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Dear Nicola,

### **LOCAL GOVERNMENT PENSION SCHEME IN ENGLAND AND WALES OPTIONS FOR A NEW LOOK SCHEME.**

I thank you for the opportunity to discuss the proposals for the new look LGPS as outlined in the Department's letter and consultation papers of 30<sup>th</sup> June 2006.

The details of these proposals and their costs were put before the Pensions Committee of South Tyneside Council (the Council) for their comments and views. The Pensions Committee have decided that, since a large proportion of the cost of LGPS is met by employers, the issue of which of the five options is most suitable is primarily a question for those employers. This response, which reflects the Council's views as administering authority, will therefore mostly be confined to technical and administrative issues. A further response to the proposals will be sent from the Council in its role as employer.

We understand that it is intended that the new scheme is to be operative with effect from 1<sup>st</sup> April 2008. This is an extremely tight timescale for such a large undertaking. It follows that the scale and complexity of the actual change to the scheme will have proportionate effect on the risk of administration, communication and public relation difficulties.

#### **Option A – The updated current scheme with additional benefit components**

We anticipate that only minor regulatory and system alterations will be necessary, requiring only a low level of modification to most calculations and administrative processes. Some calculations are likely to remain unaltered and those that do change will probably only need to do so at a minor level. Changes to system software and documentation would therefore be limited and communication of changes to the various stakeholders, and training of staff in the Pensions Service and employer payroll and HR departments should be straightforward.

Option A should therefore be relatively easy to implement for employers and for the Pensions Service. Implementation costs and the risk of administering authorities and employers not being ready to fully implement the new scheme on the proposed date of 1<sup>st</sup> April 2008 should both be comparatively low. The major problems that would arise with any of the other options with regard to the transition of membership value from the old to the new scheme would not occur. In particular, the risk of a subsequent legal challenge by a member (or their union) on the basis that the conversion methodology did not, in their particular circumstances, provide a fair and equitable outcome will be removed.

### **Option B – a new final salary scheme with an improved accrual rate.**

This scheme would represent, administratively, a medium magnitude change. We anticipate that most calculations and administrative processes would require minor level changes, but we think a number are likely to require significant or major changes. Regulatory changes, systems and document changes will be more significant than in the case of Option A, but less than with any of the other options proposed.

Employer payroll staff would require a limited amount of retraining. However, Pensions Service and HR staff will need a significant level of retraining. Obviously, communications issues will increase in complexity the further the move away from the current scheme basics.

Consequently we believe that Option B is likely to be a more difficult change to implement given the intended timescale. Costs are also likely to be greater for both employers and the Pensions Service.

However, in respect of Options B, C1, C2 and D, the calculations for the transition of existing membership to the new scheme will have to be done for all existing LGPS members. Irrespective of the actuarial complexities of such a calculation, we have serious concerns about the reliability and accuracy of the outcome. This is because, in spite of the best efforts of the Pensions Service, a considerable number of member records will not reflect the correct position. We know this to be the case because of the regularity with which employers enclose, with leaver forms, notifications of hours changes which occurred in past years. Unless, therefore, sufficient extra resources can be found by participating employers to carry out a detailed review of the information communicated to the Pensions Service for all their members, with data corrections being submitted where records are incorrect or incomplete, it is inevitable that overstated or understated membership in the new scheme will result. Discussions with some participating employers suggest that it is highly unlikely that all employers will be able to carry out the required review in the timescales implicit in an April 2008 go-live. Consequently we regard transition of existing membership as a huge undertaking that is very high risk.

### **Option C1 – Career average scheme with an accrual rate of 1.85%**

### **Option C2 – Career average scheme with an accrual rate of 1.65%**

Both these proposed schemes represent an enormous and fundamental change to the administration of LGPS. Whatever their comparative merits, virtually all calculations will need to be completely revised with many administrative processes likely to need major revision. Regulatory changes, systems and documentation changes will be of a different order to those required for Options A and B.

Using a career average pay scheme would have some administrative advantages for the Pensions Service in that less data would be required for members who work part time or have a flexible work pattern. However, the nature of a CARE scheme means that it will be vitally important for accurate pay data to be provided by employers and that it is checked and cleansed by the Pensions Service on an annual basis. It is already our current practice to carry out a substantial employer data checking and cleansing exercise which makes us very aware that information flows from certain employers are very poor. Failure to notify changes promptly and/or incomplete or incorrect notifications are typical manifestations of this problem. The requirement to provide accurate pay data each year for all their members sets for employers a much higher minimum data quality threshold and will certainly have major implications for employer payroll departments. It is thought that, on balance, any advantage to the Pension Service from a switch to CARE will be counteracted by the increase in work checking and cleansing of employer pay data.

A fundamental difference between a CARE and a final salary scheme will mean that training will be a major issue for employer payroll and HR staff and within the Pensions Service. From the Service's point of view the amount of training needed is bound to have a major impact on processing in the months leading up to 1<sup>st</sup> April

2008. The year in which a triennial valuations falls is always particularly busy, for both Fund administrators and employers, and the 2007 valuation will make the major changes inherent in a switch to CARE particularly difficult to successfully accommodate. Processing is also likely to slow significantly in the immediate aftermath of the change due to staff's initial unfamiliarity with calculations, processes and documentation.

The press have over the years characterised final salary schemes as "gilt edged" whilst CARE schemes have been rated somewhat less good but better than a defined contribution scheme. Many members are likely to have great concerns about moving away from a final salary arrangement and a major education and communications exercise will be needed involving both employers and the Pensions Service. This will have significant short term cost implications. If the change cannot be successfully sold to existing and potential members then employers may face further industrial unrest and / or a maturing membership profile with its inherent cost implications.

We believe, however, that the largest problem converting to a CARE scheme will be the difficulty of converting the value of final salary scheme rights to a membership credit within a CARE scheme that has differing accrual and revaluation rates. If existing members are to be compulsorily transferred from the old to the new scheme it is imperative that no-one be disadvantaged by this action. Devising a mechanism sophisticated enough to result in a fair and cost neutral transfer, whilst ensuring no-one is disadvantaged, will be a very difficult task, especially given the very limited development time available. In particular, the necessary use of national demographics factors means at a local level it will be almost impossible to avoid winners and losers and the need to encapsulate members with transitional protections will further complicate the position. We therefore believe that any transfer mechanism will not be 100% accurate in every case and so, to avoid losers, the mechanism will need to be generous towards the majority of the membership. We believe this is almost certain to increase employer costs and likely by more than the cost of administering two separate schemes.

Due to the magnitude of the change, Options C1 and C2 are likely to present both the Pensions Service and employers with a major implementation challenge, especially given the Government's timescales. The failure risk is judged to be much higher than Options A and B. All this assumes that clear and comprehensive regulations are issued for the chosen new arrangement together with associated actuarial guidance by the deadline of 1<sup>st</sup> April 2007. Implementation costs for C1 and C2 are likely to be much higher, for both employers and the Pensions Service than for either of the first two Options.

#### **Option D – Hybrid scheme CARE/ Final salary based on either Option C1 or C2 basis**

This Option embodies all the problems linked to C1 and C2 with a further level of complexity for both employers and the Pensions Service. For employers, the differing data requirements for members participating in the optional final salary element, when compared to members within the standard CARE scheme, together with the differing member contribution rates, will increase still further the administrative complexity and workload for payroll and HR departments. Smaller employers may well not have the resources to cope, leaving them in an extremely difficult position, especially if the resulting problems cause the Pensions Ombudsman to become involved.

The position of the Pensions Service is also made more difficult. Currently, there is a single set of scheme rules. If the hybrid option is chosen two very different sets of rules will have to be dealt with. Transfers into the scheme in respect of the final salary optants would presumably be converted to credits using different actuarial factors than the CARE scheme transfers. This significantly increases the amount of training that staff will need. It will also increase implementation and ongoing costs.

The problems of education and communication referred to in respect of Options C1 and C2 will, we feel, be even more difficult to address with a hybrid scheme on the lines set out for Option D. It is a feature of Option D that optants for the final salary scheme will have to pay a higher rate of contributions. If employees and potential employees are told that membership of the final salary scheme costs 3% more than the CARE scheme, the

perception will be that the CARE scheme is inferior and that employees who join the CARE scheme are getting an inferior deal. In reality the additional 3% is to cover the cost of selection by those employees for whom a final salary scheme would be most appropriate, but we believe it will be extremely difficult to get people to accept this.

### **Flexible and Early Retirement**

The consultation paper asks for comment on five possible extensions to the current flexible retirement provisions. In this context we support Extension a. allowing members, who would otherwise be subject to percentage reduction on retirement, to buy out any reduction in their benefits. However, this support is dependant upon (i) its being cost neutral, (ii) that it followed clear rules that are simple to administer and (iii) that provision is made to automatically upgrade contracts on ill-health retirement and to calculate partial service upgrades where the payment has not been completed for some other reason.

We note Extension b. but would point out that this is already contained within the current regulations.

With regard to Extension c, we assume that the employer consent refers to the payment of benefits on flexible retirement. In this regard we feel the accrued benefits should only be paid on being granted flexible retirement under an employer's written policy.

As regards Extension d. we would contend that the aim of flexible retirement is to provide a less abrupt way to retirement and the drop to lower hours or to a lower grade is logically an integral part of this. We would therefore not support a move to remove these conditions.

We do, however, support Extension e. in respect of payments after age 65 and up to the day before the 75<sup>th</sup> birthday.

### **Proposals for two tier health provisions.**

#### Top tier

Any member who qualifies for the top tier would have to be quite seriously incapacitated with the result that they are unable to secure gainful or regular employment before age 65. This being the case we have grave doubts that a system of automatic review of enhanced cases would be very cost effective, taking into account that only a minority of the total cases would be involved and that obvious anxiety and inconvenience would be caused to the individual.

The proposed scheme is likely to result in some generous awards of benefit, with greater benefits for younger employees than those presently awarded. At the same time older employees, and particularly those over the age of 59, would receive much less in the way of enhancement.

For example:-

A member aged 35 retiring through ill-health with 10 years service and certified as top tier would be awarded  $30 \times 0.5 = 15$  years. Current award is 10 years.

However, a member aged 60 with 10 years service retiring in the same category would receive  $5 \times 0.5 = 2.5$  years. Current award is 5 years.

Quite obviously the older member would be worse off under the proposed new arrangement than he is under current provisions. The fact that enhancement is more beneficial at the younger end of the age spectrum than at the older, where the incidence of ill-health is higher, seems to be a design flaw and we believe that the new scheme should, for existing members, have include a provision which ensures that top tier retirees should receive at least the award provided under the current regulatory provisions.

## Second tier

The second tier proposes payment of un-enhanced benefits to those leaving on ill-health grounds but who are capable of securing gainful or regular employment. We think most ill health retirements will fall within this tier.

A clear definition of what is meant by “capable of securing gainful or regular employment” will be critical to the acceptability of this approach. We do not consider it reasonable if, for example, an Executive Director who suffered a major mental breakdown is limited to second tier because he can carry out some light work in a protected environment. Some level of comparability to the existing post should be included.

Certification of the level of incapacity will no doubt give the medical practitioners problems, and we think they will be at least comparable to those encountered under current provisions. Second tier is likely to be used as a fallback in marginal cases but we foresee more appeals as members and unions challenge whether the member is “capable of securing gainful or regular employment” .

Were the second tier to be broken down into sub-tiers, with various levels of enhancement reflecting various levels of incapacity, we believe it would multiply the difficulties in administration, lead to greater employer costs and would result in numerous appeals from members seeking to be placed in a higher tier to increase the award of enhancement.

## Review of Ill Health Awards

If ill health awards were to be subject to regular review the arrangements would be costly and difficult for employers to administer. As the rules on previous involvement in the case will mean that no medical practitioner can be involved in a member’s case more than once, multiple reviews would be very difficult to organise. Even if sufficient medical practitioners can be found we are not convinced of the value of the review. In the event that the pensioner’s condition had worsened to the extent that they were incapable of securing gainful or regular employment they would receive no enhancement. If on the other hand the pensioner’s health had improved, increasing the possible earnings capacity, the Finance Act precludes the variation of the original award. We can see no potential savings to balance the extra administrative costs.

In summary, we do not believe a convincing case has been made with regard to the need to change the existing ill-health regime. Employers have, in recent years, made great strides in reducing the number of ill health cases that lead to termination of employment and payment of benefits. According to figures published by the LGE, the numbers of LGPS ill health retirements in England reduced from circa 35,000 in 1995/6 to 6,784 in 2003/4. We therefore take the view that the impact of ill health retirement as a cost driver has already been substantially addressed. We see no merit in the proposals for two-tier ill health provision, do not support sub-tiers and do not support review of ill health awards.

## **Death in service benefit**

Administratively, the increase in the death grant payable on death in service to three times pay would give no difficulties and would assist in promoting the scheme to potential members.

## **Partner’s pensions**

We believe that the case for the provision of survivor pensions for civil partners, based on pre-1988 service as well as post – 1988 service should be costed for all proposed options, in the interests of parity with other survivor pensions provided by the scheme.

Any reduction to partners' pensions, whether spouses' or civil partners', may lower scheme costs. However, we have concerns that it may also lead to sex discrimination issues, as a reduction to partners' pensions is likely to impact more negatively on women than men, due to the fact that more men have access to an occupational pension of their own.

### **Cohabitees pensions**

The extension of survivors' benefits to "common law partners" or cohabitees would appear justified in the light of changes within society. However, we believe that, in practice, the inclusion of such provision in the new scheme would be extremely problematical. In death in service cases, employers would be required to forward details of the surviving partner in a situation where much information is an unknown or cannot be substantiated and there is no legal recognition of the relationship. The situation itself may be delicate to say the least. Where a pensioner dies the Fund administrator will need to obtain similar details.

Definitions that identify how a qualifying partnership would be recognised and how the children of such partnerships who are entitled to benefit are identified will be an absolute pre-requisite. We believe that constructing such definitions would be a difficult task indeed. It has been suggested that only cases where the partners are named on a recorded nomination should qualify but this begs the question of how the information be verified as current in all cases. Another matter which would require consideration is whether only the deceased's service during the period of cohabitation should be taken into account for benefits purposes or, as in the case of spouse/partner survivor pensions, should earlier service count.

We understand that the Law Commission Consultation Paper on Cohabitation: The Financial Consequences of Breakdown is not due to report until August 2007 and we believe it would be unwise to address this until that time.

### **Proposal for Tiered Contribution Rate.**

Consultees are asked if they support the proposal that employee contribution rates should be tiered, with a lower contribution rate being payable below a certain cut off point and a higher rate for better paid employees. This proposal is intended to make LGPS membership more attractive to low paid employees.

We have a number of issues with this proposal.

Firstly, encouraging the lower paid to join the LGPS by offering a reduced contribution rate may result in employees joining who may not be best served by doing so. This is due to the impact of the Pensions Credit. Until the State creates a position where there is no disincentive to save towards a pension, we believe it is questionable whether there is merit in designing a scheme to attract the lower paid to join. We believe that there is a real risk that members who retrospectively come to believe that they should not have joined the LGPS will, whether they are truly justified in the view or not, allege mis-selling. Defending such cases may be difficult and will likely involve considerable expense.

Secondly, there is little evidence that offering employees a lower contribution rate (other than a 0% rate) on earnings below a specified level would necessarily encourage the vast majority of non joiners to join. Independent studies reveal that the bulk of the 'unpensioned' are not paying into a pension scheme because of other urgent calls on their money and not because of the level of the contribution rate.

Thirdly, we believe it is possible that a lower contribution rate might be open to age or sex discrimination claims.

Fourthly, if large numbers of employees, not currently in the LGPS, join then their employer will need to pay the appropriate employer contributions for these employees. Employers may find that, as a result, their overall pay bill increases considerably which, in turn, causes budgetary difficulties. Although this is primarily an issue for individual employers to comment upon, fund administrators will be impacted if this results in a wave of admission body failures and closures. Fund employers could also find themselves facing extra costs if their employer contribution rates have to rise to meet deficits in respect of these closing admissions.

Fifthly the introduction of tiered contribution rates may act as a severe dis-incentive to employee career progression, with employees refusing to seek promotion or even to temporarily act up because they will be worse off. This in turn may cause pressure for compensatory pay increases.

### **Future Cost Sharing between Employers and Employees**

It does seem prudent to periodically assess the impact of any long-term demographic changes that might affect scheme benchmark costs, and in particular changes in mortality rates. Where such long-term changes are identified then it would seem equitable that any adjustment to contribution rate should be proportionate between employer and employee, whether upwards or downwards.

However, if costs are increasing and a fixed limit is introduced beyond which the employer contribution will not rise that will leave the employee bearing the additional cost alone, either with further pension contributions or a reduction in the benefit accrual rate. We realise the scheme must be affordable and that an increase in pension contributions leads to increase in budget costs. However, we cannot envisage this fixed employer contribution limitation as a solution because of the usual subsequent recourse to pay claims aimed at recovering lost ground. Once again, this is primarily an issue for employers, but it will also impact on fund administrators if it results in admission bodies and contractors getting into financial difficulties.

One feature of the current dispute regarding the removal of the Rule of 85 is that different actuaries can, quite legitimately, come up with different cost outcomes in respect of the same question, and the problems that actuaries have had in correctly anticipating future trends for mortality rates are well known. If scheme costs are to be amended because of changing factors there must be evidence that change is necessary that all parties will accept or we risk ending up with increasing wages claims, or worse, industrial action. We are dubious that such a consensus on evidence of change will be achievable.

I hope these points I have raised will help you in your deliberations upon a new look LGPS.

Yours sincerely

**Stephen Moore**  
**Head of Pensions**