

The Local Government Pension Scheme

Facing the future – principles and propositions for an affordable and sustainable Local Government Pension Scheme in England and Wales

Information about proposals for a new Local Government Pension
Scheme to be introduced in 2008



"Facing the future – principles and propositions for an affordable and sustainable Local Government Pension Scheme in England and Wales"

The above consultation document was issued on 4 October 2004 by the Local Government Pensions Division of the Office of the Deputy Prime Minister ("ODPM"). It seeks the views of employers and employees on the design of a new Local Government Pension Scheme ("LGPS"). It is suggested that the new scheme could be introduced in April 2008.

A consultation exercise setting out proposals for amendments to the current LGPS took place earlier this year. The main proposals included raising the age at which unreduced benefits could be paid to age 65, subject to certain protected rights. At the date of writing these notes, the results of the consultation have not been announced. However, it is probable that the proposed amendments will proceed with effect from April 2005.

There are likely to be further amendments in April 2006 when the tax rules which govern pension schemes will be changed.

All of the public service pension schemes are currently subject to review.

These notes outline the points made in the ODPM's consultation document regarding the introduction of a new LGPS in April 2008 and the design of such a Scheme.

If you would like to read the consultation document in full you will find it on the ODPM website at: www.xoq83.dial.pipex.com/gpfva.htm and an accompanying letter is given at: www.xoq83.dial.pipex.com/gpcla.htm.

Because these notes offer only a brief summary of the document, if you wish to comment on the proposals it would be advisable first to read the document in full. You may wish to compare the proposals with the rules of the current LGPS.

Your views on the consultation document can be sent to: Nicola Rochester, Local Government Pensions Division, Office of the Deputy Prime Minister, Zone 2/E6, Ashdown House, 123 Victoria Street, London SW1E 6DE or you could e-mail your views to: lgpensions@odpm.gsi.gov.uk.

If you would like your views to be taken into account in the County Council's response then please e-mail them to pensions.consultation@staffordshire.gov.uk.

The consultation period ends on 31 March 2005. Any comments must be sent to the ODPM by that date at the latest.

Summary of proposals

The consultation document starts by saying that the Government have decided to introduce new pension arrangements for local government. Government ministers have given a commitment to keeping a final salary arrangement relevant to the local government workforce provided that it remains both affordable and sustainable.

Proposals for the basic structure are as follows –

- Employee contributions could be varied – the higher the pay the higher the contribution rate. The average employee contribution across all pay bands would be 7%.
- Normal scheme retirement age would be 65. Benefits paid before this age would be reduced, benefits paid after this age would be increased.
- Provision could be made for flexible retirement, i.e. an option to draw pension while still working - perhaps with reduced hours or in a less onerous job.
- Ill-health retirement benefits would not be reduced if paid before retirement age. If a person is permanently incapable of undertaking any gainful employment by reason of ill-health, the benefits would have an ill-health enhancement; if other employment could be undertaken, ill-health benefits could be paid but without enhancement.
- Benefits would accrue at 1.6% of pensionable pay so, for example, after 10 years a member's pension would be based on 16% of pay and after 40 years based on 64%.
- There would be no automatic lump sum as at present but, instead, an option to convert part of the pension; for every £1 of pension foregone the member would receive £12 lump sum. For example, £100 reduction in pension would give a lump sum of £1,200.
- Pensionable pay could be limited to basic salary – all other payments such as bonuses, fees, overtime and allowances would be excluded.
- Death in service grant could be increased to three times pensionable pay.
- Survivors' benefits would be paid to widows, widowers, registered civil partners, children and possibly extended to unmarried partners. The maximum spouse's/partner's pension could be 50% of the member's pension after commutation and children's pensions could be 25%.

There are suggestions that a defined contribution (i.e. "money purchase") scheme could be set up as an alternative option to the main final salary scheme should any employee prefer this. Such an arrangement could also provide an investment route for paying contributions on elements of pay excluded from counting in the main final salary scheme, or for voluntary contributions to top up benefits from the main scheme.

It is proposed that all those who are LGPS contributors at the commencement of the new Scheme would be automatically transferred to the new arrangement with a period of membership in the new Scheme equal in value to that in the old. Deferred and pensioner members would keep their benefits in the current LGPS.

Comments are invited on the way in which Compensation Regulations could be amended.

The consultation paper also touches on issues relevant to the administration of the Scheme, e.g. governance, finance, communications with members, data maintenance and transmission between Scheme employers and Fund administering authorities, and the way in which the regulations should be drafted.

These points are looked at in more detail on the following pages . . .

Aims of LGPS review

The proposals contained in the consultation document are given as being aimed at –

- scheme modernisation to reflect the broader employment context of local government in the 21st century;
- improving the Scheme's inherent attractiveness to employees and employers;
- providing a simplified regulatory framework to improve understanding, application and review;
- ensuring value for money for stakeholders, including taxpayers, members and employers;
- encouraging new patterns of delivery and organisation through new means of efficiency, including use of technology, joint working and new suppliers; and
- providing an affordable, secure and sustainable benefit structure.

Employees' contribution rates

The current contribution rate is 6% of pensionable pay for all employees except a declining number of "manual workers" who have a protected right to pay 5%. It is suggested that this would have to rise to 7% to meet an equitable proportion of the rising costs of the LGPS. (Within the public service schemes, employees usually meet one-third of the cost of benefit provision and employers meet two-thirds.)

It has been suggested that, although the current contribution rate is generally the same for everyone, higher salaried members contribute proportionately less than those with lower earnings because of the way in which tax and National Insurance bands work. (Tax relief is given on contributions and so higher rate tax payers receive a greater amount of relief. Also, the LGPS is "contracted-out" of the State Second Pension Scheme and those whose earnings are above the lower threshold will pay lower National Insurance contributions.) It is proposed that the average contribution rate across the Scheme should be 7% but that the contribution rate paid by individuals should reflect their earnings at the time, i.e.

- those earning less than £5,000 a year should pay 2.5%
- those earning more than £5,000 but less than £7,000 a year should pay 5.5%
- those earning more than £7,000 but less than £38,000 a year should pay 7%
- those earning more than £38,000 but less than £80,000 a year should pay 9%
- those earning more than £80,000 should pay 10%

Tables showing the effect on income are given in the consultation document.

The option of paying "tiered" contributions is also considered, e.g. using the above example, a person would pay contributions of 2.5% on the first £5,000 of income and then 5.5% on the next £2,000, 7% on the next £31,000, and so on.

Scheme Retirement Age

This would be 65 and is the age at which retirement benefits would normally first become payable without reduction. Benefits taken by choice before this age would be subject to actuarial reduction, benefits taken after this age would be subject to actuarial increase. The reductions/increase would be cost neutral to the Scheme and reflect the costs/savings of paying benefits early/late.

Flexibility of retirement

Current tax rules prevent an employee from drawing pension while continuing in the same employment. Changes in tax rules in 2006 will allow it. Also, age discrimination legislation will be introduced in 2006. The Government wishes to encourage those who would like to work longer to be able to do so. Pension schemes have been asked to help wherever possible to ensure that scheme rules do not discourage flexible retirement, i.e. to ensure that –

- members are offered a fair return for deferring their pension while they work beyond their normal retirement age;
- those who work beyond normal retirement age are able to continue to build up their pension entitlement; and
- members in final salary schemes who opt for part-time employment or who step down in responsibility near the end of their careers should be treated fairly.

The consultation document picks up on these points and considers how they could be built into a new LGPS. It suggests that there could be advantages to employers if they could allow members age 55 or over to draw some or all of their accrued pension benefits while remaining in full or part-time employment. "Such an amendment would allow members to take a gradual approach to retirement where this supports the business needs of the relevant employer, rather than all interests having to cope with the current "cliff edge" experience." The idea of employers having policy statements setting out how these powers would be exercised is discussed.

The document then invites comments on the following potential options –

- Members who have attained age 65 and remain in relevant employment could be allowed to continue to accrue LGPS membership regardless of the extent of their total membership.
- Members' LGPS benefits may be put into payment at age 65 and if they remain in relevant employment they may rejoin the Scheme and accrue further LGPS pension rights.
- Members who have attained age 55 and meet any qualifying requirements (e.g. reduction in pay or hours/ local policy statement criteria) may elect for payment of accrued LGPS benefits. Where benefits are brought into payment early under such provisions they would be actuarially reduced to reflect this fact.
- Members would be allowed to continue in relevant employment with the Scheme employer whilst drawing their accrued LGPS benefits and may also be allowed to rejoin the Scheme and accrue further membership.

This part of the document ends by saying –

"Any new scheme benefit package will need to ultimately ensure that local government, through the LGPS, overriding tax legislation and human resources policies, is able to operate successful flexible retirement policies. It is important that the LGPS contains no impediments or barriers to such policies, given the complementary provision they provide to allow members to take an appropriate and measured approach to retirement, set against the scheme's retirement age and employers' needs."

Ill-health retirement and income protection

The consultation document identifies the following problems with the current ill-health provisions of the LGPS –

- an independent qualified medical practitioner has to identify the permanence of a condition at the time employment ceases; no account can be taken of post-retirement improvement or deterioration in a person's medical condition or earnings potential.
- the regulations do not differentiate between those whose incapacity permanently prevents them from undertaking any gainful employment in the future and those who have an incapacity in relation to their current duties but could undertake other employment.

The document proposes that the LGPS should adopt provisions similar to those recently introduced into the Principal Civil Service Scheme, i.e. that there should be a two-tier ill-health retirement arrangement. Enhanced ill-health retirement benefits would be paid only where a member is permanently incapable of any employment. Enhancement up to Scheme Retirement Age would apply. This could be subject to review.

Those who are medically unfit for the duties of their existing employment but capable of undertaking further employment may be entitled to benefits but without enhancement.

The document also invites views on a more radical alternative approach, i.e. to remove income protection from the Scheme and link it, instead, to commercial provision in the insurance sector. This could also cover injury allowance discretions.

This section of the document ends by saying –

"There are several key matters for discussion and debate raised here in which consultees' views are invited."

Benefit structure

For each year of service the current LGPS offers a pension based on 1/80th of final pay and a lump sum based on 3/80ths of final pay. Final pay means pay averaged, normally, over the last 365 days of service.

It is suggested that the new LGPS should offer a pension based on 1.6% of final pay for each year of service. This means that after 10 years a member would have a pension based on 16% of final pay, after 40 years the pension would be 64% of final pay, after 45 years the pension would be 72% of final pay. There would not be an automatic lump sum but, instead, the member could choose to commute part of the pension into a lump sum. For every £1 of pension they choose to give up, they would receive £12 as a lump sum.

Instead of pay being averaged over the last 365 days it could, instead, be the pay as at the start of the previous financial year or, if employment commences or changes during the period, the salary on commencement of the job. Pensionable pay would be basic pay only, excluding such items as overtime, fees and bonus payments. (If these principles were adopted for benefits, the same would apply to the pay on which employee and employer contributions are assessed.)

The pension and lump sum would be limited by the new tax arrangements – see below.

New tax arrangements

Current tax rules limit a member of a final salary scheme like the LGPS to paying no more than 15% of taxable pay in pension contributions, restrict the pension so that it can be no more than 2/3rds of final pay, limit the level of pensionable pay for high earners who joined after 1989 (the "earnings cap" – currently £102,000) and restrict the lump sum to no more than 2.25 times the pension.

These rules will change completely in April 2006 and will be replaced by a limit on the total value of benefits (this limit will be £1.5million in the tax year 2006/07), a limit on the annual increase in benefit value (£215,000 for the same tax year), and the right to commute up to 25% of the total benefits value tax free. The limits will be increased each tax year. If the limits are exceeded, the benefits could still apply but there would be a tax charge.

These arrangements are not part of the consultation on the new LGPS. The changes will happen. But they have to be considered in the design of the Scheme and will require amendments to be made to the current Scheme.

Consequently, the consultation paper asks for comments on the following –

- Should the LGPS introduce a Scheme specific maximum pensionable salary equivalent to the current Inland Revenue earnings cap for post 1989 joiners?
- If the LGPS does not introduce a salary cap, should the Scheme include specific provisions to prevent any member who is currently subject to the earnings cap from making a windfall gain? (For example if the Scheme did not introduce a salary cap, a member who is currently subject to the £102,000 cap but earns £150,000 would suddenly have a higher pensionable pay figure, despite never having paid contributions in respect of the £48,000 excess above the cap. This would result in considerable cost implications for the Scheme employer.)
- If a salary cap is introduced into the Scheme, what measures should be taken to protect the uncapped position of certain pre-1989 members?
- Should the LGPS remove the maximum 40/45 year total membership restrictions and, if so, should consideration be given to removing them from the current Scheme from 2006 or only in relation to the new Scheme from 2008?
- Should members be permitted to accrue further LGPS membership even if they have reached or exceeded the new Inland Revenue lifetime limit? (Note: this is not simply a pension issue but relates to terms and conditions of employment, pressures on pay negotiations and consequential pay drift.)
- Should the new LGPS restrict scheme benefits to a specified level, for instance the lifetime allowance?
- Should consideration be given to allowing commutation lump sum payments up to 25% of the assessed value of a member's pension benefits, or should the new Scheme offer a lower maximum lump sum?
- Should consideration be given to allowing employers to meet the tax charge arising for the award of an additional period of membership which results in a member's benefits increasing above the annual allowance?
- Should the current 15% limit on employee contributions be removed from the current LGPS from 2006 or only in relation to the new Scheme from 2008?

Increasing benefits

Under the current LGPS there are provisions for a person who would not attain maximum service to "purchase" additional periods or to pay Additional Voluntary Contributions ("AVCs") to a life assurance company. (There is a requirement for Local Government Pension Funds to provide an AVC facility).

The options are limited by current tax rules. With the change in tax rules there could be more scope for improving benefit provision. There may be no limit on the period of membership which could accrue in relation to employment.

It is proposed that there should be no facility to buy additional membership of the Scheme but that consideration could be given to providing a defined contribution LGPS top-up arrangement. (This defined contribution arrangement could also be offered as an alternative to the main LGPS.)

There would be no requirement to provide AVC arrangements but LGPS members could, instead, make their own arrangements through an external provider or take out an additional pension arrangement such as a personal or stakeholder pension scheme as would be allowed under the new tax rules.

The consultation document invites questions on whether and how a defined contribution scheme could be set up.

Death benefits

The current LGPS offers a death grant, payable on death in service, of 2 x pensionable pay. There is an option for the member to nominate the recipient. The consultation document suggests the new LGPS could offer a death grant of 3 x pensionable pay and retain the nomination option.

Children's pensions are usually paid to a child under the age of 17 and after that age if the child is dependent on the member and in whole-time education or training for a trade or profession, or physically or mentally incapacitated. The consultation document proposes that children's pensions could cease at age 18.

The amount due currently depends upon whether there is another surviving parent. If there is, the child's pension is 1/4 of the member's pension. Where there are two or more children the amount due is 1/2 divided between them. If there is no surviving parent, these amounts are 1/3 and 2/3 respectively. The suggestion in the consultation paper is that the children's pensions should be 1/4 after any commutation and limited to a maximum of 1/2. There is no proposal for a greater amount if the child has no surviving parent. In the event of death in service, it is suggested that the pension upon which the children's benefits would be based could include ill-health enhancement.

Widows' and widowers' benefits

Currently, spouse's benefits are 1/2 of the member's benefits (increased by ill-health enhancement in the case of death in service). It is suggested that this could remain the same. However comments are sought on the idea that survivor benefits should be reduced where there are significant age differentials.

Short service death benefits

Under the current Scheme there is provision for a short-term dependants' award which is 3 or 6 months' payment of a pension equivalent to the member's rate of pay or pension at the date of death.

It is proposed that these short-term benefits should not feature in the new LGPS

Civil partners

If the Government's Civil Partnership Bill becomes law, the LGPS will be required to provide survivor pensions for same sex registered civil partners calculated on the member's service accrued after the Bill's enactment or from a set date.

Views are sought on whether service transferred from the current to the new LGPS could be adjusted to provide civil partner's benefits on all service.

Cohabiting partners

There are no proposals which would require pension schemes to provide survivor pensions to partners (same or opposite sex) who are neither married nor registered as civil partners. However the Government would allow a public service scheme to introduce such provisions provided the general membership wants them and the cost is borne by the membership (not the employers).

If such provisions are introduced into the new LGPS, clear evidence would be necessary to show that the couple were living together as if husband and wife or civil partners. The administering authority may need to seek evidence of the following –

- co-habitation;
- an exclusive, long-term relationship established for a minimum of 2 years;
- financial dependence or interdependence; and
- valid nomination of a partner with whom there would be no legal bar to marriage or civil registration.

Cohabiting partners' pensions would be based on membership accrued after the date the provision is introduced. The consultation document asks whether, and how, previous membership should be taken into account. It must be paid for by members.

The consultation document asks for views on–

- whether cohabiting partners' pensions should be introduced;
- the proposal that administering authorities should determine the eligibility for cohabiting partners' pensions and whether the criteria are met;
- whether to provide buy-back terms for past service of cohabiting partners;
- whether any such buyback should be optional or compulsory;
- how buy-back might work – e.g. by membership adjustment on moving to the new Scheme or by an additional payment by lump sum or instalments.

Redundancy provisions

The current LGPS allows immediate payment of benefits from age 50 or over if the member is required to leave on redundancy or efficiency grounds. It has already been announced that, apart from in some protected cases, this age will probably rise to 55 with effect from April 2005.

The consultation paper suggests that the new LGPS could continue to offer unreduced benefits to early leavers whose departure is outside their control and where termination of employment occurs on or after the member's 55th birthday. There may, however, be restrictions in a situation where a statutory redundancy payment would not be paid.

If a person leaves on redundancy grounds a compensation payment may be made. The compensation provisions are not contained in the LGPS but in separate regulations. However there is a need to review these arrangements too because they could be affected by age discrimination legislation.

The current compensation provisions allow either for the payment of a compensation lump sum or "added years" (an enhancement to the member's service thereby increasing the level of pension and lump sum). The paper suggests that the added years option could be dropped and just the lump sum option retained. It also suggests that a legal maximum level of payment should be fixed and that employers should work within a policy when deciding what award should be made, demonstrating their business case for the level of award they determine to be appropriate.

In this respect, the consultation paper asks for views on the following questions –

- Should compensation awards be limited to cases where the employee is made redundant?
- Is there a case for including employees where cessation of employment is under a compromise agreement or for another reason, i.e. where seeking volunteers to mitigate compulsory redundancies?
- What sort of matters should be set out in the business plan and policy document?
- What might be an appropriate maximum level of award?
- Is there a case for allowing LGPS members the option to exchange cash payments for LGPS benefits of equivalent value?

Governance, finance, communication, regulations

This part of the consultation paper refers to another area of consultation in respect of the LGPS. This relates to the pro-active and prudent management of Pension Funds, pension administration and effective communication systems between all LGPS interests. It raises various issues such as financial controls, transmission of data between employers and the administering authority, promotion of the Scheme and the format in which regulations should be drafted. They are not covered here because these notes concentrate on proposals for amending the benefit structure of the LGPS. This is likely to be the area of greatest interest for most members. If you would like to find out more about the above topics, however, you can find full details in the consultation document itself and of course you can submit your views on these issues to the ODPM along with any views you may hold about the benefit structure.

If a copy of this information is needed in large print, Braille, another language
or on cassette, please contact Pension Services