



Members Update October 2010



The Local Government Pension Scheme

Hutton rules out individual defined contribution for revised LGPS Interim report published - final recommendations expected Spring 2011

Lord Hutton's interim report on the future of public service pensions was published on 7th October. A response from Government was included in the Comprehensive Spending Review (CSR) on 20th October and confirmed Lord Hutton's view that some kind of defined benefit arrangement is the appropriate way forward for public sector pensions.

In the report Lord Hutton affirmed the important place public sector pension schemes, such as the LGPS, occupy in providing for a reasonable income in retirement. He also made clear that existing pensions either in payment or built up so far would not be affected by his proposals, although he did acknowledge the Government's intention to move from the Retail Price Index (RPI) to the Consumer Price Index (CPI) would impact on future increases for LGPS current or deferred pensioners.

Lord Hutton went on to say that a number of factors including increasing life expectancy meant that the

balance of risk and cost shared by employers and scheme members needed to be re-addressed. This could be achieved by a combination of staged and targeted increases to employee contributions for example and a review of the current final salary basis of the scheme. He also stressed the need to review pension age in the light of increased longevity.

He intends to explore a number of alternatives to final salary in his full report due early next year but did rule out individual defined contribution arrangements and counselled against a 'race for the bottom' in terms of pensions provision.

Short and long term options for reform

The report used the principles of **Affordable and sustainable, Adequate and fair, Supporting productivity and Transparent and simple** when considering how the LGPS should look in the future and reached the following conclusions;

Reform is needed in order to better meet the principles set out overleaf. In the **short term** such reform should include;

- A commitment to protect accrued rights – however this does “not extend as far as protecting current terms for future pension accrual”.
- No alteration in current benefit levels
- There is a case for an increase in employee contributions but any increase should be geared toward higher earners (the CSR has now confirmed a target of £1.8bn in increased contributions by 2014 – roughly equivalent to an average 3% increase)
- The LGPS should remain contracted out of the State Second Pension (SSP)

Long term reforms should address the inflexible nature of the scheme together with the issues of discouraging mobility and disproportionately rewarding high flyers. In his full report Lord Hutton will recommend options for future reform. In considering these options Lord Hutton will take into account his view that;

- Neither final salary Defined Benefit (DB) or individual Defined Contribution (DC) schemes provide an answer long term and should be ruled out

- A system providing for a rebalancing of risk away from the employer and toward the employee is needed

The final report will therefore consider the following alternative scheme structures

- Career Average (CARE) DB – These schemes calculate a benefit each year based on the salary for that year. Each year’s pension is then increased in line with the cost of living. The pension paid on retirement is the total of the pensions for all years of membership.
- Notional DC – suitable for unfunded schemes only and therefore not applicable for the LGPS
- Collective DC – contributions are paid in a central fund and a target pension set. That target pension is revised each year in line with the performance of the fund (it may go down as well as up). On retirement the final target pension is paid to the member.
- Cash Balance DC – again contributions are paid into a central fund with the employer guaranteeing a cash value for those contributions at year end. If returns are not sufficient to meet that value then the employer will provide the balance. The total pension pot on retirement is then used to purchase an annuity.

- Sequential hybrid – schemes where the type of provision changes throughout working life. For example it may start as a DC scheme but move into a DB scheme after a number of years of membership. Members are either DB or DC at any time, not both
- Capped DB – The salary used in the calculation of the pension is capped at a predetermined level. Any salary above that level is not used for calculating either contributions or benefits.
- Combination Hybrid – Both DB and DC at the same time. For example CARE DB up to a pay cap with a Collective DC arrangement for pay above the cap.

The Government's recent commitment to a defined benefit scheme (see below) means that none of the above DC arrangements will directly replace the current final salary scheme. They may however feature as a part of a sequential or hybrid arrangement.

As well as the above systems Lord Hutton will also consider:

- How to ensure pension ages stay in line with longevity
- Reviewing how pension amounts are adjusted for early or late retirement
- The method of indexation both during build up and payment of pensions

- Appropriate accrual rates for the different schemes
- The taxation framework for pensions
- The ongoing appropriateness of contracting out of the State Second Pension
- The case for and against reducing the number and types of public sector schemes
- How to best protect accrued rights whilst ensuring no future pension accrual on those terms takes place
- The potential benefits of consolidating the number of LGPS administering authorities in England and Wales.

Government response

In the Comprehensive Spending Review (CSR) published on 20th October the Government responded to the interim report as follows:

The Independent Public Service Pensions Commission (IPSPC) led by John Hutton published an interim report on 7 October. The report highlights the importance of providing good quality pensions to public servants, rejects a race to the bottom in pension provision, but concludes that there is a clear rationale for public servants to make a greater contribution if their pensions are to remain

fair to taxpayers and employees, and affordable for the country. The Government accepts these conclusions. In response to the Commission's interim recommendations, the Government will:

- *commit to continue with a form of defined benefit pension;*
- *await Lord Hutton's final recommendation before determining the nature of that benefit and the precise level of progressive contribution required;*
- *carry out a public consultation on the discount rate used to set contribution rates in the public service pension schemes;*
- *implement progressive changes to the level of employee contributions that lead to an additional saving of £1.8 billion a year by 2014-15, equivalent to three percentage points on average, to be phased in from April 2012;*
- *exempt the armed forces from this increase in employee contributions;*
- *launch a consultation on the Fair Deal policy, which Lord Hutton noted can create a barrier to the plurality of public service provision and make it more difficult to achieve innovation, to report by Summer 2011, informed by Lord Hutton's final recommendations on structural reform; and*

- *seek engagement with all stakeholders including trade unions*

The CSR also contains a commitment to equalise state pension age at 65 by April 2018 and then increase it to 66 by April 2020. It may not be too much of a leap to expect public sector pension ages to follow suit.

For further information please see the documentation available on http://www.affordable-lgps.org.uk/Commission/commission_report.htm

New Tax rules for 2011

HM Treasury has issued a document Restricting Pensions Tax relief which outlines their proposals for a new tax regime for pensions from April 2011;

The major changes are:

- A reduction in the Annual Allowance (AA) to £50,000 from 1st April 2011
- A reduction in the Lifetime Allowance (LTA) to £ 1.5m from 1st April 2012

For the majority of scheme members these changes will have no effect, however for those who are high earners or who may receive a significant increase in pay next year then there may be some impact.

Lifetime Allowance

The allowance for the total pension pot is to be reduced from £1.8m to £1.5m from 2012. To hit the £1.5m limit would require an annual pension of around £75,000 at retirement.

Most members with long service already benefit from protected individual limits which will remain in place. Anyone with more than £1.5m but less than the £1.8m current limit on 1.4.2012 will also benefit from protection.

We will aim to contact all of those who may be affected by the new limit once regulations are in force.

Annual Allowance

The method for assessing if the annual allowance has been exceeded is that the Pension Input Amount (PIA) is calculated and compared to the allowance. The PIA is the increase in pension entitlement for the year x 16

The increase in pension entitlement is calculated by taking the total pension accrued at the end of the year and subtracting the pension at the end of the previous year increased by inflation. To exceed the limit the increase would have to be greater than £3,125. Members will be allowed to bring forward any unused allowance for the last three years.

Those most at risk of exceeding the limit are high earners with long service who receive pay increases well above inflation during the year.

Example 1 (moderate pay and increase)

2011-12	
Pensionable Pay for year ending 31.3.2011	£25,000.00
Pensionable Pay for year ending 31.3.2012	£27,500.00
Pre 08 membership at start of year	10
Post 08 membership at start of year	4
Inflation in year	3%
<i>Total allowance for year</i>	£50,000.00
<i>Opening pension entitlement</i>	£5,542.64
<i>Inflated opening pension</i>	£5,708.91
<i>Closing pension entitlement</i>	£6,555.23
<i>Increase</i>	£846.32
<i>Pension Input Amount (PIA)</i>	£13,541.09
<i>Tax charge</i>	£0.00
<i>Allowance carried forward</i>	£36,458.91

In the above example the PIA is well below the allowance meaning no tax charge and allowance available to be carried forward.

Example 2 (high earner with significant increase)

2011-12	
Pensionable Pay for year ending 31.3.2011	£75,000.00
Pensionable Pay for year ending 31.3.2012	£100,000.00
Pre 08 membership at start of year	26
Post 08 membership at start of year	4
Inflation in year	3
<i>Total allowance for year</i>	£50,000.00
<i>Opening pension entitlement</i>	£35,232.56
<i>Inflated opening pension</i>	£36,289.53
<i>Closing pension entitlement</i>	£48,643.41
<i>Increase</i>	£12,353.88
<i>Pension Input Amount (PIA)</i>	£197,662.02
Tax charge	£59,064.81
<i>Allowance carried forward</i>	£0.00

In this example of a high earner with lots of service who receives a significant promotion there appears to be a very large tax liability. However the above doesn't take into account any unused allowances from previous years. If this person's pay rises over the last three years had been modest (say £1,000 per annum) the calculation would look like this;

Example 2a (high earner with significant increase and unused allowances)

2011-12	
Pensionable Pay for year ending 31.3.2011	£75,000.00
Pensionable Pay for year ending 31.3.2012	£100,000.00
Pre 08 membership at start of year	26
Post 08 membership at start of year	4
Inflation in year	3
Unused allowances	£116,210.56
<i>Total allowance for year</i>	£166,210.56
<i>Opening pension entitlement</i>	£35,232.56
<i>Inflated opening pension</i>	£36,289.53
<i>Closing pension entitlement</i>	£48,643.41
<i>Increase</i>	£12,353.88
<i>Pension Input Amount (PIA)</i>	£197,662.02
Tax charge	£12,580.58
<i>Allowance carried forward</i>	£0.00

The tax charge is still sizeable but is significantly reduced from that shown above. Treasury have also stated that where such 'one off' increases produce tax charges then there would be a possibility of recovering the tax from the pension rather than income in the year.

Further information including the full Treasury document can be found at http://www.hm-treasury.gov.uk/consult_pensionsrelief.htm

Aggregation of LGPS deferred benefits Pension credit members Early payment of 3rd Tier Ill Health

The LGPS (Miscellaneous) Regulations 2010 were laid before Parliament 25th August 2010 and come into force on 30th September 2010. They make a number of amendments to the LGPS Regulations. Many are minor corrections or updates but there are four major developments.

Those major changes are:

- Rejoining deferred members can now **aggregate all LGPS deferred benefits** not just the membership accrued in their immediately preceding local government employment
- There is a **12 month window** for active members to bring in membership they were previously prohibited from aggregating
- **Pension credit** member benefits are now payable from age 60 with reductions
- There is an **early payment option** from 55 for suspended Tier 3 Ill-health retirees

Aggregation of deferred benefits

Currently new joiners to the LGPS can only opt to transfer in deferred benefits relating to scheme membership directly preceding the current employment.

From 30.09.2010, new joiners can now opt to aggregate all of their previous membership. They have 12 months from joining to initiate the process by requesting an inter fund transfer from the previous fund/s.

12 month window

Existing members, even those who have previously turned down the opportunity to aggregate on rejoining, will be able to make an option to aggregate up to 30.9.2011. Once this date has passed no new options outside the 12 month limit can be accepted without employer consent.

The benefits of aggregation (bringing all of your previous LGPS membership into your current fund) will depend on a number of factors including your pensionable pay.

Please consider that aggregation in 2011-2 will count toward the increase in pension entitlement for that year and may therefore incur a tax charge under the new arrangements referred to above.

Please contact the pensions section as soon as possible if you have deferred benefits you may want to transfer.

Pension credits payable from age 60

This amendment extends the rights of individuals who have been awarded a share of retirement benefit following their divorce from a member of the LGPS.

Previously, pension credits could only be taken by members at their 65th birthday (unless they were suffering from serious ill-health). They are now allowed to take them from age 60 with full actuarial reductions, i.e. a male member taking them at 60 would receive a 24% reduction to his pension and a 12% reduction to any lump sum payable.

Pension credit members are not allowed to commute pension in order to increase their lump sum but may commute trivial pensions.

The effective date for this change is 6th April 2009 which means pension credit members who reached 60 prior to that date may elect to have their pension put into payment from that date with interest. If this applies to you please contact the pensions section.

Early payment of 3rd Tier Ill Health

A member who has had Tier 3 ill health retirement benefits, which have been suspended on review or after 3 years, is entitled to their retirement pension at age 65. Such members can now access their deferred benefits from age 60 or from age 55 with employer permission. An actuarial reduction will be applied to the benefits in accordance with Government Actuary guidance.

This ensures that members with suspended ill-health benefits are afforded the same capacity for release of those benefits before age 65 as deferred members of the Scheme.

This provision is effective from 1st October 2008 which was the end of a period of transitional protection, and provides continuity of rights to members who have left in receipt of the third tier of ill-health benefits from that date.

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