximately equal in value to an accrual rate of 1/64.5 (close to 1.55%). Therefore, moving to a $1/60^{th}$ (1.67%) accrual rate represents an improvement in the accrual rate of approximately 0.12%.
2. This option actually costs 0% (0.3%) more than the **adjusted** target benchmark for a new-look scheme with 50% of the savings from the removal of the 85 year rule and commutation recycled into benefit improvements. In order to ensure the scheme's affordability to employers, it would be likely that an increase in employee contribution rate from its current rate of 6% would be necessary. As Option B costs more than Options C1, C2 and particularly A, this increase would be likely to be larger.
3. A final salary scheme is a valuable recruitment and retention tool for scheme employers, as it tends to focus benefits on long-serving staff, particularly on those who progress up the earnings scale whilst in employment. It is an especially attractive option for these individuals, both currently and in the future.
4. Should this option be implemented, consideration will need to be given to a *tiered employee contribution rate,* which would encourage short-serving, low progressing staff to join the scheme, by having a lower contribution rate for pensionable pay below a certain cut-off point. This would contribute to the equality proofing of the new-look scheme, in providing fairly for the modern workforce.
5. Retaining the current final salary structure will minimise the effect of the change on existing scheme members, and indeed would slightly improve the accrual rate. However, the take-home pay of existing scheme members would be affected by any rise in the employee contribution rate, and by the introduction of a tiered employee contribution rate.

OPTION C: A new, career-average scheme

Core structure: Changes from a final-salary structure to a *career-average* structure. **Option C1** would have accrual rate of 1.85% and revaluation on the basis of the Retail Price Index (RPI) and **Option C2** would have an accrual rate of 1.65% and revaluation on the basis of the Retail Price Index (RPI) plus 1.5%, this being an estimation of wage indexation (subject to the overarching legal position).

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health benefit provision on a two tier basis

Benchmark cost: On the basis of the costing methodology applied, Option C1 would cost a total of 20.6% (17.7%) of pensionable pay, i.e. 0.6% (0.1%) more than the scheme at 1 October 2006. Option C2 would cost a total of 20.5% (18.1%) of pensionable pay, i.e. 0.5% (0.5%) more than the scheme at 1 October 2006.

	Core structure	Death benefit	Cohabitees pensions	Two-tier ill health	Total cost
C1	21.2% (18.3%)	0.3% (0.2%)	0.3% (0.2%)	–1.1% (–1.0%)	**20.6% (17.7%)**
C2	21.5% (18.9%)	0.3% (0.2%)	0.3% (0.2%)	–1.1% (–0.8%)	**20.5% (18.1%)**

Evaluation against criteria:

1. Options C1 and C2 move from a final salary scheme to a career average scheme. They cost 0.3% (0.6%) and 0.4% (0.2%) less than the **adjusted** target benchmark for a new-look scheme with 50% of the savings from the removal of the 85 year rule and commutation recycled into benefit improvements. In order to ensure the scheme's affordability to employers, it would be likely that an increase in employee contribution rate from its current rate of 6% would be necessary. This increase would be likely to be more than that which would be required for Option A, but less than that which would be required for Option B, because of their relative costs.

2. A career-average LGPS would retain the nature of the LGPS as a good quality, defined benefit government-sponsored scheme. A career-average structure would better meet the needs of the whole modern local government workforce, with high numbers of short serving, part-time employees on low-salaries, as well as *career* local government employees, as it tends to redistribute benefits towards shorter serving staff, in comparison to a final salary scheme. However, it is more complicated to explain to scheme members. The change in the structure of the pension scheme and its cost to employees might also lead to demands for related compensatory changes to pay.

3. Some employees would be better off under C1 and/or C2 than under a final salary structure, because their future pay increases will be less than the scheme's revaluation rate. Some would be worse off, because their future pay increases will be greater than the scheme's revaluation rate. However, the take-home pay of existing scheme members would be affected by any rise in the employee contribution rate. A *tiered employee contribution rate* could also be considered for Options C1 and C2 in order to provide further encouragement to join to such individuals.

OPTION D: A new, hybrid scheme

Core structure: As for Options C1 or C2. Scheme members would also have a *one-off* choice of making extra contributions, on top of the contribution rate required for the career-average core structure, to obtain final salary linked benefits in retirement.

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health benefit provision on a two tier basis.

Benchmark cost: The benchmark *scheme* cost is as for Options C1 or C2, depending on which career-average structure is chosen. On the basis of the costing methodology applied, the final-salary linked option would cost around an additional 3% for those electing to receive final salary benefits.

Some further thought will need to be given to what fixed contribution rate should be set in the event that this option is chosen, and to whether a mechanism for reviewing the figure should be introduced in light of experience of take-up.

Evaluation against criteria:

1. Option D would be based on Option C1 or C2, so the evaluation for these options also applies here. Additionally, the final salary choice would mean that those existing scheme members who wished to continue in a final salary scheme, could, while not reducing the quality of the career-average scheme which could be provided for the majority of the workforce.

2. This flexibility would be valuable to employers in recruiting and retaining long serving, high progression staff, who stand to benefit most from a final salary scheme relative to a career-average scheme.

3. However, introducing choice into the LGPS will mean that some individuals may choose what could turn out to be "the wrong option" – because of their patterns of promotion and salary growth turning out to be different to how they had thought when they decided which option to enter. There would be a need for a clear communication to scheme members, which would set out their options, without advising, potentially incorrectly, on which to opt for at the point of decision.

4. The alternative would be to allow scheme members multiple opportunities to switch between the career-average and final salary options. However, this could result in the additional cost of the final salary option possibly rising to as much as 6% because of the effect of selection. As this cost would be likely to be prohibitive, scheme members should have one opportunity, possibly at the outset of their employment, to elect to pay extra contributions.

Chapter 7

Flexible and early retirement

7.1 Supporting extended working lives is a key intention of the proposals for reform of the state pension outlined in the Government's White Paper *Security in retirement: towards a new pensions system.* Giving Scheme members the opportunity to wind down towards retirement by gradually reducing the working hours and/or responsibilities is also a key reform aim for the LGPS. The traditional approach to retirement, where an individual goes from being in full-time employment to being in full-time retirement, over the space of a weekend, no longer meets the needs and expectations of many employees and employers.

Existing provisions

7.2 The *Local Government Pension Scheme (Amendment) Regulations 2006* have already introduced some provisions to support flexible retirement in the current scheme. These provisions allow scheme members to:

a. Retire before the scheme's normal retirement age of 65 from 60, or from 50 with employer consent. For scheme members with no 85 year rule entitlement, their pension will be reduced according to a set of cost-neutral early retirement factors, to reflect the fact that it is coming into payment earlier than expected and is likely to be in payment for longer than expected;

b. Take *flexible retirement* from 60, where the employer gives their consent, and where the employee takes a reduction in hours or grade. This will mean that the employee takes payment of their reduced pension before 65, while remaining in employment; or

c. Continue to accrue service in the LGPS beyond age 65. The pension must be drawn by the day before the member's 75th birthday. Benefits accrued before age 65, which are not taken at or before age 65, will be *increased* by cost-neutral uplift factors, to reflect the fact that it is coming into payment later than expected and is likely to be in payment for shorter than expected.

Possible extensions for the new-look scheme

7.3 These amendments were made possible by the simplification of the taxation of pensions, as introduced by the Finance Act 2004. These provisions will continue in the new-look scheme from 1 April 2008[2], but we would now like to consider how to build on these improvements in the new-look scheme. The following extensions could be considered:

2 The existing provisions are governed by cost-neutral reduction factors and so are not likely to affect the cost of Options A-D.

a. Allow scheme members to make extra contributions to offset any reduction in their pension in the case that they wish to retire early. These extra contributions could be calculated according to cost neutral *buy-back factors;*

b. Extend flexible retirement from age 60 to the scheme's minimum retirement age (currently 50, but this will need to increase to 55 by 2010);

c. Remove the requirement for employees to obtain employer consent for flexible retirement;

d. Remove the requirement for employees to take a reduction in hours or grade in order to take flexible retirement;

e. Benefits accrued *after* age 65 also to be *increased* by cost-neutral uplift factors when a member elects to take payment of them after age 65.

Review of early retirement reduction factors

7.4 A separate review of the cost-neutral actuarial reduction factors is currently underway at the time of writing. This review responds to concerns which have been raised by LGPS scheme interests about these factors, which are considered now to be somewhat out-of-date in light of improvements in pensioner longevity. The intention is for the new factors to be available in the current scheme from 1 October 2006, to coincide with the date of removal of the 85 year rule from the scheme.

Chapter 8

Proposals for two-tier ill health pension provisions

Introduction

8.1 This paper summarises proposals for two-tier ill-health pension provisions for the Local Government Pension Scheme (LGPS) in England and Wales. It takes account of responses received from members of the ill-health working group to the discussion paper *Ill-Health Retirement Review: Two Tier Arrangement,* which was open to comment from the group between 26 May and 8 June 2006. This discussion paper is available in full on the DCLG LGPS website at **www.xoq83.dial.pipex.com**.

8.2 While the proposals will continue to be taken forward by the ill-health working group, comments are invited from all respondees on the proposals, and a list of specific questions follows in the technical response template at Annex 2.

8.3 HM Treasury published a *Review of Ill-Health Retirement in the Public Sector action plan* in October 2000, which included the requirement to introduce a two tier ill-health retirement pension arrangement. The ill-health working group, chaired by the then Office of the Deputy Prime Minister, was established to take forward the original action plan recommendation. The Government's intention is that the provisions which emerge from this process should come into effect on 1 April 2007, one year in advance of the new-look scheme. This would require a statutory consultation in the autumn of 2006.

General Principles

8.4 At present the ill-health retirement pension provisions within the LGPS award, in most cases, enhanced retirement benefits for life, regardless of future health and employment prospects. The underlying rationale of a two tier ill-health retirement pension arrangement is that it is better focussed and targeted compared to the present "one size fits all" arrangement.

8.5 Introducing a two tier arrangement will offer scheme employers a wider range of ill-health benefits that are more in tune with the circumstances that apply at the time employment has been terminated. Introducing a review facility would allow adjustment to the benefits in payment following subsequent changes in medical conditions, medical science and/or employment prospects. However, as we go on to discuss in paragraph 18, there would some substantial restrictions to such an approach.

The top tier

8.6 The *top tier* provision would cover those scheme members who are permanently unfit to perform the duties of their local government employment and whose incapacity is such that they are unlikely to secure gainful or regular employment again.

8.7 Consultees views are invited on what criteria should be used to define "regular employment". These criteria would need to take account of the diverse nature of the LGPS workforce. One example is the Firefighters' schemes, in which "regular employment" is defined as being "not less than 30 hours per week on average over a twelve month period".

8.8 Those ill-health retirees satisfying the top tier criteria would receive benefits based on an enhancement of their existing membership by 50% of their prospective service up to the scheme's normal retirement age of 65. Consideration could be given as to whether local authority employers should have the facility to award more than the 50% enhancement in individual cases where more generous awards can be justified on compassionate grounds.

The second tier

8.9 The *second tier provision* would cover those members who cease employment with a Scheme employer on the grounds of incapacity, but who are judged to be capable of undertaking other regular employment.

8.10 Those ill-health retirees satisfying the second tier criteria would not receive enhancement of their existing membership, but would receive immediate and unreduced payment of their accrued benefits.

Review arrangements

8.11 A key element of the two tier arrangement will be whether ill-health retirement cases are to be kept under review, with the entitlement to benefits being adjusted according to changes in circumstances. Such a review would need to be done by scheme employers in conjunction with their medical advisers and/or independent registered medical practitioners.

8.12 For the top tier it is therefore proposed that LGPS scheme employers should be given the same power to withdraw the enhanced pension if a person with a top tier pension again becomes capable of undertaking regular employment. These powers are available under the ill-health provisions of the Firefighters' Pension Scheme.

8.13 In these circumstances, it is proposed that the enhanced element of the benefit would be cancelled and substituted with one based on accrued service only up to the date of retirement.

8.14 It is recognised that 85-95% of LGPS ill-health retirees would be expected to fall within the second tier. Immediate payment of unreduced accrued benefits makes the exit gateway for these ill-health retirees easy to manage. However, retiring members would have a very wide range of incapacities, and prospective job opportunities.

8.15 One solution would be to break down the second tier into perhaps four or five different categories, each offering a different level of benefit. For example, at the top end of the second tier, immediate payment of the unenhanced benefits would be paid for life at the exit gateway. At the other end of the spectrum, immediate unreduced payment of deferred benefits would be paid for say 2 years. After two years, unreduced payment could be subject to review, and only remain if circumstances warranted the continued payment. The different categories would then allow for different review mechanisms for different sorts of incapacities and prospective opportunities.

8.16 In deciding whether or not to introduce a review mechanism, a balance needs to be struck between simplicity and ease of administration on the one hand, and the cost savings arising from a better targeted and flexible award system on the other.

8.17 A further complication stems from the requirements of the Finance Act 2004 which would need to be managed. Under the Finance Act, an enhanced benefit could be withdrawn in circumstances where an ill-health retiree no longer satisfies the criteria upon which the original ill-health benefit was based. However, it would not be possible to adjust the level of benefit paid where the degree of incapacity or ability to undertake regular employment varies further in the future.

8.18 Views are therefore sought from respondees as to whether the inclusion of a review structure would deliver a more appropriate two-tier ill-health provision for the LGPS.

Cost

8.19 The Government Actuary's Department (GAD) have carried out some analysis of the likely cost impact of the move to two-tier ill-health retirement provisions, based on the levels of retirement assumed by the funds at the 2004 valuations. There is some evidence that actuaries adjusted their assumptions at the 2004 valuations to take account of there being fewer ill-health retirements than previously anticipated.

8.20 As the cost of providing ill-health benefits has an effect on the total scheme cost, this needed to be built into the design of the new-look scheme. However, as past experience of ill-health retirement rates may be less relevant to the costing of the two-tier provision, and as experience varies greatly across different public service schemes, GAD applied a range of assumptions to their costings in order to produce an estimate as to the possible *range* of the cost impact on the new-look scheme. They also considered the effect of varying the number of ill-health retirements overall. This analysis has been carried out for each of the Options outlined in this paper. This is not included here for conciseness, but is available on request from DCLG via the contact information at Chapter 17.

8.21 However, in order to arrive at headline benchmark costings for the new-look scheme, some decision had to be taken as to which set of assumptions should be used for this purpose. We isolated the following:

a. 85% of ill-health retirements to fall under the second tier and 15% of ill-health retirements to fall under the top tier;

b. 10% uplift from second tier to top tier before NRA65 (assuming that such movement is to be permitted); and

c. 50% enhancement of prospective service for the top tier and immediate payment of unreduced benefits for the second tier.

8.22 The policy objective for introducing a two-tier structure is not to reduce the cost of the scheme. However, through the provision of better targeted benefits to those who need it most, it is clear that a significant saving is generated in comparison to the ill-health provisions currently available. Any saving provides more scope for benefit improvements within the target cost for the scheme.

8.23 This of course, is on the basis of the levels of take-up assumed at the 2004 valuations, from which experience may also differ. Additionally, in the case that the assumed behaviour is not experienced, or that the design of the two-tier provisions is altered, there will be an impact on the benchmark costings for the options, as would be the case with any assumption. Any request to extend ill-health provision should therefore take account of the impact on the rest of the benefit package post 2008.

Developing the proposals

8.24 This paper favours certain options that the Department has developed via the ill-health working group and that it is believed are appropriate to the circumstances of the LGPS. Consultees are, however, encouraged to suggest alternative proposals within the general two-tier framework outlined in this paper. In order to develop the particular proposals outlines here, consultees are also asked to consider and comment on a number of specific issues, which are detailed in Annex 3.

Chapter 9

The costing process

9.1 Neither the Department for Communities and Local Government (DCLG), nor the Government Actuary's Department (GAD), is in a position to produce average or representative costings centrally. But, in order to assess options for a new-look scheme, it is important for LGPS interests to be able to compare the costs of different options.

9.2 The Department's approach has therefore been to produce a benchmark set of costings, which enable comparisons to be drawn between the *difference in cost* of the various options for the new scheme and the current scheme, rather than the *absolute cost*. These differences can be used by individual funds, and their relevant employers, to assess the likely impact on their costs of changing to each of the different options in 2008. These outputs can help to add depth and data to individual responses to the consultation.

9.3 The individual funds, with their actuaries, are able to take an approach to valuation and administration which is appropriate to the local conditions, taking into account workforce age and pay profiles, investment and funding strategies and assumptions on (for example) life expectancy.

9.4 The Department developed an approach for costing options for a new-look scheme, in discussion with the Government Actuary's Department (GAD), LGPS fund actuaries and members of LGPS working groups, including the trades unions and the local government employers and their actuarial advisors. The basic principles of this actuarial approach are as follows:

a. The benchmark costings deal solely with future accrual. They do not take into account any past service deficits funds might have.

b. The new-look Scheme will apply to both existing members and new entrants groups. Appropriate valuation methodologies have therefore been used for each group, to provide costs both on an existing and new entrant basis.

c. The benchmark cost of the Scheme could be reasonably expected to tend from the existing member benchmark cost to the new member benchmark over time, as existing members move into retirement or leave local government employment with a deferred pension.

d. The benchmark costings are based on anonymised membership data from six un-named funds, as at 31 March 2004. Whilst they may not be entirely representative of the Scheme as a whole, they still provide a valid sample of possible typical average Scheme demographics.

e. The actuarial assumptions adopted are consistent with the approaches taken by the fund actuaries at the 2004 fund valuations, but make extra allowance for anticipated further improvements in pensioner longevity and assumes that 50% of scheme members (by value) will elect to commute pension at a commutation rate of 12:1 to obtain the maximum tax-free lump sum on retirement allowed by the Local Government Pension Scheme (Amendment) 2006 Regulations. The other 50% are assumed to take a lump-sum equal to the current automatic lump sum of 3/80ths pension.

f. A *Sensitivity analysis* has been carried out to assess the sensitivity of the benchmark costings to the demographic and actuarial assumptions adopted. This will enable funds and employers to assess the likely costs of the options, in the case of their own characteristics and approach.

9.5 Further details of the Department's approach, GAD's methodology, membership distributions and actuarial assumptions, and the resulting costings and sensitivity analysis, are available on request from DCLG, or from the DCLG LGPS website at **www.xoq83.dial.pipex.com**. These have been provided already to LGPS interests involved in developmental working groups.

Chapter 10

Summary tables of benchmark costs[3]

Table One: Calculating the target benchmark cost for the new-look scheme options

Benchmark costs	**Existing[4]**	**New[5]**
w. The scheme as at 1 October 2006	20.0%	17.6%
x. The scheme as at 30 September 2006	21.7%	19.0%
y. The scheme as at 30 March 2006	22.2%	19.4%
z. The scheme as assumed by many funds at the 2004 valuation	20.3%	17.9%
A target benchmark cost for the new-look scheme		
50% of the savings from the removal of the 85 year rule and commutation (y – w)	1.1%	0.9%
Target benchmark cost (w + 0.5 (y – w))	21.1%	18.5%
Adjusted benchmark cost (subtracting 0.2% for additional protections)	**20.9%**	**18.3%**

Table Two: Benchmark costings for the four options

Benchmark costs	**Core cost**		**Total cost[6]**	
	Existing	**New**	**Existing**	**New**
A. An updated current scheme	20.0%	17.6%	19.4%	17.3%
B. A new, final salary scheme with an improved accrual rate	21.5%	18.9%	20.9%	18.6%
C1. A new, career-average scheme (1.85% accrual rate and RPI revaluation)	21.2%	18.3%	20.6%	17.7%
C2. A new, career-average scheme (1.65% accrual and RPI + 1.5% revaluation)	21.1%	18.7%	20.5%	18.1%
D. A new, hybrid arrangement	As c, plus around an additional 3% for those who join the final salary arrangement			

3 These benchmark costs have been produced according to the approach outlined in Chapter 9.

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

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

6 "Total cost" refers to the total cost of the core structure and the additional benefit improvements, as outlined in Chapter 6.

Note: The two-tier ill health pension provisions that are included in the benchmark costings for the Options A-D with additional secondary benefit improvements have, for the purposes of these costings, been based on the following particular set of assumptions:

- 50% enhancement of prospective service for the upper tier
- 85% of ill-health retirees retire under second tier;15% under top tier
- 10% uplift from lower tier to upper tier whilst benefits are in payment, and before NRA65

If a different set of assumptions are used, a different set of total scheme costs will be produced. This may affect whether or not the Options meet the target benchmark cost. In basing the costings on one particular set of assumptions, there can be no interference that this is the most appropriate set of assumptions to use. Further analysis will need to be done to evaluate the likely impact of the ill-health provisions on the new-look scheme costings. See Chapter 8 for more details.

Chapter 11

Employee and employer contribution rates

11.1 There is an initial difficulty in assessing employee and employer costs for each Option. The benchmark costings are neither funding recommendations, nor average or representative costings. They do not deal with any past service deficits funds might have. The actual cost will clearly depend on the fund and membership characteristics and the actuarial approach taken. It is also relevant to remember that the actual cost will also depend on how quickly existing members leave the scheme and new entrants join, as this will determine how the new entrant costs and existing scheme members costs are "blended" together.

11.2 The new-look scheme cannot and should not resolve differences between funds and scheme employers – the LGPS is independently managed and administered in 89 different funds in England and Wales, which each have their own funding approach, membership characteristics and many other distinctions.

11.3 A detailed discussion of employee and employer contribution rates is at Annex 1. This draws on the benchmark scheme costings and develops an analysis which will better enable the evaluation of each Option with respect to costs to employees and employers, until further assessment is available from funds and employers as to the likely impact on their costs, should any of the options detailed here apply from 2008.

Tiered contribution rates

11.4 Chapter 4 and Chapter 6 also raise the proposal of a tiered contribution rate for Options A and B, in order to equality-proof a final salary scheme for the modern workforce in and around local government. This could also be considered for Options C and D, especially if the employee contribution rate was to increase, as a way of ensuring the scheme remains affordable for the low-paid.

11.5 We can therefore start to consider possible tiered structures that would be likely to yield appropriate average employee contributions. Under a two-tier structure, employees would pay a reduced rate of contributions on pensionable pay **below** a certain cut-off point, and then an increased rate of contributions on pensionable pay **above** the same cut-off point. This cut-off point could be fixed to the point at which earnings are taxed at the basic rate of 22% rather than the starting rate of 10%. In 2006-07 this was set at £7,185 (the sum of the personal allowance of £5,035 and the starting rate income tax band of £1 – £2,150).

11.6 An alternative two-tier structure might not be linked to tax bands – it could be based on any cut-off point which would then rise with, for example, inflation or wage inflation. As the reason for introducing a tiered structure would be to make the scheme more affordable and attractive to the low-paid, the cut-off point would need to focus on this group. Therefore, a possible cut-off point in this scenario could be, for example, £12,000.

11.7 Annex 1 details a number of possible combinations of contribution rate for each two-tier structure. In the case that a tiered structure was to be implemented, it would need to be designed in order to generate the required average employee contribution rate for the new-look scheme. Consideration would also need to be given to how this average might change due to changes in workforce demographics and the yearly revaluation of the cut-off point.

Chapter 12

Future cost sharing between employers and employees

12.1 Both the LGPS trades unions and the local government employers have considered the principle of introducing some mechanism to ensure that variations in the ratio of employer to employee contributions are limited. The LGPS is a funded scheme, with the risk of providing benefits to scheme members falling to the employers. Equally, the employer may receive the benefit of any experience gain through, for example, reduced future contribution rates.

12.2 It is realistic to consider increases in average employee contribution rates. However in recognition of rising liabilities and recycling of savings, it is not proposed to move away from a fixed contribution rate for employees. This approach is considered appropriate for a defined-benefit Government-sponsored scheme such as the LGPS, and is consistent with the approaches being taken by the other public service pension schemes.

12.3 A number of potential ways to introduce some future cost sharing arrangement have been considered, with one specific mechanism emerging. For example, there could be a requirement for a review of demographic assumptions at every second/third tri-ennial valuation post 2007. If the assumptions had increased or decreased by some substantial amount since the last review, this could trigger a review of the fixed employee contribution rate to the prevalent employer contribution rate. Were this to be found to have increased or decreased by some substantial amount since the last review, an adjustment would be made to the employee contribution rate in order to re-establish the defined ratio, OR an adjustment would be made to the Scheme's benefit package to re-establish the ratio.

12.4 At the 2004 valuations the average funding level was 74%. Employers were increasing their contribution rates, predominantly on a stepped and phased basis, in order to recover any past service deficit over the period set out in their statutory Funding Strategy Statement. The average LGPS deficit recovery period is 21 years.

12.5 It will be necessary to bear this in mind when designing the new-look scheme. However, the reforms are not intended to address the cost pressures facing employers in relation to past service. What is important is that the new-look scheme has a future service cost that is affordable for employees and employers, as well as taxpayers. A future cost sharing mechanism will be one way of securing this affordability and thereby mitigating the likelihood of past service pressures building up in the future.

Discussion of the conflicts between the nature of the LGPS and a future cost sharing mechanism

12.6 Any future cost sharing mechanism would need to be conducted nationally, as the LGPS is a national scheme. This would lead to adjustments being made to employee contributions or to Scheme design on a national level, as is appropriate to a national scheme.

12.7 However, as the funded LGPS is regulated nationally but managed and administered locally by 89 separate funds in England and Wales, the employer rate will vary locally, due to different approaches to valuation and funding, and differing local membership. This will mean that any adjustment following review would have a different effect on separate funds and employers.

12.8 These substantial issues would therefore need to be satisfactorily addressed before the Department could even consider the implementation of such a future cost sharing mechanism. Were this to be considered, a number of questions might arise. These are detailed in Annex 3.

Reviewing the take-up of additional commutation in the context of a future cost sharing mechanism

12.9 The trades unions and local government employers have raised with the Department the merits of keeping the assumptions about commutation savings under review. This would mean that discussions could be held to consider the recycling of any extra savings resulting from more members than expected commuting more of their pension for tax-free cash at retirement. Conversely, were fewer scheme members to commute, discussions would proceed to consider what adjustments might be made to the scheme's benefit package and/or the employee contribution rate, to assure the scheme's affordability in this specific regard. The Department is not proposing that such a review be implemented at this stage. However, in light of the views of the local government employers and the trades unions we are inviting comments from respondees on this specific matter.

Chapter 13

Existing scheme members in the new-look Scheme

13.1 Subject to the outcome of this consultation exercise, it is intended that the new-look scheme be available to all new entrants and existing scheme members from 1 April 2008. It is not proposed to run two different schemes (i.e. one for existing members and one for new entrants) nor that existing scheme members have different contribution rates from new entrants.

13.2 All scheme members would accrue membership from 1 April 2008 under the new-look scheme, and they would therefore receive benefits under the terms of the new-look scheme at retirement. However, the practical way in which the *accrued* benefits of existing scheme members at 1 April 2008 are to be calculated at their retirement date some time afterwards, has not yet been decided. Possible transfer methods are:

A. Give all existing scheme members at 31 March 2008 an actuarially equivalent period of service in the new-look scheme, according to a formula to be provided by GAD.

B. Give existing scheme members at 31 March 2008 more credit in the new-look scheme than they would receive under method A.

C. Treat all accrued service of existing scheme members as 31 March 2008 as a benefit to be payable on retirement, under the terms of the current scheme, based on the final salary at retirement.

13.3 Each method has advantages and disadvantages. In assessing which option is the most suitable for the LGPS, the following criteria may be useful:

a. Cost, and impact on the new-look scheme;

b. Impact on existing scheme members;

c. Implementation of transitional protections from the current scheme in the new-look scheme; and

d. Ease of administration.

13.4 Under **method A**, because the future career progression and date of retirement of the individuals would not be known, some scheme members might benefit more from this transfer than others, as even though it would be on a cost-neutral basis this could not allow for all variations on personal circumstances. Ensuring no scheme member “lost out” in the transfer would not be cost-neutral, as an *underpin* would need to be provided and this would reduce the funds available for the new-look scheme. This would mean that, other things being equal, the new-look scheme would need to be less attractive in order to implement this transfer.

13.5 **Method B** would suffer similar complications, but would additionally provide extra benefits to existing scheme members, which would go some way to smoothing transition to the new-look scheme. However, this would further reduce the available funds in the new-look scheme. Therefore, although at first glance **methods A and B** might lead to simpler administration, ensuring that no scheme member "lost out" in this method would lead to extra costs being incurred. Infact, implementation would also be complicated by the protections for existing scheme members at 30 September 2006 from the removal of the 85 year rule, as these extend beyond 1 April 2008, when the new-look scheme is to come into effect.

13.6 **Method C** might, therefore, be considered to be the more attractive option, as it would not change the expectations of existing scheme members in respect of their accrued service at 1 April 2008. As these benefits will have already been funded by employers under the terms of the current LGPS. There should therefore be no impact on the funds available for the new-look scheme. However, although this might simplify short term administration but would perhaps involve long term administration issues rather than methods A or B, as a record would need to be kept for each scheme member to detail their pre-1April 2008 service. Neither would it provide the opportunity to simplify the complicated protections of various groups of scheme members in the current scheme, which are difficult to administer. If changes are made to the ill-health, death in service and partners' pension provision, there will be an added complication in assessing benefits for existing scheme members post 1 April 2008, as they will effectively have two sets of entitlements.

13.7 This method might also provide an alternative way to implement the transitional protections. As pre-1 April 2008 service is to provide benefits at retirement based on the current scheme, direct account can be taken of accrued 85 year rule rights at 1 April 2008. However, it is not as straightforward to account for post 1 April 85 year rule rights for a scheme member who is eligible for transitional protections between 1 April 2008 and 1 April 2020, as these rights will have been accrued in the new-look scheme. The following possibilities could be considered:

i. A member who is eligible for protections between 1 April 2008 and 31 March 2013 could receive unreduced pre-1 April 2008 benefits under the terms of the current scheme, and unreduced post-1 April benefits under the terms of the new-look scheme; or

ii. A member who is eligible for protections between 1 April 2008 and 31 March 2013 could receive unreduced benefits under the terms of the current scheme for all his pre 1 April 2020 service; or

iii. A member who is eligible for protections between 1 April 2008 and 31 March 2013 could receive unreduced pre-1 April 2008 benefits under the terms of the current scheme, and unreduced post-1 April benefits under the terms of the new-look scheme, but on an *actuarially equivalent basis* to the benefits he *would have* received in post-1 April 2008 service, had the current scheme been in place.

13.8 However, all of these ways except ii would have a cost impact on the new-look scheme because, as with methods A and B, ensuring no scheme members "looses out" would lead to extra costs being incurred, and therefore would require a reduction in the cost of the new-look scheme, other things being equal.

13.9 A number of questions associated with these issues are detailed at Annex 3.

Chapter 14

Scope of scheme employers' discretions

14.1 Several LGPS administering authorities, in the light of their relatively more beneficial funding position, have suggested that specific optional scope could be provided in the new-look Scheme for LGPS employers. This would allow employers to opt to provide specific, additional benefits over and above the national benefit package for the Scheme.

14.2 Such benefits could be provided, on an individual employer basis, where the employer has satisfied itself of its ability to manage any extra liability accruing as a result, on a defined-benefit basis, over the period of appointment. The employer would also have to satisfy themselves that their policy would meet any discrimination and equality requirements arising in employment law.

14.3 Consultees views are invited on whether such a discretionary approach could or should be available to LGPS employers in any new-look scheme.

Chapter 15

Recap of recent changes to the LGPS

Background

15.1 The Secretary of State for Communities and Local Government is responsible for policy development and overall regulatory stewardship of the Scheme in England and Wales and, using the powers under the Superannuation Act 1972, sets the statutory framework within secondary legislation for the management, investment and administration of the Scheme.

15.2 The Scheme is run locally, and administered by 89 separate (predominantly) local authorities, each with the own pension fund. Within each pension fund there will be a number of separate employers, possibly including other local authorities, schools, further and higher education colleges and contractors.

15.3 The LGPS is available to all employees in Local Government, or in other organizations that have chosen to participate in it. Teachers, police officers, firefighters and employees eligible to join another statutory pension scheme are not allowed to join the LGPS. Employees of Local Government (other than Town and Parish Councils, to which special arrangements apply), automatically become members of the LGPS unless they opt not to join or have previously opted out, or are a casual employee.

The removal of the 85 year rule

15.4 The *Local Government Pension Scheme (Amendment) Regulations 2006* removed the 85 year rule from the LGPS with effect from 1 October 2006, and introduced transitional protections for those existing active scheme members at 30 September 2006 who will be 60 and would otherwise have satisfied the 85 year rule by 31 March 2013.

15.5 The 85 year rule previously allowed scheme members to retire before the Scheme's normal retirement age of 65 (from 60 or from 50 with employer consent) on an unreduced pension if their age plus service equalled 85.

15.6 As a reference point, at 30 September 2006, the 85 year rule was effectively still part of the Scheme's benefit package.

The introduction of the facility to commute pension for tax-free lump sum on retirement

15.7 Provisions contained in the *Local Government Pension Scheme (Amendment) Regulations 2006,* allow Scheme members, in accordance with the new simplified HM Revenue and Customs (HMRC) tax regime, to take *larger* lump sums on retirement – up to 25% of the capital value of the pension.

15.8 Before these amendments came into effect, LGPS scheme members could only take the automatic 3/80ths tax-free lump sum on retirement that was stipulated by the scheme's regulations.

15.9 As a reference point, at 30 March 2006, the commutation arrangements were effectively confined to the automatic tax-free lump.

The current scheme

15.10 As a reference point, the current scheme can be considered that as of 1 October 2006.

15.11 Employees pay 6%, but some existing scheme members have a protected right to pay 5%. Across the LGPS as a whole, employee contributions average 5.8% of pensionable pay.

15.12 Normal retirement age of 65[7].

15.13 Accrual rate of $1/80^{th}$ of final pay.

15.14 Index-linked benefits.

15.15 An automatic tax-free lump sum of three times pension.

15.16 Option to elect to commute part of annual pension for additional tax-free lump sum, at a commutation rate of 12:1 in accordance with the Finance Act 2004.

15.17 ill health pension from any age.

15.18 a death in service lump sum of two times final pay.

15.19 a widow's, widower's or civil partner's pension.

15.20 children's pensions.

15.21 immediate payment of unreduced pension in the case of redundancy from 50 onward.

15.22 DCLG launched a consultation on 8 May to amend the provisions to comply with age discrimination. The proposals replace the current provisions with discretion for employers to award up to 2 years pay on early termination of employment.

7 Protections for existing scheme members at 30 September 2006 will allow them to continue to retire from 60 on an unreduced pension if they would otherwise have satisfied the 85 year rule by 31 March 2013. Additionally, all existing scheme members' accrued rights at 30 September 2006 are protected.

The current consultation (from 26 May to 3 July 2006) on the draft Local Government Pension Scheme (Amendment) (No.2) Regulations 2006

15.23 The proposals under consultation between 26 May and 3 July 2006 in the draft *Local Government Pension Scheme (Amendment) (No.2) Regulations 2006* would have the following effects:

a. existing active scheme members at 30 September 2006 would continue to accrue service under the 85 year rule until 31 March 2008, in order to provide continuity with the start of the new-look scheme;

b. protection for existing members who will be 60 and satisfy the 85 year rule would be extended from 31 March 2013 to 31 March 2016; and

c. the "cliff-edge" that would then exist between 31 March 2016 (at which eligible members would suffer no reduction to their pension) and 1 April 2016 (at which members would suffer full reduction on service accrued after 1 April 2008) would then be smoothed, by applying *tapering reductions* on a linear basis from 0% reduction at 31 March 2016 to 100% reduction at 1 April 2020.

15.24 GAD have estimated that these additional protections will each cost:

a. £0.5 billion;

b. £0.5 billion; and

c. £0.35 – 0.4 billion.

15.25 The cost of the protections until 31 March 2013 was, in most cases, taken into account in the 2004 valuations, and therefore does not need to be taken into account in this context.

15.26 In calculating the cost pressures in the new-look scheme of these proposals, we need to compare the cost of these extensions with the *accrued savings* already available in the current LGPS. These accrued savings have been generated by the introduction from 1 April 2006 of a provision which would allow scheme members to *commute* some of their pension per annum (which accrues at a rate of 1/80th per year of service) for additional tax-free lump sum on retirement.

15.27 Before 1 April 2006, LGPS scheme members could only take the automatic 3/80ths tax-free lump sum on retirement that was stipulated by the scheme's regulations. The 1 April changes, contained in the *Local Government Pension Scheme (Amendment) Regulations 2006,* allow, in accordance with the new simplified HM Revenue and Customs (HMRC) tax regime, Scheme members to take *larger* lump sums on retirement – up to 25% of the capital value of the pension.

15.28 Where Scheme members chose to increase their tax-free lump sum above the automatic 3/80th provision which still remains post 1 April 2006, this increase would be paid for by the Scheme member swapping pension for tax-free cash at a certain *commutation factor*. The commutation factor is 12:1, which means for every £1 of pension foregone, the Scheme member would receive an additional £12 tax-free as a lump sum payment on retirement.

15.29 The Government Actuary's Department (GAD) have calculated that this provision could result in an overall saving to the LGPS. This is because, very broadly, a typical scheme member who has commuted some of their pension to lump sum on retirement might, on average, expect to live to receive more than 12 years worth of pension instalments.

15.30 The calculation is necessarily based on a number of assumptions, most importantly that 50% of Scheme members would continue to only take the 3/80th lump sum and that 50% would take the new maximum permissible under the new tax regime. The Final Regulatory Impact Assessment (RIA) which accompanied the Local Government Pension Scheme (Amendment) Regulations 2006 details that the capital value of savings relating to the accrued service of existing scheme is estimated to be £1¼ billion[8]. The Final RIA also explains that some of these savings were to be used to pay for the extra 18 months of service for all scheme members under the 85 year rule, as a result of the revocation of the *Local Government Pension Scheme (Amendment) (No.2) Regulations 2004*. The cost of revocation was calculated to be some £520 – 590 million.

15.31 As explained in Chapter 5, the new-look scheme options have been designed with reference to a target scheme cost which recycles 50% of the savings from the removal of the 85 year rule and commutation in respect of future service costs for existing members and new entrants. However, it will also be possible to use some or all of the accrued savings for existing scheme members from commutation to pay for either benefit improvements in the new-look scheme, or protections for existing scheme members from the removal of the 85 year rule from the current scheme.

15.32 The total cost of the additional protections and the cost of revocation is £1.9 – 2.0 billion, i.e. some £0.65 – £0.75 billion in excess of the £ 1¼ billion accrued commutation savings. Therefore, should these additional protections be implemented, it will be necessary to "eat into" the future savings by this amount. Over a period of 20 years, based on a pensionable payroll of £25bn, this is equivalent to around 0.16% – 0.18% a year of pensionable payroll.

15.33 As the new-look scheme costings are provided to one decimal place, it will therefore be reasonable to reduce the target new-look benchmark cost by 0.2%, should these additional protections be implemented. The new-look scheme options have therefore been designed to have a benchmark cost equal to this adjusted target cost, as can be seen in Chapter 10.

8 Further details can be found in the Final RIA, which is available on the DCLG LGPS website.

Chapter 16

Timetable for reform

16.1 **The new-look scheme:** It is intended that the new-look scheme comes into effect on 1 April 2008 with regards to both new entrants and future accruals for existing scheme members. In order to meet this demanding timetable, the following programmed steps will be necessary:

29 September 2006	Deadline for responses to this consultation paper
Late Autumn 2006	Consultation on draft regulations for the new-look scheme begins and extends into early 2007
1 April 2007	Regulations for the new-look scheme to come into force
1 April 2008	Regulations governing the new-look scheme take full effect

16.2 **Two-tier ill health pension provision:** Proposals are being developed for the new-look scheme and these are included at Chapter 8 for information. Comments are invited by 29 September, alongside comments on the options for the new-look scheme and the technical response template contains a series of questions on the ill-health proposals for this purpose. The ill health pension provision reforms will be subject to a separate statutory consultation in the autumn of 2006, before coming into effect in April 2007 in advance of the new-look scheme.

16.3 In parallel to this work, a number of other workstreams are proceeding. Separate working groups have been underway in recent months to develop proposals for reform, subject to the outcome of these discussions and any consultation, of the administration, access by means of admission agreements and governance arrangements of the Scheme. These developments are proceeding according to separate but parallel timetables.

16.4 **Admission:** A policy discussion document was circulated for comment to the working group on admission agreements in March, following initial discussions with key stakeholders in the contracting-out process. Comments are being considered. A more detailed consultation paper, setting out principles for possible regulatory development of the Admitted Body Status provisions, is expected to be produced and circulated shortly.

16.5 **Administration:** The working group on scheme administration has developed a set of proposals that are currently being used as a basis for preparing a draft, free-standing statutory instrument for consultation later in 2006. A key feature of this workstream will be the preparation and publication of Statutory Codes of Practice to underpin the policy objectives set out in the statutory instrument.

16.6 **Governance:** Plans are well advanced to issue a detailed discussion paper outlining the findings of the Trusteeship working group. The paper will be issued to the working group and other interested parties for comment with the view of firming up on proposals in the autumn. The paper will include the results of a survey undertaken by DCLG into the Governance Policy Statements that LGPS administering authorities were required to publish by 1st April 2006.

16.7 Further information on the ill-health, administration, admission and governance and representation arrangements are available from DCLG on request via the contact information in Chapter 17.

Chapter 17

Consultation responses

17.1 Responses are requested by 29 September 2006, in writing or electronically. We request that, where possible and appropriate, you follow the core and/or technical response templates at Annexes 2 and 3 when you respond. Responses should be sent to Nicola Rochester in the first instance at:

DCLG, Zone 2/E8, Ashdown House
123 Victoria Street, London, SW1E 6DE

lgpensions@communities.gsi.gov.uk

17.2 Requests for further clarification or information in respect of this document should be directed to Myfanwy Taylor at the address above, or at myfanwy.taylor@communities.gsi.gov.uk

17.3 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

17.4 In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department. The Department will process your personal data in accordance with the DPA and in the majority of circumstances; this will mean that your personal data will not be disclosed to third parties.

17.5 A summary of responses to this consultation will be published within three months of the close of consultation at the DCLG LGPS website, **www.xoq83.dial.pipex.com**.

17.6 The Government has adopted a code of practice on consultations. The criteria below apply to all UK national public consultations on the basis of a document in electronic or printed form. They will often be relevant to other sorts of consultation. Though they have no legal force, and cannot prevail over statutory or other mandatory external requirements (e.g. under European Community Law), they should otherwise generally be regarded as binding on UK departments and their agencies, unless Ministers conclude that exceptional circumstances require a departure.

1. **Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.**

2. **Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.**

3. **Ensure that your consultation is clear, concise and widely accessible.**

4. **Give feedback regarding the responses received and how the consultation process influenced the policy.**

5. **Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.**

6. **Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.**

The full consultation code may be viewed at
www.cabinetoffice.gov.uk/regulation/Consultation/Introduction.htm

17.6 Are you satisfied that this consultation has followed these criteria? If not, or you have any other observations about ways of improving the consultation process please contact:

Adam Bond, Department for Communities and Local Government Consultation Coordinator, Room 2.19, 26 Whitehall, London, SW1A 2WH;

or by e-mail to:
adam.bond@communities.gsi.gov.uk

Annex 1

Further analysis of employee and employer contribution rates[9]

1. In this section, we initially consider employee and employer contribution rates on the basis of the target scheme cost for simplicity. We then consider how the conclusions would vary with the benchmark costs of Options A-D, in order that each Option can be evaluated on the basis of costs to employees and employers.

2. There is an initial difficulty in assessing employee and employer costs for each Option. Although the benchmark costs of the options (including the cost of the additional transitional protections currently being consulted on) are around 21.1% (18.5%), this does not necessarily mean that they will cost 21.1% (18.5%) to all funds or all employers. The benchmark costings are neither funding recommendations nor average or representative costings. They do not deal with any past service deficits funds might have. The actual cost will clearly depend on the fund and membership characteristics and the actuarial approach taken. It is also relevant to remember that the actual cost will also depend on how quickly existing members leave the scheme and new entrants join, as this will determine how the new entrant costs and existing scheme members costs are "blended" together.

3. The new-look scheme cannot and should not resolve differences between funds and scheme employers – the LGPS is independently managed and administered in 89 different funds in England and Wales, which each have their own funding approach, membership characteristics and many other distinctions.

4. It is therefore relevant to compare the benchmark scheme cost at the last valuation in 2004 (which set employer contributions for 2005-06, 2006-07 and 2007-08) with the target benchmark cost. At the time of the 2004 valuations, the then Office of the Deputy Prime Minister (ODPM) was consulting on proposals to remove the 85 year rule from the Scheme from 1 April 2005. Many actuaries therefore assumed that this removal would take place and set employers contribution rates on this basis. The relevant baseline costing for comparative purposes can therefore be taken to be that for the scheme without the 85 year rule and without commutation. This is some 20.3% (17.9%).

5. The target benchmark cost (including the cost of the additional transitional protections currently being consulted) is therefore some 0.8% (0.6%) more than the benchmark cost for the scheme at the 2004 valuations. We can consider that, as a starting point and all other things being equal, employer contributions might need to go up by an average of some 0.8% (0.6%), in relation to those set at the 2004 valuations.

6. Of course, the actual outcome for each fund will vary according to the profile of the fund and the assumptions adopted by each fund's actuary. It is therefore essential for funds and employers, drawing on the benchmark costings in this paper, to assess the likely impact on the scheme cost, and therefore on employer contributions, in the case that each of the options be implemented. With this information, the Department will be best able to set an appropriate

9 All costs are presented here as a percentage of pensionable payroll.

employee contribution rate so as to ensure affordability for scheme employers and employees.

7. However, it has been demonstrated that we can assume, as a starting point, and all other things being equal, that the sum total of employee and employer contributions might need to go up by an average of some 0.8% (0.6%), in order to pay for a new-look scheme with a cost equal to the target benchmark cost. The starting point for employers' contributions are those set at the 2004 valuations, when total employer contributions (as a percentage of total pensionable pay[10]) were, on average, 12.5% – 13.5% in 2005-06, 14% – 15% in 2006-07 and 16% – 17% in 2007-08. These relate to both future service costs and extra payments in respect of past service deficits. The starting point for employees' contributions is 5.8%. Scheme members currently pay contributions of 6% of their pensionable pay, but some existing scheme members have a protected right to pay 5% contributions, which leads to an effective average employee contribution rate of some 5.8% for existing scheme members. New entrants currently pay 6%.

8. We can proceed to consider the following possible employee contribution rates for existing members (new entrant contribution rates will need to equal existing member contribution rates):

a. Around 6.6%, in order to maintain the employer contribution rates set in 2004 (all other things being equal);

b. Around 7.1%, in order to achieve a reduction of 0.5% in the employers' contributions in relation to those set in 2004 (all other things being equal);

c. Around 7.6%, in order to achieve a reduction of 1% in the employers' contributions in relation to those set in 2004 (all other things being equal); or

d. Around 8.1%, in order to achieve a reduction of 1.5% in the employers' contributions in relation to those set in 2004 (all other things being equal).

9. These costings explore employee rates that would, other things being equal, maintain or reduce employer rates. We have proceeded on this basis because it is crucial that contribution rates must remain affordable to employers in order to ensure the scheme's long-term sustainability as a defined benefit, government sponsored scheme. A rise in employee contributions might be considered reasonable, given that the target benchmark cost recycles 50% of the savings from the removal of the 85 year rule and commutation, and is therefore more expensive than the scheme with no 85 year rule and no commutation.

10. **Option A** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 19.4% for existing members. This is some 1.5% less than the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates could be reduced by 1.5% in order to achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8, all other things being equal.

10 Pensionable pay is as defined in Regulation 13 of the Local Government Pension Scheme Regulations 1997.

11. **Option B** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 20.9% for existing members. This is equal to the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates set out in paragraph 8 would achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8, all other things being equal.

12. **Option C1** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 20.6% for existing members. This is some 0.3% less than the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates could be reduced by 0.3% in order to achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8 all other things being equal.

13. **Option C2** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 20.5% for existing members. This is some 0.4% less than the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates could be reduced by 0.4% in order to achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8, all other things being equal.

14. Costings for **Option D** are as for Options C1 or C2, depending on which career-average core is chosen. Those employees who choose to receive final salary linked benefits would pay an additional fixed contribution rate of approximately 3%. There would be no extra contribution from the employer.

15. We intend to have one contribution rate for existing scheme members and new entrants in the new-look scheme from 1 April 2008. Consideration will need to be given to the treatment of those existing scheme members with protected rights to pay 5% contributions. Additionally, an assessment will be needed of the actual employee rate which will be required to achieve affordability overall, particularly as some of these illustrative arguments produce different employee contributions for new entrants and existing scheme members on the basis of these benchmark costings.

Possible average employee and employer contribution rates

16. The above analysis has shown that there is some flexibility surrounding the cost sharing of each of the new-look scheme options between employees and employers, drawn up from comparisons between benchmark costings. We summarise the possible employee and employer rates for each Option in the table below, based on a scheme cost equal to the benchmark costings for each option.

Table 1: Existing members (current average contribution rate 5.8%)

Option	Benchmark Cost	Employee Contributions	Benchmark Employer Contributions	% change with respect to the 2004 valuations
A	19.4% + 0.2%	5.1% 5.6% 6.1% 6.6%	14.5% 14% 13.5% 13%	0% –0.5% –1% –1.5%
B	20.9% + 0.2%	6.6% 7.1% 7.6% 8.1%	14.5% 14% 13.5% 13%	0% –0.5% –1% –1.5%
C1	20.6% + 0.2%	6.3% 6.8% 7.3% 7.8%	14.5% 14% 13.5% 13%	0% –0.5% –1% –1.5%
C2	20.5% + 0.2%	6.2% 6.7% 7.2% 7.7%	14.5% 14% 13.5% 13%	0% –0.5% –1% –1.5%
D	Employees who elect for final salary linked benefits pay an additional approximately 3%. Otherwise, costings are as for Option C1 or C2.			

17. We must continue to ensure that the scheme remains affordable for employees, especially for those part-time and lower-paid workers who tend to have less disposable income. The scheme must be attractive and encourage saving. Due consideration should therefore be given to what the average employee contribution rate should be, bearing in mind the implications this will have for the employer contribution rate, as set out above.

Tiered contribution rates

18. Chapters 4, 10 and 11 explain the context for considering a tiered contribution rate for Options A and B, in order to equality-proof a final salary scheme for the modern workforce in and around local government; and for Options C and D, if, for instance, the employee contribution rate was to increase, as a way of ensuring the scheme remains affordable for the low-paid. Based on the figures set out in Table 1, we can therefore start to consider possible tiered structures that would be likely to yield appropriate average employee contributions for the new-look scheme. Consideration would also need to be given to how this average might change due to changes in workforce demographics and the yearly revaluation of the cut-off point.

19. Under a two-tier structure, employees would pay a reduced rate of contributions on pensionable pay **below** a certain cut-off point, and then an increased rate of contributions on pensionable pay **above** the same cut-off point. This cut-off point could be fixed to the point at which earnings are taxed at the basic rate of 22% rather than the starting rate of 10%. In 2006/07 this was set at £7,185 (the sum of the personal allowance of £5,035 and the starting rate income tax band of £1 – £2,150).

20. An alternative two-tier structure might not be linked to tax bands – it could be based on any cut-off point which would then rise with, for example, inflation or wage inflation. As the reason for introducing a tiered structure would be to make the scheme more affordable and attractive to the low-paid, the cut-off point would need to focus on this group. Therefore, a possible cut-off point in this scenario could be, for example, £12,000.

21. Tables 2 and 3 detail a number of possible combinations of contribution rate for each two-tier structure. These have been chosen to generate a range of average employee contribution rates from 5% to 8%, in order to cover all scenarios explored in Table 1. These figures are illustrative only and are based on full-time equivalent (FTE) data from a sample of funds, for employees who currently pay 6% contributions.

Table 2: Possible two-tier structures with a cut-off point of £7,185

Lower band	Upper band	Weighted rate (1 decimal place)
4.0%	5.5%	4.9%
3.5%	6.0%	5.1%
4.5%	6.0%	5.4%
3.0%	7.0%	5.5%
5.0%	6.5%	5.9%
3.5%	7.5%	6.0%
4.0%	8.0%	6.5%
5.0%	7.5%	6.6%
6.0%	7.5%	6.9%
5.5%	8.0%	7.1%
6.5%	8.0%	7.4%
6.0%	8.5%	7.6%
7.0%	8.5%	7.9%
6.5%	9.0%	8.1%

Table 3: Possible two-tier structures with a cut-off point of £12,000

Lower band	Upper band	Weighted rate (1 decimal place)
3.0%	8.0%	4.9%
4.0%	6.5%	5.0%
4.0%	8.0%	5.6%
5.0%	6.5%	5.6%
5.0%	7.5%	6.0%
5.5%	7.0%	6.1%
6.0%	7.0%	6.4%
5.5%	8.0%	6.5%
6.5%	7.5%	6.9%
6.0%	8.5%	7.0%
7.0%	8.0%	7.4%
7.0%	8.5%	7.6%
7.5%	8.5%	7.9%
7.5%	9.0%	8.1%

Annex 2

Core response template

Consultees who wish to respond to the core issues raised in this paper are encouraged to refer to the core response template below. A technical response template is at Annex 3 for those who wish to respond to the more technical aspects of the paper. Note is also made of the Chapters which are most relevant to each series of questions.

This template provides a list of questions which the Department believes to be particularly relevant to the successful development of a new-look scheme. The use of this template is not compulsory and nor are respondees limited to commenting on the specific issues it raises.

The four options

Relevant Chapters: 1-6

C1 Which of the four options, or variations on them, would you support and which would you oppose? Why?

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?

Flexible and early retirement

Relevant Chapters: 2, 3, 7

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?

Employee and employer costs

Relevant Chapters: Chapters 1-6, 11

C4 What should the average employee contribution rate be in the new-look scheme?

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?

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?

Annex 3

Technical response template

Consultees who wish to respond to the more technical aspects of this paper are encouraged to refer to the technical response template below. Note is also made of the Chapters which are most relevant to each series of questions.

The template provides a list of questions which the Department believes to be particularly relevant to the successful development of a new-look scheme. The use of this template is not compulsory and nor are respondees limited to commenting on the specific issues it raises.

The four options

Relevant Chapters: 1-2, 5-8

T1 For scheme employers: What assessment have you made of the likely impact of each of any / all of the four options on the employer contributions you would otherwise have be required to make (or would otherwise have recommended that fund employers make) under the current scheme?

T2 For LGPS funds: What assessment have you made of the likely impact of any/all of the four options on the employer contributions you would otherwise have recommended that the scheme employers in your fund make under the current scheme?

Flexible and early retirement

Relevant Chapters: 2, 3, 7

T3 For scheme employers: How would the introduction of any/all of these extensions affect your ability to manage your workforce?

T4 For scheme employers: What policies and/or provisions would you need to put in place to ensure fair and effective application and management of any/all of these extensions?

Employee and employer costs

Relevant Chapters: 2-6, 9, 11, Annex 1

T5 If you do support a tiered employee contribution rate which of the tiered structures contained in Annex 1, or variations on them, would you support or oppose? Does your view depend on which Option is implemented, and if so how and why?

T6 On the basis of your answers to C4 and C6, is it likely that the recommendation you made in C2 could be implemented? If not, how would you adjust your answers to C2, C4 and C6 in order for your recommendation to be affordable?

Two-tier ill-health pension provisions

Relevant Chapters: 8

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-heath retirees be assessed?

T8 Do you have proposals for alternative two-tier ill health pension provisions?

A future cost sharing mechanism

Relevant Chapters: 12

T9 Do you support or oppose the principle of introducing a future cost sharing mechanism into the LGPS? Why?

T10 Do you support the approach outlined in Chapter 12, or do you have alternative suggestions for other mechanisms?

T11 Do you support or oppose the idea of keeping the assumptions about commutation savings under review, as part of any cost sharing mechanism?

T12 How might the conflict between the nature of the LGPS and a future cost sharing mechanism might be resolved? The following questions may be relevant:

a. How might the introduction of this mechanism tend to change the actuarial approach taken to valuation, and therefore scheme employers' costs?

b. Who should conduct the national review?

c. What proportion of funds should this be based on?

d. What, if any, additional provision of data or reporting would need to be required from funds or employers?

e. How often should the review take place?

f. Which demographic assumptions should be subject to review?

g. What size increase/decrease in these assumptions should trigger a review?

h. What should the defined ratio of employee: employer contributions be?

i. What size increase/decrease in this ratio should trigger a review?

j. How, if at all, might the regulatory framework governing the management and administration of funds need to adjust, if at all?

k. How, if at all, might the regulatory framework governing the management and administration of funds need to adjust?

l. By what, if any, national consultative processes would the benchmarks and triggers be agreed?

m. By what, if any, national consultative processes would any resulting change in employee contribution rate or Scheme design be agreed?

Existing scheme members in the new-look scheme

Relevant Chapters: 13

T13 Which of the possible three transfer methods would you support and which would you oppose? Why?

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?

T15 Do you have proposals for alternative methods of transfer?

T16 Bearing in mind the criteria for evaluation, which method would you recommend be taken forward for the new-look scheme?

Scope of scheme employers' discretions

Relevant Chapters: 14

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?