Agenda Item No. 6

Pension Fund Committee

30 October 2006

Consultation response on 'new-look' Local Government Pension Scheme

Report of Stuart Crowe, County Treasurer

Purpose of the Report

1 The purpose of the report is to inform Members of the response Durham County Council made to the recent consultation exercise on the future of the Local Government Pension Scheme.

Background

2 The Department for Communities and Local Government (DCLG) issued a consultation document on 30 June 2006 setting out four options for a new-look Local Government Pension Scheme. The stated intention was to ensure the Scheme can go forward on an affordable and sustainable basis. None of the four options were specifically recommended and the DCLG stated that the consultation was "a genuine opportunity for <u>all</u> Scheme interests to engage in an important stage in the introduction of a new-look LGPS to meet the needs of the workforce, employers and other relevant objectives". Consultation responses were required by 29 September 2006.

3 Members authorised me to consider, in consultation with the Chairman and Vice-Chairman, what response to make to the consultation on behalf of Durham County Council as the administering authority of the Fund and following consultation with representatives from the HR Committee to produce a response on behalf of Durham County Council as a Scheme employer as well.

Consultation response

4 The four basic options consulted upon were:

a) a slightly updated version of the current scheme
b) a new final salary scheme with a better accrual rate
c) a career average scheme
d) a hybrid scheme – a career average scheme with the option to pay more for benefits based on final salary

5 Before drafting our response I met with representatives of GMB and Unison.

6 After consultation with the Chairman and Vice-Chairman along with representatives from the HR Committee it was decided that unless the members' contribution rate is appropriately increased Option (a) was on balance our preferred option as it does not involve an additional burden on the taxpayer and provides benefits that are at an appropriate level and are readily understood.

7 The consultation document raised a number of other issues and our response to these can be summarised as follows:

- Extending flexible retirement options – on balance we felt it was appropriate to support greater flexibility in taking scheme benefits provided this did not result in additional employer costs
- Tiered employee contribution rates – we did not support this because of the risk that lowering rates for the lower paid could encourage some individuals to join who would be better off not contributing to the scheme and relying instead on the state pension and means-tested benefits.
- Employer contribution rates for future service benefits – we felt it was important these did not increase above their current levels
- Two-tier ill-health benefits – we recommended consideration be given to allowing a lower benefit to be awarded in cases where incapacity was judged to be serious but possibly not 'permanent' in terms of the current regulations
- Future cost sharing mechanism – we agreed that it could be appropriate to ask members to share in any future increase in scheme costs caused by demographic (but not financial) changes. However, we flagged up the difficulty in implementing this in a locally-based scheme like ours if for example mortality improvements were only regional in nature.

8 The full consultation response is included at Appendix A.

Conclusion

9 Members are asked to note the report.

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Appendix A

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Nick Orton

Ms N Rochester
DCLG

By email

28 September 2006

Dear Ms Rochester

Where next? – Options for a new-look Local Government Pension Scheme in England and Wales
Consultation response on behalf of Durham County Council

I am writing in response to the 'Where next?' consultation document issued in June 2006. We welcome the opportunity to comment on this document.

Durham County Council is the largest local authority in the North East of England with a population of 499,800. It is also a major employer within the Local Government Pension Scheme with almost 10,000 current employees contributing to the Scheme. The Council also has a key role to play as an administering authority within the Local Government Pension Scheme and is responsible for the administration (including investments) of the Durham County Council Pension Fund.

Please find enclosed a response sent on behalf of Durham County Council both as an employer and as an administering authority within the Scheme.

I hope this is useful, please contact me if you need to discuss any of the issues raised in this response.

Yours sincerely

Nick Orton
Head of Pensions

Where next? – Options for a new-look Local Government Pension Scheme in England and Wales

Consultation Response from Durham County Council as an Administering Authority and as an Employer within the Durham County Council Pension Fund.

The four options

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

Option A (updated current scheme)

Support

- Provides good quality final salary scheme
- Slight reduction in cost
- No issues with converting existing scheme membership

However

- Does not always support flexible working patterns – e.g. reducing grade and responsibility prior to retirement could affect benefits as the definition of final salary is fairly restrictive. Could final salary definition be expanded to include best of previous 5 (or 10) years uplifted by a factor which could be RPI or something similar?

Option B (final salary scheme with higher accrual rate)

Not able to support

- Increased costs would be difficult to justify to taxpayers particularly against a backdrop of declining provision of good quality pension schemes in the private sector.

Unless:

- Scheme members pay for the full additional cost compared to Option A through higher contribution rates.

Option C (career average scheme – two sub-options)

Support

- Career average structure appears more equitable – benefits are more closely linked to contributions than in a final salary scheme which disproportionately rewards long serving members who have significant pay increases late in their careers.

However

- Accrual rate and indexation need to be considered carefully to ensure a career average scheme is not more expensive than the current scheme. A more expensive scheme could be acceptable provided scheme members pay the full additional cost compared to Option A through higher contribution rates.

- A career average scheme would be difficult to sell to staff – final salary schemes have long been promoted as the best for of pension provision so career average may be viewed with suspicion. Whilst career average schemes appear more equitable in some respects than other options there appears to be no great support for this option from Trade Unions.

Option D (hybrid – career average with opportunity to choose final salary)

Do not support

- Too complex - offering members a one-off choice about career average or final salary creates problems around communicating with and educating members without straying into the realms of giving advice. Most members will not have the necessary background knowledge to make an appropriate choice and will rely heavily on the literature provided by the administering authority. Inevitably some members will make the wrong choice and this would lead to resentment, disputes and perhaps appeals.
- If the basic scheme is career average with a 1.85% accrual rate, if final salary is selected this is equivalent to an accrual rate of 1/54th. Even with additional member contributions required this seems an unnecessarily generous scheme to be offering in the public sector.

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?

- Unless the members' contribution rate is appropriately increased Option A is on balance our preferred option as it does not involve an additional burden on the taxpayer and provides benefits that are at an appropriate level and are readily understood.

Flexible and early retirement

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?

We support (a) (allowing members to pay extra contributions to offset any reduction in pension should they wish to retire early) and (e) (benefits earned after age 65 to be increased when a member retires after age 65). Both these options should be cost-neutral to the scheme – at present, it could be argued that not increasing benefits earned after age 65 is not equitable as members are paying contributions based on retiring at 65.

We also support (c) and (d) provided they are both implemented together. If the decision to take pension benefits whilst remaining in work is cost-neutral to the Fund, employer consent should not be required. There is also no requirement to link it to a change in working practices through a reduction in hours or grade. We recognise that there are risks to this approach – scheme members could take their pension benefits early even though they may be substantially reduced for early payment where this may not be in their long term financial best interest. Also, if flexible retirement does encourage scheme members to take benefits earlier and with greater reductions applied than currently happens, this could lead to a burden on taxpayers in future as they are more likely to need financial support from the State in old age. However on balance we feel individuals should be allowed a broad range of options when it comes to taking their pension benefits from the Scheme.

Employee and employer costs

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

If Option A is chosen, this has a slightly lower cost than the current scheme and as such we feel it is appropriate to have an employee contribution rate of 6%. To the extent that the new-look scheme costs more any increase in cost should be borne by the scheme members through a higher member contribution rate and not by the taxpayer.

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?

A tiered contribution rate is not appropriate if a career average structure is selected as this type of scheme already ensures an equitable cost / benefit split. For a final salary scheme there are some attractions to a tiered contribution rate, particularly if this would encourage wider participation in the Scheme. However, there are significant problems with a tiered contribution rate particularly regarding the lower paid. If we encourage lower paid workers to join the Scheme by offering them lower contribution rates, there is a risk that we will encourage people to join who would be better off remaining contracted-in to the State scheme and relying on a combination of State scheme benefits and means-tested top-ups in retirement. On the other hand, there is an argument that all employees should join as Scheme benefits provide more certainty of income than future State benefits and / or means-testing. A tiered contribution rate also raises equality issues – for example, it is not clear why it is equitable to charge a higher contribution rate to someone who joins and remains on a high salary for a number of years compared with someone whose salary increases from low to high over the same period.

On balance, we do not support a tiered contribution rate in the new-look scheme, although this could be reviewed if the State provision alters in future (as proposed in the Government's recent pensions White Paper 'Security in retirement: towards a new pensions system').

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?

Future service costs for employers should not increase above their current levels when the new-look scheme is introduced.

Two-tier ill-health pension provisions

T7 Do you support or oppose the proposal to move to a two-tier basis for ill health pension provision? Why?

We support the concept of two-tier ill health provision but think further debate is needed over to what extent the benefits available to those qualifying for the top-tier of ill health benefit should be reduced to 'pay' for the additional cost of providing second-tier ill health benefits.

The two-tier proposal refers to the possibility of periodic reviews of incapacity but does not explicitly deal with the issue of permanence. Most of the declined ill health cases we have occur where the individual is currently unfit to carry out their own job or any other comparable job but the independent doctor is not able to certify that their incapacity is permanent i.e. it will last at least until age 65. Consideration should be given to a two-tier ill-health structure where the top-tier is for those judged to be permanently incapacitated and the second-tier is for those judged to be incapacitated for a lesser period (at least 5 years?). In this situation anyone granted second-tier benefits could have immediate unenhanced but unreduced benefits paid with a medical / earnings review after 5 years.

A future cost sharing mechanism

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

In principle we can see there is an argument for introducing a future cost sharing mechanism into the LGPS and we would support its introduction subject to the following comments:

The structure of the LGPS – split into 89 parts that are locally funded and administered and are valued by different actuaries working to their own assumptions – makes introduction of cost sharing problematic. For example, a review of demographic assumptions over the last few years will probably have revealed lower improvements in mortality in the Durham Fund than have been experienced nationally. If this situation continued in future it could lead to anomalies if the cost sharing mechanism triggered a required increase in member contributions because of improved mortality in the LGPS when the mortality rates for the members of some Funds may have improved only minimally or not at all.

Any future cost sharing mechanism can not simply be linked to an assessment of scheme funding level. In our view it would be inappropriate to increase member contributions and/or reduce future member benefit accrual rates purely in response to a perceived change in market conditions or a set of investment returns that were below expectations. Currently actuaries tend to value pension scheme liabilities by setting a discount rate which is based on the yield on fixed interest gilts (appropriately adjusted). This approach can give fairly volatile results, particularly if interest rates are changing. For example, the recent rise in interest rates will (all things being equal) have improved the funding position of the Scheme. If a cost sharing mechanism is introduced some method will have to be formulated to try to strip out most of the short term volatility that can feature in pension scheme valuations.

Future cost sharing based on demographic changes (such as a national improvement in mortality beyond that assumed in future pension costs) would be much easier to justify than future cost sharing based on financial factors such as a perceived reduction in expected investment returns.

Existing scheme members in the new-look scheme

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

The most transparently equitable approach and one which will not impose additional costs on the Scheme (except some marginal costs caused by additional administrative complexity) would be Method C. This involves continuing to calculate members' pre April 2008 service based on the old regulations.

Scope of scheme employers' discretions

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?

Oppose - Employer discretions add complexity and cost to the Scheme. Employers wishing to provide additional benefits to employees can do so outside of the pension scheme.

Scheme Actuary Costings

We asked our actuary Chris Archer of Hewitt Bacon & Woodrow Limited to provide some costings for the Durham Fund based on the options in the consultation document. The following table summarises the results and shows estimated future service costs for new entrants under each option. Chris provided a full report which explained a number of reasons for the different costs shown for the Durham Fund and the deviation from the GAD costings. These included the use of different assumptions and in particular different methodology (the Projected Unit rather than Attained Age/ Entry Age contribution method of calculating contribution rate). It is perhaps more relevant to look at the relative costs shown in the following table instead of focussing on the specific percentages.

Benefit Scale	Total Estimated Cost (% Pay)	Estimated Employee Rate (see below) (% Pay)	Estimated Employer Cost (% Pay)
Z – as certified at the 2004 valuation	19.4	5.8	13.6
W – Scheme at 1 Oct 2006 for new entrants	18.2	6.0	12.2
A – Updated current scheme	17.9	5.1	12.8
B – 1/60th Final salary scheme	19.6	6.6	13.0
C1 – CARE Scheme (1.85%, RPI)	18.8	6.3	12.5
C2 – CARE Scheme (1.65%, RPI + 1.5%)	19.9	6.2	13.7
D – Hybrid arrangement	19.7	7.0	12.7