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THE ROYAL BOROUGH OF KENSINGTON AND CHELSEA

CABINET 28 SEPTEMBER 2006

REPORT BY THE EXECUTIVE DIRECTOR FOR FINANCE, INFORMATION SYSTEMS AND PROPERTY

LOCAL GOVERNMENT PENSIONS SCHEME 2008 - GOVERNMENT CONSULTATION PAPER

Cabinet is asked to approve the response as set out in **Appendix A,** subject to any changes it may wish to make. **FOR DECISION**

Background

1. The Department for Communities and Local Government (DCLG) issued a consultation paper on 30 June 2006 which set out a number of options being suggested for a new Local Government Pension Scheme (LGPS) to be introduced in April 2008 and seeking responses to a number of questions or submission of other proposals to be considered.

2. Responses are required by the 29 September 2006 and the Cabinet, on 27 July 2006, appointed a Pensions Sub-Committee to consider this in more detail and recommend the Council's response for endorsement by the Cabinet.

Introduction

3. New pension arrangements need to work for the local government of the future. The Government's consultation is an opportunity to reflect on what that scheme should look like.

4. The future scheme will need to
   - Enable local government to attract and retain the workforce it needs
   - Be acceptable to the taxpayer
   - Achieve desirable public policy outcomes such as pensions participation, equality, avoiding poverty in old age.

5. The Government consultation document seeks views on four different options for the LGPS:

Option

A Current scheme with no recycled savings

B Current scheme with 1/60th accrual rate no automatic lump sum

C1 Career average pay– 1.85 per cent annual accrual with RPI revaluation

C2 Career average pay– 1.65 per cent annual accrual with RPI +1.5 per cent revaluation

D Hybrid - as C1 or C2 with employee paying extra for final salary linked benefits in retirement

6. The different options distribute benefits differently between scheme members.
    - Final salary favours people with long service
    - Final salary favours people with large salary progression
    - Career average favours people with static salary or short service
    - Option C2 – with faster accrual while people work is preferable for long service; Option C1 with slower accrual, but an assumption of a higher earnings uplift, benefits short service more
    - A move to career average would disadvantage most the younger career officers, and advantage most the female part-timers or older career workers whose salary growth has flattened out for some time.

Attracting and retaining the right workforce

7. Some facts about membership: whilst the current stereotype scheme member is a man with a long career, the Borough's workforce is actually now very different.
    - 64 per cent of the Fund membership are women
    - 26 per cent are part time
    - The median earnings is £24,400
    - The average length of service is 8.7 years
    - The average annual pension is £5,860
    - The average age of the Fund's members is 42.

    The proportion of low paid workers in our fund is likely to be less than the norm – for example, we have no Direct Service Organisations (DSOs).

8. The differences in distribution mean it is relevant to ask what impact we want the scheme to have for the future workforce. Do

we want to favour the numerically greater short service staff or to favour, incentivise and attract experience and career progression?

9. In terms of attractiveness to the workforce it has been pointed out that a final salary scheme (Option B) is widely regarded as the gold standard and that career average schemes are currently treated with some suspicion.

10. The hybrid Option D tries to be the best of both worlds, and address these potentially divergent interests, with career average as the norm, but the option for career minded staff to opt to pay more for a final salary enhancement. This is proposed as a one-off choice although that seems restrictive for people who start work without great expectations and whose careers blossom later.

Tiered rates

11. Distribution of cost and benefits between employee groups can also be varied by tiered rates, whereby high earners pay a bigger percentage of salary than low earners. Tiered rates may be more likely to draw low earners into an occupational pension, and would adjust for the fact that people with long service and career progression benefit most from the current scheme. The government believe tiered rates would need to be considered in conjunction with options A or B. This approach also addresses a concern that pensions accrued by low paid people can result in a reduction of means tested benefits.

12. Conversely, it can be argued that the current tax and benefits regimes are not a stable foundation for the pension scheme, and that, long term, means testing is likely to become less favoured. There are administrative difficulties where people move in and out of bands or have multiple occupations. Lower take home pay for types of staff in short supply might also be recovered through pay bargaining, negating the cost benefit to the scheme.

Acceptable to the taxpayer

13. The costings below are the estimated <u>total</u> (for both employee and employer) for each option, as a percentage of pay. These are all costs for future service, e.g. what next year's work accrues. They exclude the existing backlogs that are currently being recovered.

Option	Description	Cost
A	Current scheme with no recycled savings	19.4%
B	Current scheme with 1/60th accrual rate no automatic lump sum	20.9%

C1	Career average pay– 1.85% annual accrual with RPI revaluation	20.6%
C2	Career average pay– 1.65% annual accrual with RPI +1.5% revaluation	20.5%
D	Hybrid - as C1 or C2 with employee paying extra for final salary linked benefits in retirement	

These figures were prepared by the Government Actuary – they do not represent actual contributions which depend on investment markets at valuation and on demographics.

14. In summary, Option A is the cheapest, because it includes in full the savings against the current scheme arising from the introduction of a lower cost two-tier ill health retirement basis, while increasing the benefits for death in service and partners pensions. Option B (a final salary scheme) and C (career average) offer the same scheme changes as above but include an estimated 50 per cent of savings recycled, as the agreed outcome of the tripartite talks with Government, employers and Unions. Option D is a hybrid – a career average scheme with an option for career minded people to opt (once only) to buy their own final salary benefit, by paying approximately three per cent more.

15. The Government's options focus on total cost, and assume a stable level of employee contributions. Any of the options could be made more affordable by increasing employee contributions – to say seven per cent (as the Royal Borough has previously suggested in its response to the Pensions Stocktake in 2003). This would probably be more acceptable to the workforce in combination with Option B or C - where the benefits package has improvements, than Option A – where benefits overall are reduced.

Cost sharing

15. The biggest effects recently on contribution rates have been due to
    - Investment return (post tax) – affecting asset values
    - Reduced bond yields – affecting liabilities
    - Longevity – affecting liabilities.

16. The four options themselves, as defined benefit schemes, will not change the current variability and the options have a similar spread of risk on contribution rates. There could be other ways risks can be shared between employer and employee, by, for example,
    - Revising contributions if costs vary
    - Changing benefits packages up or down
    - Varying pensions after retirement.

17. The DCLG sees significant problems in changing the contribution rate, which would have to be at national level, but would have differing impact on individual funds. For example in a well-funded scheme this could mean increasing contributions to create a surplus. A triennial variation in contributions or benefits could also

be a recipe for rolling employment disputes. However there could be more support for sharing longevity costs. This might also perhaps be more acceptable to scheme members than sharing risks on investment performance, which they could not control.

18. Relative stability in contribution rates can also be addressed through actuarial means, such as rolling averages of contribution rates across more than one valuation period, or the current toolbox of phasing, using differing asset performance assumptions, or periods of recovery. This Council has also used reserves for smoothing.

Draft response

19. The Pensions Sub-Committee proposed response is attached at **Appendix A**

20. Key points from the proposed response are:
    - Support for a defined benefit scheme.
    - Preference for Option A as striking the best balance between the need for an attractive scheme that supports professional local government service and the interests of the taxpayer.
    - Preference for an increase in employee contributions to seven per cent, particularly if Option B or C is selected by Ministers, as these increase the value of the package.
    - Not support tiered employee contribution rates.
    - Support for risk sharing of increased life expectancy, through periodic reviews of the benefits package in the context of future funding costs. It is suggested employers' contributions for future funding could be capped at 14 per cent (in line with teachers), calculated on a rolling three period average (or other technique that recognises the volatility of spot market valuations).
    - Support for flexible retirement but not without employer approval.
    - Comment that the implementation timetable seems very ambitious, given that IT systems changes depend on finalisation of details
    - Support for transitional arrangements that minimise the creation of winners and losers through the technique chosen

Recommendation

21. The Cabinet is asked to approve the response as set out in **Appendix A,** subject to any changes it may wish to make.

Sue Beauchamp
Executive Director for Finance, Information Systems and Property

DCLG Consultation Paper:
http://www.lge.gov.uk/pensions/content/documents/consultation_new_look.pdf

APPENDIX A

ROYAL BOROUGH - PROPOSED RESPONSE

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?

Suggested response
The Royal Borough would not oppose any of the options being proposed as they all have some merit. If a career average pay scheme were to be adopted (C1 or C2) then we can see no reason why a hybrid system should not be introduced for those employees who wish to meet the additional cost themselves (three per cent) of maintaining a final salary scheme.

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?

Suggested response
The Council has an important duty to taxpayers to keep costs low while at the same time being fair to existing staff. We believe that Option A offers the most acceptable way forward in that it is the lowest cost option while at the same time maintains the same basis as the present scheme in that it is based on final salary, and therefore likely to the one most acceptable to employees in the scheme since it is most familiar.

A final salary scheme is a valuable recruitment and retention tool, as it tends to focus benefits on longer-serving staff, particularly on those who progress up the earnings scale whilst in employment. Longer serving, career staff are likely to receive a lower benefit under a career average scheme than under a comparable final salary scheme. This is an issue for scheme members if they wish to plan and budget for their retirement. Under a career average scheme they will need to have a view at the outset of their employment about what level they may rise to in their career in local government in order to consider what replacement income level they wish to target. This will be extremely difficult to determine early on in a person's career.

Option A also presents the least administratively complex solution, which is important, as we believe that there is a real danger that options B-D will *not be capable of being delivered within the desired timescale, especially if a transfer of all staff to a new basis from 1 April 2008 were to be attempted so that all staff operate on the same basis from that date onwards. This is a very ambitious target considering the amount of work still to be done. In moving to a new scheme we would prefer a transitional arrangement that minimizes the number of winners and losers.*

As an additional improvement, not covered by the consultation paper, we would propose that pensionable pay could be redefined to exclude 'one-off' elements of pay such as ad hoc bonus payments, since this can distort the pension cost within a final salary scheme, and result in hidden additional costs to the pension fund. This would require some protection for employees who have already made contributions to the pension in the past, based on these elements of pay.

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?

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;
   Oppose *as this would be administratively complex and the employee can already contribute to an AVC scheme to compensate for a lower pension on earlier retirement.*

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)
   There is no need to make this change as the scheme rules already permit flexible retirement from age 50.

c. Remove the requirement for employees to obtain employer consent for flexible retirement.
   Strongly Oppose *as this can be costly for the pension fund / employer. The latter must retain the option to give consent.*

d. Remove the requirement for employees to take a reduction in hours or grade in order to take flexible retirement.
   Strongly Oppose *as there would be a strong incentive for <u>every</u> employee over the minimum age to request flexible retirement so that they carry on drawing a salary <u>and</u> a pension at the same time. This was not the intention of the present scheme which was to*

enable a managed "winding down" to 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.
   Support *– it is difficult to argue against this since benefits taken later are less costly for the pension fund.*

Employee and employer costs
Relevant Chapters: Chapters 1-6, 11
C4 What should the average employee contribution rate be in the new-look scheme?

Suggested response
In our response to the Pensions Stocktake in 2003 we proposed that the employee contribution rate should be increased from six per cent to seven per cent and see no reason why this should not still be appropriate. This maintains approximately a 1/3rd: 2/3rds split between the employee and employee based on the projected future cost of the scheme in the long term. We do not believe that it is possible, within a national pension scheme, where individual employers' contribution rates are determined on the basis of the fund's local characteristics, that future service contributions can be determined other than on a standard percentage basis for all schemes.

Furthermore we do not believe that it is sensible to base a scheme cost-sharing formula on a "target" cost that is dependent on savings that are presently indeterminate. Future longevity changes will be offset by reduced employer costs as existing members leave the scheme. Any further demographic changes can be considered in the future and the scheme benefits adjusted, or contribution levels re-considered in the light of the circumstances at the time. This could be triggered if employer contribution rates nationally exceeded an average of 14 per cent.

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?

Suggested response
We are pleased to note that the previously proposed complex range of tiered employee contribution rates, linked to National Insurance (NI) bands and with a "cliff-edge" effect at each tier are no longer being pursued. We have argued, in our responses to previous proposals, for a flat rate cut off point with zero contribution rate below this level but no longer believe this to be a sensible approach.

Depending on the level of their earnings and career path/working pattern, an employee could, under the current pensions system, (due to the combination of the employee contribution rate (six per cent) and the level of any tax relief and reduced national insurance contributions[1]) be better off not *joining the LGPS. The employee could rely instead on the State Second Pension and the Pension Credit. Until the Government creates a position whereby there is no disincentive to save towards a pension, there is little merit in designing a scheme to attract the lower paid to join. A zero rate would naturally attract more employees into the scheme but this would result in an increased pay bill for employers. With any scheme that has a flat rate cut-off there will be complications arising from people with more than one job, especially if it is with more than one employer.*

While the new scheme objective is to equality-proof the scheme we are not convinced that this is a sensible objective. A pension scheme is not an appropriate vehicle for redistribution of wealth, which ought to be the responsibility of national taxation and savings policies. One alternative, not considered in the consultation paper, could be to limit tax relief on pension contributions to the standard rate of tax so that higher paid employees pay exactly the same proportion of gross pay as lower paid employees. At present the real cost is 3.6 per cent of pay for higher rate taxpayers and 4.7 per cent for basic rate taxpayers. However it is recognized that this might discourage some people from increasing their saving for retirement.

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?

Suggested response
We believe that an affordable employer contribution rate would be one that is around 13 per cent of pensionable pay. This equates to the equivalent to Option A with the employee paying seven per cent. Over time, as existing members leave the scheme, this would ultimately reduce to about ten per cent, though increased longevity may well result in this level being higher in practice.

[1] The cost of joining the LGPS for lower paid employees who are not paying tax or NI is a full six per cent of pay as they will receive no tax relief on their contributions and no reduction in NI contributions.