PENSIONS COMMITTEE

AGENDA

7.30pm	Thursday, 21 September 2006	Havering Town Hall, Main Road, Romford

Members 6: Quorum 3

COUNCILLORS:

Conservative Group (4)
Melvin Wallace - (Chairman)
Roger Ramsey - (V.Chairman)
David Charles
Mark Gadd

Residents' Group (2)
Clarence Barrett
Linda van den Hende

Trade Union observers with no Voting Rights (2)
Brian Long (Unison)
Michael Parker (TGWU)

For information about the meeting please contact:
Debbie Okutubo (01708) 432432
E-mail: deborah.okutubo@havering.gov.uk

NOTES ABOUT THE MEETING

1. HEALTH AND SAFETY

The Council is committed to protecting the health and safety of everyone who attends meetings of its Committees.

At the beginning of the meeting, there will be an announcement about what you should do if there is an emergency during its course. **For your own safety and that of others at the meeting, please comply with any instructions given to you about evacuation of the building, or any other safety related matters.**

2. MOBILE COMMUNICATIONS DEVICES

Although mobile phones, pagers and other such devices are an essential part of many people's lives, their use during a meeting can be disruptive and a nuisance. Everyone attending is asked therefore to ensure that any device is switched to silent operation or switched off completely.

3. CONDUCT AT THE MEETING

Although members of the public are welcome to attend meetings of the Committee, they have no right to speak at them. Seating for the public is, however, limited and the Council cannot guarantee that everyone who wants to be present in the meeting room can be accommodated. When it is known in advance that there is likely to be particular public interest in an item the Council will endeavour to provide an overspill room in which, by use of television links, members of the public will be able to see and hear most of the proceedings.

The Chairman of the meeting has discretion, however, to invite members of the public to ask questions or to respond to points raised by Members. Those who wish to do that may find it helpful to advise the Committee Officer before the meeting so that the Chairman is aware that someone wishes to ask a question.

PLEASE REMEMBER THAT THE CHAIRMAN MAY REQUIRE ANYONE WHO ACTS IN A DISRUPTIVE MANNER TO LEAVE THE MEETING AND THAT THE MEETING MAY BE ADJOURNED IF NECESSARY WHILE THAT IS ARRANGED.

If you need to leave the meeting before its end, please remember that others present have the right to listen to the proceedings without disruption. Please leave quietly and do not engage others in conversation until you have left the meeting room.

AGENDA ITEMS

1. CHAIRMAN'S ANNOUNCEMENTS

The Chairman will announce details of the arrangements in case of fire or other events that might require the meeting room or building's evacuation.

2. APOLOGIES FOR ABSENCE AND ANNOUNCEMENT OF SUBSTITUTE MEMBERS

(if any) - receive.

3. DECLARATION OF INTERESTS

Members are invited to declare any interests in any of the items on the agenda at this point of the meeting. Members may still declare an interest in an item at any time prior to the consideration of the matter.

4. MINUTES OF THE MEETING HELD 3 JULY AND 22 AUGUST 2006

To approve as a correct record minutes of the meetings held 3 July and 22 August 2006 and to authorise the Chairman to sign them.

5. ANNUAL PRESENTATION FROM WM

6. PENSION FUND PERFORMANCE MONITORING FOR THE QUARTER ENDED 30 JUNE 2006 - *attached*

7. REVIEW OF THE STATEMENT OF INVESTMENT PRINCIPLES AND THE FUNDING STRATEGY STATEMENT - *attached*

8. GOVERNMENT CONSULTATIONS ON PROPOSED CHANGES TO THE LOCAL GOVERNMENT PENSIONS SCHEME (LGPS) - *attached*

9. REVIEW OF THE PENSION FUND CUSTODIAN - *attached*

10. URGENT BUSINESS

To consider any other item in respect of which the Chairman is of the opinion, by reason of special circumstances which shall be specified in the minutes, that the item should be considered at the meeting as a matter of urgency.

Stephen Evans
Chief Executive

MINUTES OF A MEETING OF THE PENSIONS COMMITTEE
Havering Town Hall, Romford

3 July 2006 (7.30pm – 10.05pm)

Present:

COUNCILLORS:

Conservative Group	Melvin Wallace (in the Chair), David Charles, Mark Gadd and Roger Ramsey
Residents Group	Clarence Barrett Linda van den Hende
Non - Voting Union Member	Brian Long, Unison Michael Parker, TGWU

No Member declared an interest in any of the items before the Committee.

The Membership of the Committee and appointment of Chairman and Vice Chairman was noted by the Committee.

The Chairman advised everyone present of action to be taken in the event of emergency evacuation of the Town Hall becoming necessary.

1. **MINUTES**

The minutes of the meeting held 14 March 2006 were agreed as a correct record and signed by the Chairman.

2. **PENSION FUND PERFORMANCE MONITORING FOR THE QUARTER ENDED 31 MARCH 2006**

A report providing the Committee with an overview of the performance of the Havering Pension Fund investments for the quarterly period to 31 March 2006 was presented by Val Burdett-Callan from Psolve.

The performance information presented is taken from the quarterly performance report supplied by each Investment manager, the WM Company quarterly performance review report and the Psolve monitoring report. Gross return on the Fund's investment for the quarter to 31 March 2006 was 4.2%. The tactical benchmark returned 3.6% over the same period. This represents an out performance of 0.6%.

The overall gross return of the Fund's investment for the year to 31 March 2006 was 23.4%. This compared to the annual tactical combined benchmark of 20.3% an out performance of 3.1%.

Val Burdett-Callan reported to the Committee that as trustees they need to be aware of the different level of risk associated with the different asset classes.

Each Manager's individual performance with the key information relevant to their performance, was reported to the Committee.

Alliance Bernstein
Les Komaromy, Client Relations & Servicing Institutional Investments Manager and Michael Palmer, Senior Portfolio Manager- Global Style Blend attended the Committee.

The Committee was informed that, as at the inception date of 15 February 2005, the value of their portfolio within the Pension Fund was £55.3 million. The value of the portfolio as at 31 March 2006 was £76.8 million, which represented an increase of 39%.

Alliance Bernstein achieved a net performance of 7.7% during the quarter. This reflected an outperformance against the quarterly target of 1.2% or 120 basis points. Alliance Bernstein achieved an annual net return of 39.1% which was 6.2% or 620 basis points above the annual target. The outperformance annual target being 2.5% above the MSCI All Share Index benchmark, over a rolling 3 year period.

During the year ended 31 March 2006, world equity markets posted healthy gains amid robust and more balanced economic growth. It was a period when value indices again took a lead, as acquisition bids drove up many value holdings. However, although the value team has continued to deliver strong performance, it views the value opportunity as limited, creating opportunities for the growth team to buy superior growth stocks at unusually attractive prices.

Alliance Bernstein representatives attributed their good performance to their fundamental research approach that has given rise to established track record of success, consistent investment philosophies and bottom-up, research-driven stock selection. Representatives warned the Committee that performance since April may not be as favourable as in the previous quarter, due to the performance of the global stock markets.

Following the presentation, it was noted that there were no governance or whistleblowing issues to declare.

Psolve commented that they remain positive on Alliance Bernstein for both UK as well as Global Equities.

The Chairman thanked the Alliance Bernstein representatives for attending the Committee and they left the meeting.

Western Asset
Michael Zelouf, and Bruno Noble from Western Asset Management attended the meeting and presented to the Committee.

During the quarter ended 31March 2006, Western Asset achieved a gross return of -0.5%. This was 70 basis points above the benchmark, but equal to the quarterly target. The target set is an annual 3% gross return over the benchmark, over a rolling three year period. The performance to the year produced a gross return of 12.6% compared to the benchmark of 10.7%, an out performance of 1.9%. The annual result was however 110 basis points below the target. This poor performance during the year raised concerns. Psolve stated that they would monitor the situation.

Psolve commented that they have a positive view of Western's process and capabilities. Psolve also recommended that the investment is maintained and would continue to monitor the situation in the months following the transition to Western.

Following the presentation, it was noted that there were no governance or whistleblowing issues to declare.

The Chairman thanked the Western Asset representatives for attending the Committee and they left the meeting.

Val Burdett-Callan also left the meeting.

3. CIRCULATION OF REPORT ON THE WORK OF THE INVESTMENT COMMITTEE

The Interim Pension Fund Accountant presented a report on the work of the Investment Committee for the period 1 April 2005 to 31 March 2006 to all Members. The report included the financial position of the Havering Pension Fund, a summary of the performance of the Pension Fund investments and a list of key issues addressed during the period.

The Investment Committee met on seven occasions. During these meetings the investment strategy of the Fund Managers and their performance were reported on a quarterly basis to the Investment Committee. The Fund Managers were obliged to submit reports and valuations for this purpose and attend officer and Investment Committee meetings to make oral presentations and answer Members' and officers' questions

The value of the Fund as at 31 March 2006 was £341m. This was invested in equities in listed companies both in the UK and overseas, fixed interest securities, property funds and cash.

The financial year since April 2005 represents the first full year since the Fund has been restructured and split into 5 separate mandates for which a full tender process was carried out. The Council sets the overall investment strategy of the Fund and monitors performance of each manager against an agreed performance in relation to an agreed benchmark. The Council had delegated this responsibility to the Investment Committee, and now to the Pension Committee.

The Committee **noted** the report and wished to place their appreciation on record to the work of the previous Committee (Investment).

The Committee **agreed** that the Chairman present this report at full Council.

4. ANNUAL PLAN AND TRAINING PROGRAMME

A report setting out the plan of work and the training arrangements for the Committee for 2006/07 was outlined by the Group Director Finance & Commercial.

It is planned for the Pensions Committee to meet four times over the municipal year. The importance of all Members of the Committee and substitute Members being adequately trained and briefed in order to achieve the terms of reference of this Committee was emphasised.

A training questionnaire was distributed to Members with a request to return these to Debbie Ford the Acting Pension Fund Accountant.

Members **agreed** the annual plan and training programme.

5. STATEMENT OF ACCOUNTS – YEAR ENDED 31 MARCH 2006

The Interim Pension Fund Accountant presented an extract of the Council's Statement of Accounts for the year to 31 March 2006 showing the accounts of the Havering Pensions Fund.

The Committee was informed that the Pension Fund Accounts are presently subject to audit by the Audit Commission as part of the overall audit of the Council's accounts.

Key items to note from the statement were:

- The Net Assets of the Fund have increased from £276million to £341 million, a net increase of £114million. This is a reflection of the return of 23.4% on the Fund's investments for the year.

- The Fund outperformed the strategic benchmark by 9.7% and the tactical benchmark by 3.1% for the year to 31st March 2006. This has been the first full year since the fund restructure, which had seen the management of the pension fund move from one to five managers. The good performance, confirms that arrangements have settled and that the fund is showing good returns and is achieving the Fund's new objective.

The Annual Accounts for 2005/06 was presented unaudited. A copy of the audited accounts would be made available to every Member of the Council once it is completed and signed off.

Members **noted** the statement of accounts for year ended 31 March 2006.

6. PERFORMANCE OF THE PENSIONS ADMINISTRATION SERVICE 2005/2006

A report on the performance of the Pensions Administration Service was presented to the Committee by the Head of Exchequer Services.

The report outlined the numbers of active and deferred members and also included pensioners.

On performance of the service, the Committee was informed that the impact of a vacancy in the section and long term sickness absence resulted in an overall downturn in performance measures.

Two of the local performance indicators showed an improved performance over last year.

Following discussions Members **noted** the report of the Pensions Administration Service for 2005/2006.

7. LOCAL GOVERNMENT PENSIONS SCHEME REGULATION CHANGES 2006

The Head of Exchequer Services presented a report updating Members on the changes to the Local Government Pension Scheme (LGPS) that became effective from April 2006 and the proposed changes effective from October 2006.

The changes to the LGPS in 2006 are aimed at safeguarding the scheme and ensure it remains affordable and sustainable to the scheme's employers and local tax payers whilst being fair to existing

and future employees. The changes seek to address the social and economic challenges that result from changing demographics by encouraging people to work longer in order to improve the retention and transfer of valuable knowledge and skills in the workforce.

The proposed changes planned for October 2006 are still subject to a formal consultation process and ratification although it is unlikely that there would be significant amendment. The changes are:

- Phasing out the 85 year rule
- The normal retirement age for scheme members is already age 65 but employees can voluntarily retire from age 60 onwards (or from age 50 and before age 60 with their employer's consent).
- This is not changing but changes to what is known as the 85 year rule are being made.

ALIGNMENT OUT OF KILTER HERE
The 85-year rule decides if a person's benefits should be reduced or not if they choose to retire early. If you do not satisfy the 85-year rule, then your benefits are reduced if voluntarily drawn before age 65.

If a person decide to retire before age 65 and their age plus membership (each in whole years) at the time you start drawing your pension add up to at least 85 years there would be no early retirement reduction applied to their benefits. If they work part time, their membership counts towards the 85-year rule at its full calendar length.

The Government's legal advice is that the '85 year rule' will be in breach of Age Discrimination legislation which comes into force on 1st October 2006. For this reason the 85-year rule has been removed, but only in respect of benefits employees build up in the future. The pension rights have banked up to 30 September 2006 (or up to 31 March 2016 if be aged 60 or over by then) will not be affected and will continue to be calculated in the same way as if the changes had not been made.

This means if a member retires before age 65 the benefits they build up in the Scheme after 30 September 2006, or after 31 March 2016 if they will be aged 60 or over by then, may be paid at a reduced rate to reflect the fact that they will be drawing them early.

The change to the 85 year rule would not affect members if they draw their pension at age 65, if they are retired on the grounds of permanent ill health at any age, or if they are retired on or after age 50 on the grounds of redundancy or efficiency of the service. Pension benefits in these circumstances continue to be paid at an unreduced rate. The benefits of pensioners and deferred pensioners who left before 1October 2006 will also not be affected.

Members may not be affected by the change but if they are they would have full protection for the benefits they have built up in the Scheme to 30 September 2006 (or 31March 2016 if they will be 60 or over by then).

Only employees joining the Scheme after 30 September 2006 will be wholly affected by the change.

The Committee was informed that a news letter is about to go out to all staff in Havering, Redbridge and all other employees contracted in to the fund to update them of this proposed changes.

Following discussion, Members **noted** the changes to the LGPS effective from April 2006 and the proposed changes effective October 2006.

MINUTES OF A SPECIAL MEETING OF THE PENSIONS COMMITTEE
Havering Town Hall, Romford

22 August 2006 (7.00pm – 7.20pm)

Present:

COUNCILLORS:

Conservative Group	Melvin Wallace (in the Chair), Mark Gadd, Steven Kelly and Robby Misir
Residents Group	Clarence Barrett Linda van den Hende

Apologies for absence were received from Cllr Roger Ramsey and the non-voting union member Brian Long

+Substitute Members: Councillors Steven Kelly (for David Charles) and Robby Misir (for Roger Ramsey)

No Member declared an interest in the item before the Committee.

On behalf of the Chairman everyone present was advised of action to be taken in the event of emergency evacuation of the Town Hall becoming necessary.

8. THE ADMISSION OF 'CATERING FOR EDUCATION' TO HAVERING'S PENSION FUND

A report recommending that the eight members of staff transferring under a TUPE arrangement from the Council to a private contractor, Catering for Education continue to be members of the Local Government Pension Scheme was presented to the Committee.

It was explained that this would be done by admitting Catering for Education to the London Borough of Havering's Pension Fund as an admitted body. Catering for Education had succeeded in winning the contract to provide catering facilities to Abbs Cross School. The contract was for two years and would commence on 1 September 2006, hence the need to convene the Committee meeting as an urgent one pursuant to the Local Government Act 1972.

Officers explained that in accordance with Government policy for Local Government employers, Catering for Education were encouraged to

provide pension benefits for future service which were broadly comparable to those provided under the LGPS scheme.

New employees joining would not be covered under the TUPE transfer, as it was a closed admission agreement and this policy had been agreed in the past by members of the Committee. Officers suggested that the closed agreement might need to be reviewed sometime in the future as the current policy created a two tier system and best practice advocated for an open system.

The Committee were advised that the Pension Fund's actuary had assessed the level of indemnity bond and had set the initial level of the bond cover at £42,000.

Following further discussion, Members **agreed**;

- To admit Catering for Education to Havering's Pension Fund as an admitted body to enable staff transferring from the Council under TUPE to continue membership (or have the right of membership) of the LGPS (Local Government Pension Scheme) subject to;
  - All parties signing up to an Admission agreement and
  - An indemnity or insurance bond in an approved form with an authorised insurer or relevant institution, being put into place to protect the pension fund.

MEETING	DATE	ITEM
PENSIONS COMMITTEE	21 September 2006	6

REPORT OF THE CHIEF EXECUTIVE

SUBJECT: PENSION FUND PERFORMANCE MONITORING FOR THE QUARTER ENDED 30th JUNE 2006

SUMMARY

This report provides the Committee with an overview of the performance of the Havering Pension Fund investments for the quarterly period to 30th June 2006. The performance information is taken from the Quarterly Performance Report supplied by each Investment Manager, the WM Company Quarterly Performance Review Report and the Psolve Monitoring Report.

The net return on the Fund's investments for the **quarter** to 30th June 2006 was -2.7%. The tactical benchmark returned -2.3% over the same period. This represents an under performance of -0.4%.

The overall net return of the Fund's investments for the **year** to 30th June 2006 was 13.9 %. This compares to the annual tactical combined benchmark of 11.4% an out performance of 2.5%. It is now possible to measure the individual managers' annual return for the new tactical combined benchmark as they became active on the 14th February 2005. These results are shown later in the report.

RECOMMENDATION

1. That the Committee considers the Psolve performance monitoring report and presentation.
2. That the Committee receives the presentations from our UK Bonds Manager (Royal London) and our UK Equities Manager (Standard Life).

3. That the Committee notes the summary of the performance of the Pension Fund within this report
4. That the Committee considers the quarterly reports provided by each investment manager.
5. That the Committee considers and notes any Corporate Governance issues arising from voting as detailed by each manager.
6. That the Committee considers any points arising from officer monitoring meetings.
7. That the Committee considers having an Annual General Meeting for representatives of admitted and scheduled bodies.

REPORT DETAIL

1. Background

1.1 A major restructure of the fund took place in the first quarter of 2005. The transition of the assets to the transition manager's account happened in mid-January 2005, with the new managers taking charge of the assets from 14th February 2005.

1.2 Each manager has been set a specific benchmark as well as an outperformance target against which their performance will be measured. This benchmark is appropriate to the type of investments being managed. These are shown in the following table:

Manager and percentage of total Fund awarded	**Mandate**	**Benchmark**	**Out performance Target (net of fees)**
Standard Life 30%	UK Equities	FTSE All Share Index	2%
Alliance Bernstein 20%	Global Equities	MSCI All World Index	2.5%
Royal London Asset Management (RLAM) 30%	Investment Grade Bonds	• 50% iBoxx Sterling Non Gilt Over 10 Year Index • 16.7% FTSE Actuaries Uk Gilt Over 15 Yea Index • 33.3% FTSE Actuaries Index-Linked Over 5 Year Index	0.75%
Westerns 10%	Global High Yield Bonds	Gilts	3.0% (gross)
UBS 10%	Property	HSBC All Balanced Funds Median Index	n/a

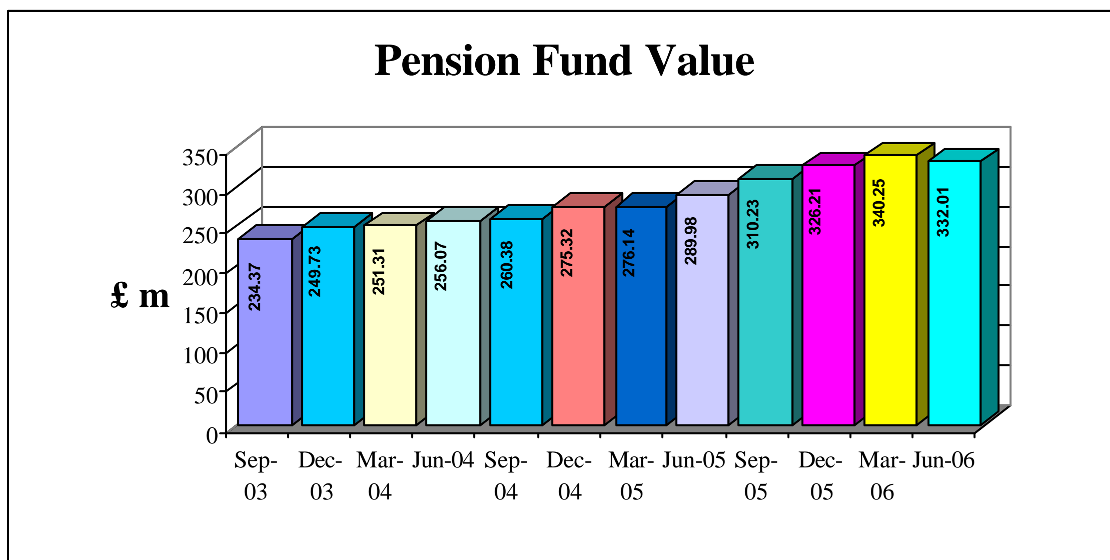
1.3 Both Western Asset and UBS manage the assets on a pooled basis. Standard Life, Royal London and Alliance Bernstein manage the assets on a segregated basis. Performance is monitored by reference to the benchmark and out performance target. Each manager's individual performance is shown in this report with a summary of any key information relevant to their performance.

1.4 Managers are invited to present at the Investment Committee Meeting every 6 months. On alternate dates, they meet with officers for a formal monitoring meeting. The exception to this procedure is the Property Manager, UBS, who will attend two meetings per year, one with Officers and one with Pensions Committee. Royal London and Standard Life are to make a presentation to this Committee.

1.5 Psolve's performance monitoring report is attached at Appendix A.

2. Fund Size

The total combined Fund value at the close of business on 30th June 2006 was £332.01m. This compares with a revised value of £340.25m at the 31st March 2006; a decrease of 2.42%. The funds decrease in value is a reflection of the quarter 2 performance, which is outlined and follows in this report.



3. Performance Figures against Benchmarks

The overall net performance of the Fund against the new Combined Tactical Benchmark is shown below:

	Quarter to 30.06.06	12 Months to 30.06.06	3 Years to 30.06.06	5 years to 30.06.06
Fund	-2.7	13.9	13.9%	4.8%
Benchmark return	-2.3	11.4	13.6%	5.0%
Difference in return	-0.4	2.5	0.3%	-0.2%

As the fund has only been under its new arrangements since February 2005, historical performance greater than one year is no reflection of the new strategy.

The following table shows how each manager has performed against their specific benchmark in the quarter to 30th June 2006.

NET FUND PERFORMANCE vs BENCHMARK %

Manager	Net Performance	Benchmark	Over/(Under) Performance
Standard Life	-1.30	-1.80	0.50
Alliance Bernstein	-7.68	-7.00	-0.68
RLAM	-1.70	-1.80	0.10
Westerns*	-5.55	-2.68	-2.87
UBS	4.40	5.00	-0.60

*Performance is gross to reflect the benchmark and target

NET FUND PERFORMANCE vs TARGET %

The table below compares the net performance returns against the target which comprises of the benchmark plus the agreed mandated out performance target.

Manager	Net Performance	Target	Over/(Under) Performance
Standard Life	-1.30	-1.30	-
Alliance Bernstein	-7.68	-6.38	-1.31
RLAM	-1.70	-1.61	-0.09
Westerns*	-5.55	-1.93	-3.62
UBS	4.40	5.0	-0.60

*Performance is gross to reflect the benchmark and target

Source: WM Company, Fund Managers and PSolve

ANNUAL PERFORMANCE

The table below details the individual managers' performance over the latest 12 months against their specific benchmark and target:

	Standard Life	Royal London	Alliance Bernstein	Western Asset*	UBS	Total
Return (performance)	24.10	2.40	19.61	-0.24	21.40	13.90
Benchmark	19.70	2.00	14.40	0.98	21.10	11.40
Over/(Under) Performance vs Benchmark	**4.4**	**0.40**	**5.21**	**-1.22**	**0.30**	**2.5**
TARGET	21.70	2.75	16.90	3.98	21.10	
Over/(Under) Performance vs Target	**2.40**	**-0.35**	**2.71**	**-4.22**	**0.3**	

4. Fund Manager Reports

4.1. UK Equities (Standard Life)

Standard Life achieved a net return for the quarter of -1.30%. They have outperformed the benchmark by +.50% (50 basis points). This performance equals the target set for the quarter. Over the year they outperformed the target by 2.40% (240 basis points).

The fund is distributed between UK equities and small companies fund units.

In line with other global stock markets, UK equities suffered weakness during the quarter. However the fund outperformed in a volatile quarter. Overweight positions in mining groups were positive and the fund benefited from an underweight position in Prudential after it rejected a merger proposal. The underweight position in emerging markets which suffered in the quarter was also positive for the fund.

The outlook for UK equities in the short term is that they are susceptible to the potential impact of weakness in the US economy, strength in sterling and short term risk aversion among investors. Commodity share prices may encounter more volatility although Standard Life believes there is still value to be found in the sector in certain stock specific cases.

UK smaller company stocks retreated during the quarter on fears that rising interest rates in the US and a strengthening pound would impact corporate earnings and economic growth. Standard life remains optimistic about the outlook for smaller companies in the second half of 2006.

There were no significant voting issues, but Standard Life is prepared to vote against a number of companies' remuneration changes. Standard Life also stated that there were no whistle blowing issues to report in the quarter.

Representatives from Standard Life are to make a presentation at this Committee.

4.2. Global Equities (Alliance Bernstein)

In accordance with agreed procedures officers met with a representative from Alliance Bernstein on the 14th August 2006 at which a review of the quarter 2 (Apr 06 to June 06) performance was discussed.

Alliance Bernstein achieved a net return for the quarter of -7.68. This represents an under performance of .68% (68 basis points) when compared to the benchmark. They also under performed the target by -1.31% (131 basis points). Over the year they outperformed the target by 2.71% (271 basis points).

The under performance during the period has reflected that quarter 2 was very volatile and that markets were down generally. The growth part of the portfolio suffered the greater losses and the portfolios overweight of emerging markets also detracted from performance but the outlook is positive.

Some of the sectors that detracted from relative performance were in Information Technology, Financials and the Healthcare sectors. These fell the farthest as they were more sensitive to interest rates. Some of the sectors that contributed to relative performance were in the Energy and Utilities sectors.

Looking ahead Alliance Bernstein believe that compressed (lower) stock valuations continue to create opportunities for the Growth team to buy superior growth stock at unusually attractive prices while the Value team have limited opportunities to find bargains as shares are becoming less cheap.

Alliance Bernstein also believes that the Japanese interest rate rises will not impact on emerging markets.

Representatives from Alliance Bernstein stated that no corporate governance or whistle blowing issues.

4.3. UK Investment Grade Bonds (Bonds Gilts, UK Corporates, UK Index Linked, UK Other) – (RLAM)

In the quarter to 30th June 2006 RLAM achieved a net return of -1.70%. This represented an out performance of 0.10% (10 basis points) against the agreed benchmark. The quarterly performance against the target was under achieved by -0.9% (9 basis points). RLAM under achieved its annual target by 35 basis points.

RLAM have stated that no corporate governance or whistle blowing issues were reported during the quarter.

Representatives from RLAM are to make a presentation at this Committee.

4.4. Global High Yield Bonds (Westerns)

In accordance with agreed procedures officers met with representatives from Westerns on the 14th August 2006 at which a review of the quarter 2 (Apr 06 to June 06) performance was discussed.

Westerns achieved a net return for the quarter of -5.55. This represents an under performance of -2.87 (287 basis points) against the benchmark. Westerns have under achieved its annual target by -4.22% (422 basis points).

Although this was a disappointing performance from Westerns they remain confident, that even though there was some volatility in the quarter and poor performance related to the market performance generally; that over the longer term they can meet the season cycle and have made changes to the way they monitor exposure to equities and bonds.

Westerns reported that the out performance for July/early August is looking more positive. They have reported that the gross return for July is 2.5% against the benchmark of 2.29%. This reflected a 0.2% (20 basis points) out performance against the benchmark. However it should be noted that the target (benchmark plus 3% per annum) should equate to 25 basis points per month and are therefore slightly under performing against the target by 5 basis points.

There were some positive performances during the quarter; however these were not enough to offset the negative performances. The positive performance of the fund was attributable to 'Long dated gilts' and 'Treasury Inflation Protected Securities' (TIPS) and the negative performance of the fund was attributable to the rise in US interest rates, the emerging market debt, mortgage backed securities, fundamentals and high yield corporate bonds.

Three things that Westerns are banking on in the future for improved performance is low volatility, low exposure to emerging markets (being cautious against earnings on high yield bonds) and the US being stable.

Concerns were raised about whether the US can be stable given the terrorists and Middle East situation but Westerns maintain they are more reliant on Central Bank keeping interest rates unchanged and believe that the terrorist threat will dampen down activity.

Concerns were expressed regarding the investment in lower grade stock (from the benchmark AAA graded stock to A grade) in order to achieve greater returns as an attempt to claw back some of their past losses. Westerns believe that the mix of securities is in the riskier sector but they are being selective to reduce this risk.

Westerns were also informed of Members' concerns regarding their performance and were notified that they are being closely monitored and informed of the possibility that Members may require Westerns to attend Committee every 3 months instead of the current requirement of every 6 months.

Westerns were also asked to clarify if they have changed the product. Westerns confirmed that the product has not been changed, just re-branded as a Western Asset fund and whilst the strategy has changed the prospectus has not.

Westerns were also asked to consider the possibility of re-negotiating their fee terms. Westerns were going to come back to officers after they had discussed this. Progress has been sought from Westerns regarding this issue and officers are waiting for representatives from Westerns to respond.

Representatives from Westerns stated that there were no corporate governance or whistle blowing issues during the quarter.

4.5. Property (UBS)

During the second quarter ended 30th June 2006, UBS achieved a net return of 4.40%. This reflected a -0.6% under performance against the benchmark.

There were no direct property purchases or sales during the quarter. Letting activity at the 10 King William Street office in London now means that only 2,800 square feet remain vacant. At Milton Gate an extensive refurbishment programme is underway, with the shell and core due to be finished by January 2007.There is significant tenant interest in this building. Asset management deals during the quarter added an estimated £53m in value.

The Triton fund remains closed. However UBS have tentative plans to reopen later in 2006 or early 2007.

No corporate governance or whistle blowing issues were reported during the quarter.

5. Corporate Governance Issues

The Committee agreed that it would:

1. Receive quarterly information from each relevant Investment Manager, detailing the voting history of the Investment Managers on contentious issues. This information is included in the Managers' Quarterly Reports, which is available for scrutiny in the Members Lounge.

2. Consider a sample of all votes cast to ensure they are in accordance with the policy and determine any Corporate Governance issues arising.

3. Receive quarterly information from the Investment Managers, detailing new Investments made.

- Points 1 and 3 are contained in the Managers' reports.

- With regard to point 2, Members should select a sample of the votes cast from the voting list supplied by the managers placed in the Member's room which is included within the quarterly report and question the Fund Managers regarding how Corporate Governance issues were considered in arriving at these decisions.

This report is being presented in order that:

- The general position of the Fund is considered plus other matters including any general issues as advised by Psolve.

- Psolve will discuss the managers' performance after which the particular manager will be invited to join the meeting and make their presentation. The managers attending the meeting will be from:

  Royal London
  Standard Life

- Psolve and Officers will discuss with Members any issues arising from the monitoring of the other managers.

Communication and Governance Policy Statement updates:

The Committee is to note that changes have been made to the Governance Policy Statement to reflect that as well as undertaking an annual review the Council will review the policy as and when changes occur. Changes to the name and composition of the Committee is in the process of being amended and will be reflected in the Governance Policy statement.

A questionnaire was sent to the employers of the fund concerning improved consultation. Though there was a limited response there was a preference to have an employers Annual General Meeting.

Financial Implications and risks:

Pension Fund Managers' performances are regularly monitored in order to ensure that the investment objectives are being met and consequently minimise any cost to the General Fund.

Legal Implications and risks:

None arising directly

Human Resources Implications and risks:

None arising directly

Equalities and Social Inclusion Implications and risks:

None arising directly

Staff Contact: Debbie Ford

Designation: Acting pension fund Accountant

Telephone No: 01708 432569

E-mail address : debbieford@havering.gov.uk

STEPHEN EVANS
Chief Executive

Background Papers List

Standard Life Quarterly report to 30th June 2006
Alliance Bernstein Quarterly report to 30th June 2006
Royal London Quarterly report to 30th June 2006
Western Asset Quarterly report to 30th June 2006
UBS Quarterly report to 30th June 2006
The WM Company Performance Review Periods to 30th June 2006
Psolve Monitoring Report to 30th June 2006

MEETING	DATE	ITEM
PENSIONS COMMITTEE	21 September 2006	**7**

REPORT OF THE CHIEF EXECUTIVE

SUBJECT: REVIEW OF THE STATEMENT OF INVESTMENT PRINCIPLES AND THE FUNDING STRATEGY STATEMENT

SUMMARY

This report sets out the Statement of Investment principles and the Funding Strategy Statement. It also explains why a review is required and how this will be undertaken.

RECOMMENDATION

To note the existing Statement of Investment Principles and Funding Strategy Statements.

To note that a review will take place during the forthcoming weeks, the results of which will be reported back to this Committee in December.

To provide any comments as necessary

REPORT DETAIL

1. The Pension Fund has:

- a Statement of Investment Principles explaining the strategy, risks and other matters. This is appended as Appendix A.
- a Funding Strategy Statement which illustrates how the fund is operating to improve funding levels. This is appended as Appendix B.

1.1. The Committee must review and amend the above for a number of reasons including:

- it is good practice to review the above annually to ensure they are fit for the purpose and fully compliant and are up to date.
- there is a need to show how the Committee will rebalance the Fund as necessary.
- Myners; the principle of good governance has recently been reviewed and a compliance check is necessary.
- to clarify and evaluate the Fund's approach to risk definition, identification, monitoring and mitigation
- to ensure that all interested parties have had the opportunity to comment.

1.2 The Committee membership is new and part of the change involves ensuring all Members are fully trained and conversant with responsibilities. This should be complete by December 2006. In the meantime:

- the strategy and statements are provided in order that Members become familiar with them in anticipation of their training review.
- the Committee should note that admitted and scheduled bodies will be asked for views on changes.
- staff representatives will be asked for views on any necessary changes.
- Our advisers will also be asked for views on any necessary changes.

1.3 The aim is that the review will take place by taking on board any comments provided by the above as well as discussing with Members any necessary or possible changes at the December meeting.

Financial Implications and risks:
There are no financial implications or risks arising directly from this report. The review will however ensure that the Pension Fund is both compliant with the Myners and CIPFA requirements, and reduces the financial commitment on the General Fund, as far as possible.

Legal Implications and risks:
None arising directly

Human Resources Implications and risks:
None arising directly

Equalities and Social Inclusion Implications and risks:
None arising directly

Staff Contact: Rita Greenwood
Designation: Group Director Finance and Commercial
Telephone No: 01708 432218
E-mail address : rita.greenwood@havering.gov.uk

STEPHEN EVANS
Chief Executive

Background Papers List

Draft Statement of Accounts (Extract of Pension Fund Accounts)
WM Company Report as at 31st March 2006

February 2005

LONDON BOROUGH OF HAVERING PENSION FUND

Funding Strategy Statement

Overview

This Statement has been prepared in accordance with Regulation 76A of the Local Government Pension Scheme Regulations 1997 (the LGPS Regulations). The Statement describes London Borough of Havering's strategy, in its capacity as Administering Authority (the Administering Authority), for the funding of the London Borough of Havering Pension Fund (the Fund).

As required by Regulation 76A(2), the Statement has been prepared having regard to guidance published by CIPFA in March 2004.

Consultation

In accordance with Regulation 76A(1), all employers participating within the London Borough of Havering Pension Fund have been consulted on the contents of this Statement and their views have been taken into account in formulating the Statement. However, the Statement describes a single strategy for the Fund as a whole.

In addition, the Administering Authority has had regard to the Fund's Statement of Investment Principles published under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (the Investment Regulations).

The Fund Actuary, Hewitt Bacon and Woodrow, has also been consulted on the contents of this Statement.

Policy Purpose

The three main purposes of this Funding Strategy Statement are:

- To establish a clear and transparent strategy, specific to the Fund, which will identify how employer's pension liabilities are best met going forward.
- To support the regulatory requirement in relation to the desirability of maintaining as nearly constant employer contribution rates as possible.
- To take a prudent longer-term view of funding the Fund's liabilities.

The Aims of the Fund

The aims of the Fund are:

1. To enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the Scheduled bodies, Admitted bodies and to the taxpayers.

   The Administering Authority recognises that the requirement to keep employer contribution rates as nearly constant as possible can run counter to the following requirements:

- the regulatory requirement to secure solvency,
- the requirement that the costs should be reasonable, and
- maximising income from investments within reasonable cost parameters (see 4 below)

Producing low volatility in employer contribution rates requires material investment in assets which ‘match’ the employer’s liabilities. In this context, ‘match’ means assets which behave in a similar manner to the liabilities as economic conditions alter. For the liabilities represented by benefits payable by the Local Government Pension Scheme, such assets would tend to comprise gilt edged investments.

Other classes of assets, such as other equities and property, are perceived to offer higher long term rates of return, on average, and consistent with the requirement to maximise the returns from investments the Administering Authority invests a substantial proportion of the Fund in such assets. However, these assets are more risky in nature, and that risk can manifest itself in volatile returns over short term periods.

This short term volatility in investment returns can produce a consequent volatility in the measured funding position of the Fund at successive valuations, with knock on effects on employer contribution rates. The impact on employer rates can be mitigated by use of smoothing adjustments at each valuation.

The Administering Authority recognises that there is a balance to be struck between the investment policy adopted, the smoothing mechanisms used at valuations, and the resultant smoothness of employer contribution rates from one valuation period to the next.

The Administering Authority also recognises that the position is potentially more volatile for Admission Bodies with short term contracts where utilisation of smoothing mechanisms is less appropriate.

2. <u>To ensure that sufficient resources are available to meet all liabilities as they fall due</u>.

   The Administering Authority recognises the need to ensure that the Fund has, at all times, sufficient liquid assets to be able to pay pensions, transfer values, costs, charges and other expenses. It is the Administering Authority’s policy that such expenditure is met, in the first instance, from incoming employer and employee contributions to avoid the expense of disinvesting assets. The Administering Authority monitors the position on a monthly basis to ensure that all cash requirements can be met.

3. <u>To manage employers’ liabilities effectively.</u>

   The Administering Authority seeks to ensure that all employers’ liabilities are managed effectively. In a funding context, this is achieved by seeking regular actuarial advice, ensuring that employers and Investment Committee Members are properly informed, and through regular monitoring of the funding position.

4. <u>To maximise the income from investments within reasonable risk parameters.</u>

   The Administering Authority recognises the desirability of maximising investment income within reasonable risk parameters. Investment returns higher than those available on government stocks are sought through investment in other asset classes such as stocks and property. The Administering Authority ensures that risk parameters are reasonable by:

   - restricting investment to the levels permitted by the Investment Regulations.

- restricting investment to asset classes generally recognised as appropriate for UK pension funds.
- analysing the potential risk represented by those asset classes in collaboration with the Fund's Actuary, Investment Advisors and Fund Managers.

Purpose of the Fund

The purpose of the Fund is:

1. To pay out monies in respect of scheme benefits, transfer values, costs, charges and expenses.
2. To receive monies in respect of contributions, transfer values and investment income.

Responsibilities of the key parties

The three parties whose responsibilities to the Fund are of particular relevance are the Administering Authority, the Individual Employers and the Scheme Actuary.

Their key responsibilities are as follows:

Administering Authority

The Administering Authority's key responsibilities are:

1. Collecting employer and employee contributions and, as far as the Administering Authority is able to, ensure these contributions are paid by the due date.

   Individual employers must pay contributions in accordance with Regulations 79, 80 and 81 of the LGPS Regulations. The Administering Authority will ensure that all employers are aware of these requirements especially the requirement of the Pensions Act 1995 that members' contributions are paid by the 19th of the month following the month that it is paid by the member. The contributions to the Pension Fund are monitored and processed by the Pension Administration team. If contributions are received more than a month after payment is due, interest will be charged at the rate of 1% above the bank base rate.

   The Administering Authority will ensure that action is taken to recover assets from Admitted Bodies whose Admission Agreement has ceased by:

   - requesting that the Fund Actuary calculates the deficit at the date of the closure of the Admission Agreement
   - notifying the Admitted Body that it must meet any deficit at the cessation of the Agreement .

2. Invest surplus monies in accordance with the regulations.

   The Administering Authority will comply with Regulation 9 of the Investment Regulations.

3. Ensure that cash is available to meet liabilities as and when they fall due.

   The Administering Authority recognises this duty and discharges it in the manner set out in the Aims of the Fund above.

4. Manage the valuation process in consultation with the Fund's actuary

The Administering Authority ensures it communicates effectively with the Fund Actuary to:

- agree timescales for the provision of information and provision of valuation results
- ensure provision of data of suitable accuracy
- ensure that the Fund Actuary is clear about the Funding Strategy
- ensure that participating employers receive appropriate communication throughout the process
- ensure that reports are made available as required by Guidance and Regulation

5. Prepare and maintain a Statement of Investment Principles and a Funding Strategy Statement after due consultation with interested parties.

The Administering Authority will ensure that both documents are prepared and maintained in the required manner.

6. Monitor all aspects of the Fund's performance and funding and amend these two documents if required.

The Administering Authority monitors the funding position of the Fund on a quarterly basis, and the investment performance of the Fund on a monthly basis. The Statement of Investment Principles and Funding Strategy Statement will be formally reviewed annually, unless circumstances dictate earlier amendment.

Individual Employers will:

1. Deduct contributions from employees' pay.
2. Pay all contributions, including their employer contribution as determined by the actuary, promptly by the due date.
3. Exercise discretions within the regulatory framework.
4. Pay for added years in accordance with agreed arrangements.
5. Notify the administering authority promptly of all changes to membership, or other changes which affect future funding

The Fund Actuary will:

1. Prepare valuations including the setting of employers' contribution rates after agreeing assumptions with the administering authority and having regard to the Funding Strategy Statement.

Valuations will also be prepared in accordance with generally accepted actuarial methods and reported on in accordance with Guidance Note 9 issued by the Institute and Faculty of Actuaries, to the extent that the Guidance Note is relevant to the LGPS.

2. Prepare advice and calculations in connection with bulk transfers and individual benefit-related matters.

Such advice will take account of the funding position and Strategy of the Fund, along with other relevant matters.

Solvency

The Administering Authority will prudentially seek to secure the solvency of the Fund. For this purpose the Administering Authority defines solvency as being achieved when the value of the Fund's assets is greater than or equal to the value of the Fund's liabilities when measured using 'ongoing' actuarial methods and assumptions.

'Ongoing' actuarial methods and assumptions are taken to be measurement by use of the projected unit method of valuation, using assumptions generally recognised as suitable for an open, ongoing UK pension fund with a sponsoring employer of sound covenant.

The financial assumptions used to assess the funding level will have regard to the yields available on long term fixed interest and index linked gilt edged investments. The Administering Authority has also agreed with the Fund Actuary that the assumptions will make partial allowance for the higher long term returns that are expected on the assets actually held by the Fund, and understands the risks of such an approach if those additional returns fail to materialise.

Consistent with the aim of enabling employer contribution rates to be kept as nearly constant as possible, and having regard to the risks inherent in such an approach, the Administering Authority has also agreed with the Fund Actuary the use of explicit smoothing adjustments in making the solvency measurement. It is unlikely that use of these smoothing adjustments will be extended to employers whose participation in the Fund is for a fixed period (for example, an employer admitted by virtue of having been awarded a best value outsourcing contract).

Funding Strategy

Where a valuation reveals that the Fund is in surplus or deficiency against this solvency measure, employer contribution rates will be adjusted to target restoration of the solvent position over a period of years (the recovery period). The recovery period applicable for each participating employer is set by the Administering Authority in consultation with the Fund Actuary and the employer, with a view to balancing the various funding requirements against the risks involved due to such Where a valuation reveals that the Fund is in surplus or deficiency against this solvency measure, employer contribution rates will be adjusted to target restoration of the solvent position over a period of years (the recovery period). The recovery period applicable for each participating employer is set by the Administering Authority in consultation with the Fund Actuary and the employer, with a view to balancing the various funding requirements against the risks involved due to such issues as the financial strength of the employer and the nature of its participation in the Fund.

The Administering Authority recognises that a large proportion of the Fund's liabilities are expected to arise as benefit payments over long periods of time. For employers of sound covenant, the Administering Authority is prepared to agree to recovery periods which are longer than the average future working lifetime of the membership of that employer. The Administering Authority recognises that such an approach is consistent with the aim of keeping employer contribution rates as nearly constant as possible. However, the Administering Authority also recognises the risk in relying on long recovery periods and has agreed with the Fund Actuary a limit of 30 years. The Administering Authority's policy is to agree recovery periods with each employer which are as short as possible within this framework.

For employers whose participation in the fund is for a fixed period it is unlikely that the Administering Authority and Fund Actuary would agree to a recovery period longer than the remaining term of participation.

Consistent with the requirement to keep employer contribution rates as nearly constant as possible, the Administering Authority permits some employers to be treated as a group for the purposes of setting contribution rates. In particular, contribution rates could be very volatile for smaller employers due to the increased likelihood that demographic movements would have a material effect. The Administering Authority recognises that grouping can give rise to cross subsidies from one employer to another over time. The Administering Authority's policy is to consider the position carefully at each valuation and to notify each employer that is grouped that this is the case, and which other employers it is grouped with. If the employer objects to this grouping, it will be offered its own contribution rate. For employers with more than 50 contributing members, the Administering Authority would look for evidence of homogeneity between employers before considering grouping. For employers whose participation is for a fixed period grouping is unlikely to be permitted.

Again, consistent with the requirement to keep employer contribution rates as nearly constant as possible, the Administering Authority will consider, at each valuation, whether new contribution rates should be payable immediately, or should be reached by a series of steps over future years. The Administering Authority will discuss with the Fund Actuary the risks inherent in such an approach, and will examine the financial impact and risks associated with each employer. The Administering Authority's policy is that in the normal course of events no more than three equal annual steps will be permitted. Further steps may be permitted in extreme cases, but the total is very unlikely to exceed six steps.

Identification of risks and counter measures

The Administering Authority's overall policy on risk is to identify all risks to the Fund and to consider the position both in aggregate and at an individual risk level. The Administering Authority will monitor the risks to the Fund, and will take appropriate action to limit the impact of these both before, and after, they emerge wherever possible. The main risks to the Fund are:

Demographic

The main risks include changing retirement patterns and longevity. The Administering Authority will ensure that the Fund Actuary investigates these matters at each valuation or, if appropriate, more frequently, and reports on developments. The Administering Authority will agree with the Fund Actuary any changes which are necessary to the assumptions underlying the measure of solvency to allow for observed or anticipated changes.

If significant demographic changes become apparent between valuations, the Administering Authority will notify all participating employers of the anticipated impact on costs that will emerge at the next valuation and will review the bonds that are in place for Transferee Admitted Bodies.

Regulatory

The risks relate to changes to regulations, National pension requirements or Inland Revenue rules. The Administering Authority will keep abreast of all proposed changes and, where possible, express their opinion during consultation periods after careful

consideration. The Administering Authority's policy will be to ask the Fund Actuary to assess the impact on costs of any changes and, where these are likely to be significant, the Administering Authority will notify Employers of this likely impact and the timing of any change.

Governance

This covers the risk of unexpected structural changes in the Fund membership (for example the closure of an employer to new entrants or the large scale withdrawal or retirement of groups of staff), and the related risk of the Administering Authority not being made aware of such changes in a timely manner.

The Administering Authority's policy is to require regular communication between itself and employers, and to ensure regular reviews of such items as bond arrangements, financial standing of non-tax raising employers and funding levels.

Statistical/Financial

This covers such items such as the performances of markets, Fund investment managers, asset reallocation in volatile markets, pay and /or price inflation varying from anticipated levels or the effect of possible increases in employer contribution rate on service delivery and on Fund employers. The Administering Authority's policy will be to regularly assess such aspects to ensure that all assumptions used are still justified.

Solvency measure

The Administering Authority recognises that allowing for future investment returns in excess of those available on government bonds introduces an element of risk, in that those additional returns may not materialise. The Administering Authority's policy will be to monitor the underlying position assuming no such excess returns are achieved to ensure that the funding target remains realistic relative to the low risk position.

Smoothing

The Administering Authority recognises that utilisation of a smoothing adjustment in the solvency measurement introduces an element of risk, in that the smoothing adjustment may not provide a true measure of the underlying position. The Administering Authority's policy is to review the impact of this adjustment at each valuation to ensure that it remains within acceptable limits to ensure that it does not alter the disclosed solvency level by more than 5%.

Recovery period

The Administering Authority recognises that permitting surpluses or deficiencies to be eliminated over a recovery period rather than immediately introduces a risk that action to restore solvency is insufficient between successive measurements. The Administering Authority's policy is to discuss the risks inherent in each situation with the Fund Actuary and to limit the permitted length of recovery period to no longer than 25 years.

Stepping

The Administering Authority recognises that permitting contribution rate changes to be introduced by annual steps rather than immediately introduces a risk that action to restore solvency is insufficient in the early years of the process. The Administering Authority's policy is to discuss the risks inherent in each situation with the Fund Actuary and to limit the number of permitted steps to three annual steps or, in exceptional circumstances, to six annual steps.

Links to investment policy set out in the Statement of Investment Principles

The Authority has produced this Funding Strategy Statement having taken an overall view of the level of risk inherent in the investment policy set out in the Statement of Investment Principles and the funding policy set out in this Statement.

The Administering Authority will continue to review both documents to ensure that the overall risk profile remains appropriate including, where appropriate, asset liability modelling or other analysis techniques.

Future monitoring

The Administering Authority plans to formally review this Statement as part of the triennial valuation process unless circumstances arise which require earlier action.

The Administering Authority will monitor the funding position of the Fund on an approximate basis at regular intervals between valuations, and will discuss with the Actuary whether any significant changes have arisen that require action.

SIP Review February 2005

Statement of Investment Principles
London Borough of Havering Pension Fund ('The Fund')

Background

Legislation

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 as amended require Local Authority Pension Funds to prepare a Statement of Investment Principles (SIP) and to review it at least annually. They are also required to set out a Statement of Compliance with the ten Principles of Investment Management contained in the CIPFA document "Principles for Investment Decision Making in the Local Government Pension Scheme in the UK" published in April 2002.

Purpose and Scope of Scheme

The London Borough of Havering is the administering authority for the London Borough of Havering Pension Fund. The Fund is part of the Local Government Pension Scheme (LGPS) and provides death and retirement benefits for all eligible employees and their dependants. It is a final salary defined benefit Pension Scheme, which means that benefits are payable based on the employees' final salary. All active members are required to make pension contributions which are based on a fixed percentage of their pensionable pay as defined in the LGPS regulations and currently set at 6%. Manual workers in employ before 1st April 1998 have a protected 5% rate.

The London Borough of Havering is responsible for the balance of the costs necessary to finance the benefits payable from the Fund by applying employer contribution rates, determined from time to time (but at least triennially) by the Fund's Actuary.

The London Borough of Havering has a direct interest in the investment returns achieved on the Fund's assets, but the benefits paid to pensioners are not directly affected by investment performance.

Investment Committee

A dedicated group of Councillors (the "Investment Committee") has been set up to deal with the majority of the Fund's investment issues. Major investment decisions will be referred for consideration to the Investment Committee. In particular, the Investment Committee, which consists of six Councillors (and two trade union representatives in an observer capacity), has duties that include:

- monitoring the investment performance of the Fund on a quarterly basis
- determining overall strategy

- ensuring compliance with legislative requirements
- receiving the triennial valuation prepared by the Council's Actuary with recommended contribution levels
- determining asset allocation and benchmarking
- appointment of Investment Managers

The Committee is set up under the Local Government Act so that, where necessary it can exercise decision-making powers. The Committee meets eight times per year to hear reports from its officers, investment managers, actuary, investment adviser and performance measurement provider. Additional meetings are held as required in particular to ensure the appropriate Councillor training.

The Fund also utilises the services of an investment adviser to provide professional advice and training, and receives advice and information from suitably qualified officers from within the Council.

The Regulations state that the administering authority must, when formulating its investment policy, have regard to the advisability of investing fund money in a wide range of investments and to the suitability of particular investments and types of investments.

Fund Objective

It was agreed at the Investment Committee Meeting of 4th April 2003 that the following be adopted as the Fund objective:

' The underlying aims of the Fund are

- to ensure that it has sufficient assets to pay pension benefits to scheme members as they fall due and;
- to set employer contribution rates at a level to attain 100% funding, as certified by the Fund's Actuary, whilst keeping the employer contribution rate as low and as stable as possible.'

In order to lessen the burden on the employers within the Fund, the investment strategy is designed to achieve a higher return than the lowest risk strategy whilst maintaining a prudent approach to meet the underlying aims of the Fund.

Investment Objective

It was agreed at the Investment Committee Meeting of 17th December 2003 that the following be adopted as the Investment Objective:

'To target 100% funding on an ongoing basis by investing to achieve a return on the overall Fund of gilts +3.6% p.a. over a ten-year time horizon, thereby reducing the likelihood of an increase to the employers' future contribution.'

This is to be achieved by targeting:

- Gilts + 1.0% p.a. in the Matching Fund (which comprises 30% of the Total fund)
- Gilts + 4.5% p.a. in the Investment Fund (which comprises 70% of the Total Fund)

Asset Allocation

- At the Investment Committee meeting on 17th December 2003, the following strategic asset allocation was approved:

		%
Property	-	10
Global High Yield Bonds	-	10
UK Equities	-	30
Global Equities (ex UK)	-	20
Fixed Interest Gilts } Index-Linked Gilts } Corporate Bonds }	-	30

- The general asset allocation was based on results taken from the Asset /Liability study undertaken by the Fund Actuary (Hewitt Bacon & Woodrow). The detailed allocation was taken following advice from Psolve, the Fund's investment adviser.
- The above allocation has resulted in 5 separate specialist Investment Management mandates, with 5 different managers being appointed. These are as follows:

UBS Asset Management – Property Mandate
Citigroup Asset Management – Global High Yield Mandate
Standard Life Investments – UK Equity Mandate
Alliance Bernstein Investment Management – Global Equity (ex UK) Mandate
Royal London Asset Management – Investment Grade Bond Mandate

Investments managed by Citigroup and UBS are within Collective Investment Schemes.

Investment Responsibilities

Responsibilities of the London Borough of Havering

The Council is responsible for:

- Tactical asset allocation, where appropriate, around the strategic benchmark and the rebalancing of asset positions back to benchmark

- Locking in gains that materialise on the investment fund by crystallising profits and transferring the same to the matching fund, thus increasing the matching fund allocation over time in order to keep pace with the growth in liabilities
- Determining overall investment strategy
- Putting in place a Statement of Investment Principles
- Monitoring compliance with the Statement and reviewing its contents
- Appointing Investment Manager(s), an independent custodian, the Actuary and the Investment Adviser.
- Reviewing the performance of the Investment Managers on a regular basis, against agreed Benchmarks and being satisfied as to the expertise and operations of the Investment Manager.

The Investment Committee advises the Council on the above.

Responsibilities of the Investment Manager

Active investment decisions and detailed asset allocation within the mandates are currently delegated to the Investment Managers.

The Investment Committee expects the Investment Managers to manage the assets delegated to them under the terms of their contract and to give effect to the principles in this statement in so far as is reasonably practicable.

The Investment Managers are responsible for:

- (For segregated mandates) tactical asset allocation, around the strategic benchmark set by the Investment Committee and stock selection within asset classes
- (For pooled vehicle mandates) tactical asset allocation within the restrictions laid down in the prospectus of the relevant pooled vehicle.
- Realisation of investments
- Quarterly reporting to the Council, including a review of investment performance
- Attending meetings of the Investment Committee and the Council as required
- Providing the accounting data covering details of all investment transactions over the quarter
- Providing a detailed valuation statement at the end of each calendar quarter
- Providing investment details in a timely manner to the Fund's benchmarking company (WM) for performance measurement purposes

The remuneration is based on an agreed fee structure which is included within the Investment Manager Agreements.

Performance

The critical test of the manager's performance are the results on a three year rolling basis. It is on the outcome of these results that alternative performance solutions (e.g. a change in investment manager arrangements) would be considered. It is expected that by appointing the most suitable specialist managers rather than a balanced manager, a better investment return will be achieved. The selection process is very stringent, and is based on the Manager's historical performance, the investment process, their capability of meeting the performance target and detailed information on their organisation structure.

Responsibilities of the Custodian

Global Custodial services are carried out State Street Bank and Trust Company. This arrangement provides a separation of duties between the investment and the safe keeping of the assets.

The custodian is responsible for:

- The safe custody of all securities, settlement of all investment transactions, collection of income, cash management, tax reclaims corporate action administration, foreign exchange services, derivatives clearing, proxy voting and reporting on all movements within the Pension Fund.

The Auditor

- The Fund is audited annually by the Audit Commission. The financial year end is 31st March.

Responsibilities of the Actuary (Hewitt Bacon and Woodrow):

- Undertaking the triennial actuarial valuation
- Providing advice on the appropriate strategic allocation of the assets, given the structure of the Fund's liabilities.

Responsibilities of the Investment Adviser (Psolve):

- Advising the Investment Committee on Investment Strategy.
- Advising the Investment Committee on the Statement of Investment principles.
- Advising on Benchmarking issues.
- Operating under an agreement to provide a full service designed to ensure that the Investment Committee is fully briefed to take the decisions that they take themselves and to monitor those that are delegated.
- Advising on and evaluating the Investment Manager and Custodial tenders.

- Monitoring the performance of the Investment Managers
- Attendance at Investment Committee Meetings as required
- Ad-hoc investment issues that the Council does not have the knowledge or resources to resolve.

The Investment adviser is paid on a time-cost basis to ensure that the Investment Committee receives all the necessary investment advice.
The fees for some one-off projects are negotiated separately.

The Historic Position of Fund

The Fund is unlikely to be fully funded for several years. This has arisen for two main reasons. Firstly the reduction in the funding level to 75% of liabilities as a result of government regulations prior to the introduction of the community charge. Secondly, the cost of the redundancy programme in the mid 1990's (Note that since 1998 redundancies and early retirements are a charge on departmental cost centres and external employers rather than the Pension Fund). In addition the withdrawal of tax relief on pension fund dividend income arising from the 1997 budget has been a further factor in delaying the achievement of full funding. The recent downturn in the value of equities has been a further problem.

At the last triennial valuation (at 31st March 2004) the funding ratio was 65.3%.

The Fund is obliged to prepare a publicly available document called a Funding Strategy Statement (FSS) by March 2005. This will outline the method by which the Fund will return to an acceptable level of solvency. This will be achieved by a combination of increased contributions to the Fund, and expected increased investment returns. The preparation of this statement is currently underway.

Review

- The investment strategy is reviewed by the Investment Committee, at least on an annual basis
- The current review is based on the Asset/Liability study and advice on asset allocation from Psolve

Reporting

The investment performance of the manager is reported to the Investment Committee and Officers quarterly. Reports are received from The WM Company and Psolve, along with executive summaries from each Investment Manager including details of any voting undertaken in that quarter.

INVESTMENTS

The powers and duties of the Fund to invest monies are set out in the Local Government Pension Scheme (Management & Investment Funds) Regulations 1998. The Fund is required to invest any monies which are not required to pay pensions and other benefits and in so doing take account of the need for suitable diversified portfolio investments and the advice of persons properly qualified (including officers) on investment matters.

Types of Investment

In broad terms investments may be made in accordance with the regulations in equities, fixed interest and other bonds and property and in the UK and overseas markets. The regulations specify other investment instruments may be used e.g. financial futures, traded options, insurance contracts, stock lending, sub underwriting contracts, although historically it has not been the practice of the Fund to participate in these. This may change with the appointment of specialist Investment Managers. Any limitations on the use of these instruments will be included within the IMAs.

The regulations also specify certain limitations on investments. Principally these place a limit of 10% of the total value of the Fund on any single holding, or deposit with a single bank or institution or investments in unlisted securities.

The Investment Committee has set out control ranges and restrictions for the Fund’s investments. These control ranges and restrictions have been considered when setting the benchmarks for each Manager.

Investment Management

The Investment Manager’s are each bound by an investment management agreement (IMA) that takes account of:

- the benchmark set, and the allocation of assets within this benchmark
- cash needs
- risk tolerances
- the policies on Corporate Governance and Socially Responsible Investment, given later in this document

The Investment Manager must also select the appropriate types of investment as defined in the Regulations.

Investment Manager Controls

The Investment Managers are authorised and regulated by the Financial Services Authority (FSA), and must comply with the regulations contained within the Financial Services and Markets Act 2000 (FSMA 2000). Under these regulations, the manager must ensure that suitable internal operating procedures and risk frameworks are in place. FSMA is designed to provide a Fund such as this with an adequate level of protection, and the Investment Managers are obliged to meet their obligation imposed by this act.

The mandates that will be set for the Manager's going forward will contain controls to ensure compliance with best practice and regulations. Additonal controls on cash levels and transfers of cash and assets will also be set within the new IMA's.

SOCIAL ENVIRONMENTAL AND ETHICAL CONSIDERATIONS

> 'The Investment Committee has considered socially responsible investment in the context of its legal and fiduciary duties, and the view has been taken that non-financial factors should not drive the investment process at the cost of financial return on the Council's Pension Fund. Therefore, the Investment Committee is of the view that there should be non-interference with the short-term day-to-day decision making of the Fund Managers.
>
> Over the longer term, the Investment Committee requires the Investment Manager(s) to consider, as part of the investment decisions, socially responsible investment issues and the potential impact on investment performance. Beyond this, the Investment Manager(s) has full discretion with the day to day decision making.'

Corporate Governance and Voting Policy

Corporate Governance Policy

> 'The policy of the Havering Pension Fund is to accept the principles laid down in the Combined Code as interpreted by the Institutional Shareholders Committee 'Statement of Principles'.

In making investment decisions the Council will, through its Pension Fund Investment Manager, have regard to the economic interests of the Pension Fund as paramount and as such

1. Will vote at all general meetings of UK companies in which the Fund is directly invested.
2. Will vote in favour of proposals that enhance shareholder value.
3. Will enter into timely discussions with management on issues which may damage shareholders' rights or economic interests and if necessary to vote against the proposal.
4. Will take a view on the appropriateness of the structure of the boards of companies in which the Fund invests.
5. Will take a view on the appropriateness of the remuneration scheme in place for the directors of the company in which the Fund invests

Beyond this, the Council will allow its Investment Manager(s) full freedom with the day to day decision making.

The Investment Committee will, where appropriate,

6. Receive quarterly information from the Investment Manager, detailing the voting history of the Investment Manager on contentious issues.
7. Consider a sample of all votes cast to ensure they are in accordance with the policy and determine any Corporate Governance issues arising.
8. Receive quarterly information from the Investment Manager, detailing new Investments made.'

7 – COMPLIANCE

The Investment Committee will regularly review the Scheme's compliance with this Statement of Investment Principles.

The Statement of Investment Principles will be reviewed at least annually and a revised version issued as soon as any significant change occurs.

8 – MYNERS Principles for Investment Decision Making

The Action the Council has taken to meet the recommendations made in the Myner's report (as further discussed in the CIPFA Principles for Investment Decision Making in the LGPS) is currently being updated.

MEETING	DATE	ITEM
Pensions Committee	**21 September 2006**	**8**

REPORT OF THE CHIEF EXECUTIVE

SUBJECT: Government Consultations on proposed changes to the Local Government Pensions Scheme (LGPS)

SUMMARY

This report details three consultation papers issued by the Department for Communities and Local Government (DCLG) on proposed changes to the LGPS and provides draft responses for Member approval.

RECOMMENDATION

That Members consider the options within the consultation papers and approve the draft responses to DCLG as follows;

1) Appendix B – The options for a New Look Local Government Pension Scheme (**to follow)**
2) Appendix D – Governance Arrangements
3) Appendix F – Admitted Body Status **(to follow)**

REPORT DETAIL

The Government has issued three consultation papers which they seek responses to from Local Authorities and other key stakeholders.

The first paper entitled 'Where next – Options for a new-look Local Government Pension Scheme' was published on 30th June and responses are sought by 29th September 2006.

This consultation puts forward four options for the future of the Local Government Pension Scheme, including final salary and career-average options. Reform of the LGPS is required because people are living longer than ever before and working lives have also altered significantly. The Government's objective is to safeguard the LGPS as a good quality, defined benefit, funded scheme, while ensuring that it remains affordable,

sustainable and acceptable to taxpayers. The paper is attached at Appendix A and a draft response is attached at Appendix B (to follow).

The second paper entitled 'A Blueprint for Governance arrangements in the Local Government Pension Scheme in England and Wales' was published on 26th July and responses are sought by 6th October 2006.

The purpose of this paper is to outline principles and propositions for the future governance and stewardship of the Local Government Pension Scheme in England and Wales and, in particular, how a consistent level of effective representation of key stakeholders on LGPS pension/investment issues can be achieved. The paper is attached at Appendix C and a draft response is attached at Appendix D.

The third paper entitled 'Consultative Discussion Paper on Admitted Body Status' was published on 20th July 2006 and responses are sought by 6th October 2006.

The existing Admitted Body Status provisions provide for administering authorities to enter into admission agreements with transferee admission bodies to allow specified groups of employees to have continued access to the LGPS. They were originally introduced in 1999; in their current form they date from 2003.

Several issues have been brought to the Government's attention in recent months about the practical operation of the admitted body status provisions and following discussions by the working group comprising key stakeholders in the contracting-out process the Government is now seeking views on some principles for possible regulatory development of the Admitted Body Status (ABS) provisions. The paper is attached at Appendix E and a draft response is attached at Appendix F (to follow).

Financial Implications and risks:

There are no financial implications or risks resulting directly from this report. Any financial consequences arising from the outcome of the consultation process and possible changes to the Local Government Pension Scheme will be reported back to the Committee and will be included in the Council's medium Term Financial Strategy as appropriate.

Legal Implications and risks:

As the terms of the LGPS are governed by specific legislation, it is possible for them to be amended by statutory instrument without the consent of scheme members, i.e. it will not be a breach of contract for such a change to occur.

The introduction of greater member involvement in advising on the Havering scheme would require amendments to the Council's constitution.

The possible changes for admitted bodies would not have particular legal implications.

Human Resources Implications and risks:

No human resource implications arise, directly, from this report

Staff Contact Jeff Potter
Designation: Head of Exchequer Services
Telephone No: 01708-434139
E-mail address: jeff.potter@havering.gov.uk

STEPHEN EVANS
Chief Executive

Background Papers List

The Local Government Pension Scheme Regulations 1997 (as amended)

APPENDIX A

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

June 2006

Department for Communities and Local Government
Eland House
Bressenden Place
London SW1E 5DU
Telephone 020 7944 4400
Web site www.communities.gov.uk
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DCLG Publications
PO Box 236
Wetherby
West Yorkshire
LS23 7NB
Tel: 0870 1226 236
Fax: 0870 1226 237
Email: communities@twoten.press.net
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Foreword

1. I see this document as a crucial step in the development of the Government's proposals for sustainable and affordable solutions to the challenges facing the Local Government Pension Scheme (LGPS) in England and Wales.

2. The Scheme is recognised by all stakeholders as a key component of the reward package available to workers in and around local government. Scheme employers greatly value the LGPS and now wish to see it secured on a sustainable and affordable basis. So too do scheme members. A degree of consensus is emerging around the need to reform the Scheme, both to ensure it meets the challenge of a changing and more diverse workforce and adapts to increasing pensioner longevity. It must also remain fair to taxpayers who underwrite its benefits and its pension promise.

3. The development of a new-look LGPS is taking place alongside reforms to other public service schemes and to the state pension system. A White Paper on Pensions Reform, *Security in retirement: Towards a new pensions system,* was published on 15 May. The Teachers', Civil Service and NHS pension schemes are each completing, or are in the process of developing, new schemes.

4. Against this background, a number of costed options are now put forward in this document for a new-look Local Government Pension Scheme in England and Wales to apply to its existing and future workforce from April 2008. These options take forward the principles and propositions first consulted on in *Facing the Future* in October 2004. They have been developed in conjunction with LGPS stakeholders over the last six months.
5. The Government now seeks the views of all LGPS interests on these options by 29 September, in order to build a consensus around what affordable, viable, fair and equality-proofed reforms can be delivered for 1 April 2008.

Phil Woolas MP
Minister for Local Government and Community Cohesion

Executive Summary

1. The Government's policy for the Local Government Pension Scheme (LGPS) in England and Wales can be summarised as follows. The Scheme should be:

   a. **affordable** and **viable**;
   b. **fair** to taxpayers, who ultimately guarantee its pension promise;
   c. **attractive** to existing and future scheme members, and to employers;
   d. regarded and valued as **an integral part of the overall remuneration package** for employees in an increasingly diverse workforce; and
   e. able to deliver an appropriate **defined benefit**, **index-linked income** in retirement for its members.

2. At this stage, Ministers have agreed to invite consultees views on four options for the new-look scheme. These options were developed in conjunction with LGPS interests over the past six months, and build on the responses received to the October 2004 Green Paper *Facing the Future – Principles and Propositions for a new-look Local Government Pension Scheme in England and Wales.* The four options are:

   A. An updated current scheme, with additional benefit improvements;
   B. A new, final salary scheme with an improved accrual rate;
   C. A new, career-average scheme; and
   D. A new, hybrid arrangement, based on a career-average core with a final salary *option*.

3. Options B-D have been designed to have an indicative benchmark cost of around 20.9% for existing members. This is because, within the costing methodology adopted, 20.9% represents a scheme cost in which 50% of the savings from the removal of the 85 year rule and commutation are recycled, once the additional protections for existing scheme members from the removal of the 85 year rule are taken into account. DCLG is currently consulting on these extensions, but we assume, for the purposes of this consultation, that they are implemented. Option A is a somewhat lower cost option, at 19.4% for existing members.

4. These benchmark costings are not intended to provide a funding recommendation for the scheme, nor a representative or average scheme cost. This is because it is not considered appropriate to produce average or representative costings centrally for a Scheme which is run by 89 separate funds in England and Wales, each with their own profile and individual challenges. Funds will take different approaches to valuing their individual assets and liabilities, and will make different recommendations for contribution rates to employers.

5. Instead, the Department developed an approach for costing options for a new look scheme in discussion with the Government Actuary's Department (GAD). This has also involved LGPS fund actuaries and actuarial advisors to main LGPS stakeholders. The costings have been developed in consultation with and have been made available to LGPS working groups. This approach allows for valid comparisons to be made, based on the differences between the cost of the current scheme and the costs of the new-look scheme options.

6. Funds and scheme employers are now strongly encouraged to use these to assess the likely impact on their costs, should any of the options detailed here apply from 2008. This data will be important to the Department and to stakeholders in assessing range of local cost implications of the options for funds, employers and employees. In order to ensure the Scheme's affordability, employees' and employers' contribution rates must be acceptable to all parties and an appropriate mechanism for sharing of future cost pressures should be considered.

7. The responses received to this consultation will be carefully considered before Ministers decide on which proposal to conduct a statutory consultation, in the form of draft Scheme regulations, later this year. It is intended that the new look scheme will be available to all new entrants *and* existing scheme members from 1 April 2008. The mechanics of how the accrued rights of existing scheme members in the current scheme will be transferred or protected remain to be discussed with stakeholders. However, the objective would be to have one local government scheme for all members and therefore a fair means to transfer existing scheme members to the new-look scheme must be developed.

8. The four options represent the range of views from across the scheme and from scheme interests. The priorities and perspectives of scheme employers are important, as the LGPS provides for their employees. So too are those of LGPS members, who benefit in retirement from choosing to save **now**. It is also important to value and take account of the views of those employees who currently choose not to join the Scheme, and to focus on how their needs can be provided for in the reforms. Finally, the views of the taxpayer, through their representatives, need to be taken into account during the consultation process and beyond.

9. Response templates can be found at Annexes 2 and 3.

Chapter 1

The Departmental and regulatory position

1.1 This consultation stage in the development of new-look LGS considers costed options from which it is hoped that the basis of specific regulatory proposals to reform and modernise the LGPS in England and Wales will emerge. Ministers have indicated consistently throughout this reform process that they wish to develop a modern, flexible LGPS which can better serve the needs of local government and its workforce, as well as being affordable and viable for stakeholders.

1.2 Given their stewardship and regulatory responsibilities for the Scheme, Ministers have confirmed that they wish to see local authority employees, and other LGPS members, enjoy the benefits of a good quality pension scheme. To achieve that, the LGPS must be regulated on the basis of fairness and affordability, and be proportionate in terms of the balance between the level of benefits which are provided for its membership, and the costs incurred by its providers. Finally, of course, the Scheme itself is under-pinned by taxpayers who ensure its pension promise.

1.3 The LGPS in England and Wales has developed considerably since the early part of the last century. Its rules are now defined in regulations made under section 7 of the Superannuation Act 1972. It is defined also for the purposes of the Pensions Schemes Act 1993 as a statutory, public service pension scheme.

1.4 The Scheme is sponsored by the Department for Communities and Local Government (DCLG), which is responsible for its stewardship and maintaining its regulatory framework. However, within that framework, it is administered, managed and funded at local authority level.

1.5 In defining the policy framework, as a prelude to discussing the possible architecture of options for a new-look Scheme, it may be helpful to state the basis for the Scheme's new arrangements to be set out in new regulations, made under powers in the Superannuation Act 1972. They should be:

- **comprehensive** in their overall provision;
- **flexible and responsive** to the needs of stakeholders, in terms of the balance between provision and cost;
- **efficient and cost effective** in terms of delivery;
- **fully transferable** and;
- **provide the continued security** of an inflation-proofed pension promise for all Scheme members.

Chapter 2

Increasing longevity and reform of the state pension system

2.1 Today's population can expect to live for longer than ever before. Longevity brings advantages and disadvantages, depending on one's perspective. Men and women are living longer in general but these personal and social gains produce implications for society, governments and policy makers. Pension provision, driven as it is by the combination of time, costs and long term promises does not escape. Inevitably, there is a need for a proper balance between reasonable expectation and viable provision. In the LGPS, a funded public service scheme which is underwritten by the taxpayer, this is a fundamental requirement to the upheld in any reform process.

2.2 Societal changes impinge on that process. Expectations, lifestyles, social patterns of behaviour have fundamentally changed since the LGPS was first introduced and indeed have accelerated over the past two decades. Working lives have altered with more variation than ever in each adult's lifetime as between work, study, caring, career breaks and semi-retirement. Multiple employments are far more common-place. The role of women in the workforce, and especially so in local government has seen very significant increases, including high proportions in part-time employment.

2.3 Perhaps most fundamental of all is the need to deal with the challenge of an ageing population and consequently the dramatic increase in dependency ratios. The Department for Work and Pensions (DWP) White Paper on Pensions Reform – *Security in retirement: towards a new pensions system* (cm 6841), published on 25 May, helpfully summarises the position. In particular, it states (paragraph 18) that:

"we are about to experience a dramatic acceleration in the dependency ratio – the balance between the numbers of people of working age and those over State Pension Age. Rising longevity means this is on a long-term upward trend. However, with the large cohort of baby-boomers born just after the second world war swelling the workforce, this ratio has been artificially depressed in recent decades. As that generation goes through to retirement, we will rapidly catch up with the long-term trend."

2.4 To emphasise the point, the White Paper points out that the pensioner population in 1950 stood at 19 per cent of the working age population. Today the figure is 27 per cent. By 2050, once the ratio has caught up with the underlying trend, it might be 47 per cent. This demographic shift, the White Paper suggests, will transform the context for pensions policy.

2.5 In addressing the challenges described in the White Paper, the Government has set five tests for its reform package. Any reformed pension system must:

- **Promote personal responsibility;**
- **be fair;**
- **be simple;**
- **be affordable;** and
- **be sustainable.**

2.6 In taking these five tests forward, the White Paper clarifies the Government's reform proposals for State pensions and personal provision in the following ways:

Making it easier to save for retirement: Automatic enrolment in the new Personal Accounts system is not targeted at employees who already have access to good quality workplace pension schemes like the LGPS. DWP will be consulting later this year on an exemption test for employers who offer such schemes.

Providing a solid foundation on which people can save: The Second State Pension is estimated to become flat-rate by 2030. The basic State Pension will be re-linked to average earnings during the next Parliament.

Making the state pension fairer and more widely available: Qualifying requirements and the way in which women, carers and other groups build entitlement to the state pension are being adjusted.

Supporting and encouraging extended working lives: The state retirement age is proposed to rise in line with gains in average life expectancy. The state pension age for women is already due to rise from 60 to 65 between 2010 and 2020, and there will now be a subsequent rise for both men and women from 65 to 68 between 2024 and 2046.

Streamlining the regulatory environment: Contracting out is to be abolished for defined contribution schemes. The long-term future of contracting out for defined benefit schemes will be subject to ongoing review.

2.7 The White Paper's intentions, therefore, are designed to make a difference to the retirement prospects of everyone and to achieve a new balance between individuals, their employers and the State. Measures to protect the current pensioners will remain and steps will be taken to ensure all pensions will share in rising national prosperity. Legislation is proposed for the second session of this Parliament.

2.8 These proposals, including the rising state pension age, clearly provide a relevant context to the reform of the LGPS, and will need to be taken into account as the development of a new-look LGPS progresses.

Chapter 3

A changing workforce in and around local government

3.1 Consultant actuaries, Hymans Robertson LLP, produced, in September 2005, a demographic study for the then Office of the Deputy Prime Minister, entitled *Local Government Pension Scheme in England and Wales: Review of Demographic Patterns.* This review included an analysis of changes in employee membership structure, drawing on the experience of six LGPS funds particularly between the 2001 and 2004 valuations. The report found that the membership of the LGPS had changed significantly since the existing benefit structure was introduced in the early 1970's. This had become particularly apparent since all part-timers were allowed to join in 1993.

3.2 The LGPS now demonstrates characteristics of substantive divergence. In a Scheme of this size, covering up to 1/12 of the labour market and with such a wide variety of jobs and professions such divergence, reflecting national employment trends, should not perhaps be a surprise. This diversity provides a strong case for the benefit structure evolving in order to suit a wide range of needs fairly. An ageing working population and a substantially increasing pensioner population (relative to the working population) also means that retaining older workers in employment will become increasingly important. The following main trends were identified:

3.3 **Part-time working:** 72% of the current employee membership is female, with 57% of female workers working part-time. Almost half the employee members work part-time, and will therefore be building up benefits in retirement on the basis of a part-time salary.

3.4 **Length of service:** The average length of service for members leaving active status in the LGPS has reduced from 8.1 years in 1992-95 to 6.3 years in 2001-04. This means that scheme members, over the course of their careers, are likely to build up pension provision in other schemes as they change employers. Short serving scheme members are not likely to expect to draw the majority of their retirement income from the LGPS. Indeed 75% of pensions in payment in 2004 were less than £5,000 a year. Additionally, women tend to be in receipt of lower pensions than men, primarily due to a combination of their shorter service, part-time working patterns and lower pay.

3.5 **Salary distribution:** Although average annual Full Time Equivalent (FTE) pay for women and men at 31 March 2004 was found to be some £16,400 and £20,800 respectively, analysis of the distribution of women's pay in particular shows that the distribution is skewed with large numbers of women being paid less than the average, and small numbers of women being paid significantly more. In other words, there is a bunching around lower annual pay levels, between the ranges of £10,000 – £17,000.

3.6 **Pensioner longevity:** For men retiring at 65, based simply on LGPS population mortality, the average period that a pension is expected to be in payment has risen from 12.2 years to 16.0 years since the early 1970's, an increase of some 31%. For women, the rise is from 16.1 years to 19.0 years, a rise of some 18%.

Chapter 4

Equality proofing

4.1 The demographic study by Hymans Robertson also provided some evidence that LGPS pensioners with larger pensions tend to survive for longer in retirement. This should not, in itself, be surprising: a number of studies have shown a definite correlation between wealth and longevity.

4.2 A final salary scheme such as the LGPS also tends to focus benefits on long serving staff, and particularly those who progress up the earnings scale whilst in employment. While it is not the role of a pension scheme to redistribute wealth, in order to equality proof the LGPS, a smoothing of these differences, whilst maintaining mutuality across the pension scheme, seems a reasonable objective. These steps seem necessary, given the diverse nature of the modern LGPS workforce as outlined in Chapter 3. They might also serve to meet the needs of those potential scheme members who have already or who might in future choose not to join the LGPS.

4.3 The Prime Minister's Foreword to the Department for Work and Pensions (DWP) White Paper on Pensions Reform – *Security in retirement: towards a new pensions system,* states that "we need to put in place an affordable and sustainable pension system which…encourages people to save for their retirement". To ensure the new-look LGPS is attractive and affordable **across the whole diverse range** of a modern workforce – including school dinner ladies, town planners, teaching assistants, road sweepers, accountants and chief executives, with their different salaries, periods of scheme membership and progression prospects seems a necessary objective.

4.4 A good quality, workbase pension is, for many individuals, a key component of their retirement income. The reform of the LGPS will secure its status as a good quality, defined benefit pension scheme, but the reforms must also be equality-proofed, and must remain attractive and affordable to employees and employers and fair to the taxpayer who underwrites its pension promise.

4.5 In Chapter 6, four options for the new-look scheme are presented. Some of these options retain and build on the final salary structure of the LGPS, but others are based on a career-average structure. While a final salary structure tends to focus benefits on long serving staff, and particularly those who progress up the earnings scales whilst in employment, a career average structure tends to redistribute benefits back towards the shorter serving staff or those with lower career salary growth. This would, therefore be one equality proofed option for a new-look scheme that is attractive and provides benefits fairly across the whole diverse range of the modern workforce.

4.6 Consideration must therefore also be given to how the final salary options could be equality-proofed, in the context of the diversity of the modern workforce. Lower cost entry points are one possibility, to make a final salary structure more attractive to those whom it does not tend to benefit as much as long serving staff, and particularly those who progress up the earnings scales whilst in employment. However, any reduction in contribution rate for one part of pensionable earnings will need to be mirrored with an increase in contribution rate for another part, in order to generate the required average employee contribution rate, other things being equal.

4.7 The merits for one element of the workforce of a *tiered contribution structure* must therefore be weighed against the downside for another element. Such a structure would be necessary, were a final salary scheme to be implemented, and it could be considered to be desirable also in the case that a career average scheme is to be implemented. In Chapter 11, consideration is given to exploring possible tiered structures.

Chapter 5

Arriving at a target benchmark cost

5.1 The LGPS has had a normal retirement age of 65 since the 1920s. However, the 85 year rule currently allows scheme members whose age plus service equals 85 to retire from 60 (of from 50 with employer consent) on an *unreduced pension.* Any scheme member can retire from 60 (or from 50 with employer consent), but if they do not satisfy the 85 year rule, they will face a reduction in their pension to reflect the fact that it is coming into payment earlier than expected and is also likely to be in payment for longer than expected.

5.2 The 85 year rule was removed from 1 October 2006 by the *Local Government Pension Scheme (Amendment) Regulations 2006,* which were laid in Parliament on 30 March 2006. These regulations also introduced protections for those existing scheme members closest to retirement, who would be 60 and satisfy the 85 year rule by 31 March 2013 and who would therefore not have time to make alternative arrangements. The new-look scheme options do not assume any 85 year rule rights, except for those existing scheme members who satisfy the 31 March 2013 protections.

5.3 As many consultees will be aware, the 85 year rule was previously removed from 1 April 2005, but these regulations were subsequently revoked, so the rule was effectively reinstated to the scheme. Chapter 15 contains descriptions of the Scheme's benefit package over the recent period of changes. These variations on the current LGPS have also been costed on this same basis as the new-look scheme options, in order to allow respondees to compare the relative costs of the options with the current scheme.

5.4 Within the methodology of *benchmark* costings, carried out by the Government Actuary's Department (GAD) (this methodology and approach is outlined in Chapter 9), and by comparing the cost of the scheme at 30 March 2006 (when the 85 year rule was in place but increased commutation was not) with the cost of the scheme at 1 October 2006 (when the 85 year rule will not be in place, but increased commutation will be), it is possible to arrive at a representative figure for the cost of a new-look scheme in which 50% of the savings from the removal of the 85 year rule and the introduction of increased commutation are recycled.

5.5 Chapter 10 shows that, on this basis, some 1.1% (0.9%) 1 would be available for recycling into the new-look scheme, giving an indicative new-look scheme cost of some 21.1% for existing scheme members and 18.5% for new entrants. The trades unions and local government employers reached an agreement, detailed in their joint statement of 11 April 2006, to develop the new-look scheme on this basis. We have viewed these indicative costings as a target cost for the new-look scheme, and have developed the options accordingly.

5.6 DCLG is conducting a consultation from 26 May to 3 July 2006 on proposals to provide additional affordable and legal additional protections for existing scheme members from the removal of the 85 year rule. These proposals were put to the Department following joint discussions between the local government employers and the trades unions. Subject to the outcome of the consultation exercise, amending regulations will be made and laid by the summer Recess in order to implement these changes from 1 October 2006.

5.7 It is important to obtain the cost of these additional protections, and to take account of how this cost would be likely to impact on the cost of the new-look scheme, should the proposals be implemented. Chapter 15 outlines costings from the Government Actuary's Department (GAD) which show that the target costings should be **reduced** by 0.2% in the case that these proposals for additional affordable and legal additional protections are be implemented. This document has been prepared on the basis that they will be, and therefore the target benchmark scheme costs for the new-look options should be adjusted to 20.9% for existing scheme members and 18.3% for new entrants, as is illustrated in Chapter 10. The four options contained in this paper have been designed with reference to this **adjusted target benchmark cost.**

Chapter 6

Four options for the new-look scheme

6.1 The LGPS has a varied membership, with a complex set of needs to meet, within an affordable package which is fair to taxpayers. The reform of the Scheme must take this into account. The Department is, sensitive to the needs and perspectives of different LGPS interests and four costed options have therefore been designed to allow for the full range of views. Each of the four options would deliver the Government's policy for the Local Government Pension Scheme in England and Wales.

Core structures

6.2 The four options detail different *core structures* for the new-look LGPS, which have a normal retirement age of 65. Options A and B retain the *final-salary* nature of the Scheme, in which a pension per annum is paid to scheme members from the normal retirement age of 65 as follows:

Pension p.a. = (Accrual rate) x (No. years membership) x (Final salary)

6.3 The accrual rate defines the proportion of final salary which the member builds up (or *accrues)* for each year of their membership of the pension scheme. For the LGPS, the accrual rate is currently 1/80th, i.e. members build up pension rights payable per annum in retirement at a rate of 1/80th of their final salary per year of scheme membership. This pension is then increased in line with inflation (RPI) in retirement.

6.4 Option C has a *career-average* structure, in which scheme members build up entitlement to a pension in retirement based on their salary *in each year of membership*, not just on their final salary. Pension per annum is paid to scheme members from the normal retirement age of 65 as follows:

Pension p.a. = (Accrual rate) x (Year 1 Salary) x (Re-valuation index)

+ (Accrual rate) x (Year 2 Salary) x (Re-valuation index)

+ ... + (Accrual rate) x (Final Year Salary) x (Re-valuation index)

6.5 The member's benefits in retirement are therefore the sum of each year's accrual indexed according to the chosen revaluation index, which effectively revalues the benefits accrued in each year of service according on a certain basis. Option C1 revalues each year's benefits in line with price inflation, and Option C2 revalues each year's benefits in line with a measure of wage inflation. As a greater revaluation index is more expensive (as it gives more value to each year's benefits), the accrual rate for Option C2 is lower than that for C1.

6.6 Option C1 provides each member with an element of pension (1.85%) for the pay received in each year, which is fixed in real terms for each year (by RPI revaluation). Deferred members benefits are increased in line with RPI also – there is therefore no difference in revaluation between active members and deferred members. Option C2 provides members remaining in service with increases to their benefits in line with wage inflation (taken to be RPI + 1.5%). They therefore receive a more favourable revaluation than deferred members.

6.7 Under the current final salary structure, benefits are paid according to final salary. Options C1 and C2 will affect existing scheme members differently in relation to the current scheme, depending on their circumstances. As option C2 is someway between Option C1 and a final salary scheme, Option C2 could be considered to have less of an effect of the change on existing scheme members than Option C1.

6.8 Any implications of the 1993 Pensions Act for the treatment of leavers from the LGPS would need to be considered further in the event that Option C2 was to be taken forward.

6.9 Option D builds on Options C1 and C2, but would also offer scheme members a *one-off* choice of making extra contributions to obtain final salary linked benefits in retirement. There would be no extra contribution from the employer.

The additional benefit improvements

6.10 Options A-D would also provide an increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees, and better targeted ill-health pension provision on a two-tier basis. The proposals for two-tier ill health pension provision are detailed in Chapter 8.

6.11 These improvements would provide better security for scheme members and their dependants in the event of death or inability to work due to serious ill-health retirement. The four options have therefore been costed to include all three of these additional benefit improvements. However, two points are worth bearing in mind from the outset: firstly, that were partners' provisions to be reduced for married, civil and cohabiting partners, this would reduce the cost of the options, and secondly, that the Law Commission are due to make a final report to the Government on reform of the law surrounding relationship breakdown in August this year.

6.12 **Partners' pensions:** This consultation paper on options for the new-look scheme makes no proposition that partners' benefits should be reduced in the LGPS at this stage. However, as more women enter the workforce, and more households draw on more than one income, the need to provide partners' pensions reduces, as long as both partners have access to a good workplace based pension scheme, and are able to build up enough entitlement.

6.13 Additionally, it should be pointed out that where the accrual rate in the scheme is improved, most noticeably in Option B, the long term survivor benefits for partners are also improved, as these are set at 50% of pension entitlement. Therefore, this represents an additional benefit improvement, which might be valued at about 0.4% (0.3%). Were this not to be provided, the cost of the Option would fall.

6.14 **Cohabitees pensions:** The Law Commission published, on 30 May 2006, Consultation Paper No 179, *Cohabitation: The Financial Consequences of Relationship Breakdown,* having been tasked by the Government to consider how any reform of the law of this area could be carried out. The paper considers the case for allowing cohabiting couples to "opt-in" to a scheme imposing enforceable financial obligations on the parties in the event of their separation.

6.15 The consultation is open until 30 September 2006, and a final report is expected by August 2007. The introduction of cohabitees pensions into the LGPS may need to be reconsidered in light of any resulting change in the law, as it is clearly desirable that any provision be compatible and aligned with any reform in law in this area which may emerge. However, for the purposes of this paper, we proceed to cost the introduction of cohabitees benefits, according to the same principles and criteria as have been adopted for the Civil Service Pension Scheme.

Evaluation of the four options

6.16 Having considered the general aspects of the options, each option is now considered in turn, its associated cost is outlined and it is evaluated against the following specified criteria:

Cost – is the option affordable for employees and employers? This is dealt with in more detail in Chapters 11 and 12.

Effect on existing scheme members – how will the future accrual of existing scheme members be affected by the new options? This is dealt with in more detail in Chapter 13.

Attractiveness to employees – does the scheme encourage saving and encourage working later in life? This is also considered in Chapters 2, 3 and 7.

Design – is the option fit for the modern and future workforce in and around local government? This is also considered in Chapters 3 and 4.

Attractiveness to employers – would the option help employers to recruit and retain staff? The related issue of a discretionary approach for scheme employers is raised in Chapter 14.

6.17 The four options in this paper have been costed according to the approach outlined in Chapter 9. The benchmark costings used to evaluate the four options (summarised in Chapter 10) are drawn from this approach, and have been designed with reference to an adjusted target benchmark cost of 20.9% (18.3%), as detailed in Chapter 5. This adjusted benchmark cost represents the cost of a scheme in which 50% of the savings from the removal of the 85 year rule and commutation are recycled into benefit improvements, when the proposals for additional protections for existing scheme members as contained in the draft *Local Government Pension Scheme (Amendment) (No.2) Regulations 2006* are taken into account.

OPTION A: An updated current scheme, with additional benefit Improvements

Core structure: The current LGPS – a final salary scheme with an accrual rate of 1/80th of final salary per year of membership, an automatic tax-free lump sum on retirement of 3/80th of final salary per year of membership.

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the verarching legal position and timetable) and better targeted ill-health benefit provision on a two tier basis.

Benchmark cost: On the basis of the costing methodology applied, this Option would cost a total of 19.4% (17.3%) of pensionable pay, i.e. 0.6% (0.3%) **less than** the scheme at 1 October 2006.

Core Structure	Death Benefit	Cohabitees pensions	Two-tier ill-health	Total Cost
20.0% (17.6%)	0.3% (0.2%)	0.2% (0.2%)	-1.0% (-0.7%)	19.4% (17.3%)

Evaluation against criteria:

1. This is a lower-cost option than Options B and C. The reduction in costs generated by the move to two-tier ill health pension provision actually means it costs less than the scheme at 1 October 2006 (i.e. without the 85 year rule), despite the improvements to death in service benefits and cohabitees pensions. This option would therefore, other things being equal, require a lower contribution rate for employers and/or employees than would be the case for Options B and C.

2. A final salary scheme is a valuable recruitment and retention tool for scheme employers, as it tends to focus benefits on long-serving staff, particularly on those who progress up the earnings scale whilst in employment. It is an especially attractive option for these individuals, both currently and in the future.

3. Should this option be implemented, consideration will need to be given to a *tiered employee contribution rate,* which would encourage short-serving, low progressing staff to join the scheme and would ensure the scheme catered fairly for the modern workforce.

4. Retaining the current structure will minimise the effect of the change on existing scheme members. However, the introduction of a tiered employee contribution rate would affect employees' take-home pay immediately, as this might be increased or decreased in comparison with the contribution rate they currently pay, depending on the salary of that person.

OPTION B: A new, final salary scheme with an improved accrual rate

Core structure: Retains a final-salary structure, but moves from a "1/80th: 3/80th"structure to a 1/60th accrual rate, with no automatic tax free lump-sum on retirement.

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health pension provision on a two tier basis.

Benchmark cost: On the basis of the costing methodology applied, this Option would cost a total of 20.9% (18.6%) of pensionable pay, i.e. 0.9% (1.0%) more than the scheme at 1 October 2006.

Core Structure	Death Benefit	Cohabitees pensions	Two-tier ill-health	Total Cost
21.5% (18.9%)	0.3% (0.2%)	0.3% (0.2%)	-1.1% (-0.8%)	20.9% (18.6%)

Evaluation against criteria:

1. It is difficult to compare the value of the current 1/80th:3/80th structure to one in which there is no automatic lump sum. However, on the basis of assumptions consistent with those underlying these benchmark costings, the current structure is approximately equal in value to an accrual rate of 1/64.5 (close to 1.55%). Therefore, moving to a 1/60th (1.67%) accrual rate represents an improvement in the accrual rate of approximately 0.12%.

2. This option actually costs 0% (0.3%) more than the **adjusted** target benchmark for a new-look scheme with 50% of the savings from the removal of the 85 year rule and commutation recycled into benefit improvements. In order to ensure the scheme's affordability to employers, it would be likely that an increase in employee contribution rate from its current rate of 6% would be necessary. As Option B costs more than Options C1, C2 and particularly A, this increase would be likely to be larger.

3. A final salary scheme is a valuable recruitment and retention tool for scheme employers, as it tends to focus benefits on long-serving staff, particularly on those who progress up the earnings scale whilst in employment. It is an especially attractive option for these individuals, both currently and in the future.

4. Should this option be implemented, consideration will need to be given to a *tiered employee contribution rate,* which would encourage short-serving, low progressing staff to join the scheme, by having a lower contribution rate for pensionable pay below a certain cut-off point. This would contribute to the equality proofing of the new-look scheme, in providing fairly for the modern workforce.

5. Retaining the current final salary structure will minimise the effect of the change on existing scheme members, and indeed would slightly improve the accrual rate. However, the take-home pay of existing scheme members would be affected by any rise in the employee contribution rate, and by the introduction of a tiered employee contribution rate.

OPTION C: A new, career-average scheme

Core structure: Changes from a final-salary structure to a *career-average* structure. **Option C1** would have accrual rate of 1.85% and revaluation on the basis of the Retail Price Index (RPI) and **Option C2** would have an accrual rate of 1.65% and revaluation on the basis of the Retail Price Index (RPI) plus 1.5%, this being an estimation of wage indexation (subject to the overarching legal position).

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health benefit provision on a two tier basis

Benchmark cost: On the basis of the costing methodology applied, Option C1 would cost a total of 20.6% (17.7%) of pensionable pay, i.e. 0.6% (0.1%) more than the scheme at 1 October 2006. Option C2 would cost a total of 20.5% (18.1%) of pensionable pay, i.e. 0.5% (0.5%) more than the scheme at 1 October 2006.

	Core Structure	Death Benefit	Cohabitees pensions	Two-tier ill-health	Total Cost
C1	21.2% (18.3%)	0.3% (0.2%)	0.3% (0.2%)	-1.1% (-1.0%)	20.6% (17.7%)
C2	21.5% (18.9%)	0.3% (0.2%)	0.3% (0.2%)	-1.1% (-0.8%)	20.5% (18.1%)

Evaluation against criteria:

1. Options C1 and C2 move from a final salary scheme to a career average scheme. They cost 0.3% (0.6%) and 0.4% (0.2%) less than the **adjusted** target benchmark for a new-look scheme with 50% of the savings from the removal of the 85 year rule and commutation recycled into benefit improvements. In order to ensure the scheme's affordability to employers, it would be likely that an increase in employee contribution rate from its current rate of 6% would be necessary. This increase would be likely to be more than that which would be required for Option A, but less than that which would be required for Option B, because of their relative costs.

2. A career-average LGPS would retain the nature of the LGPS as a good quality, defined benefit government-sponsored scheme. A career-average structure would better meet the needs of the whole modern local government workforce, with high numbers of short serving, part-time employees on low salaries, as well as *career* local government employees, as it tends to redistribute benefits towards shorter serving staff, in comparison to a final salary scheme. However, it is more complicated to explain to scheme members. The change in the structure of the pension scheme and its cost to employees might also lead to demands for related compensatory changes to pay.

3. Some employees would be better off under C1 and/or C2 than under a final salary structure, because their future pay increases will be less than the scheme's revaluation rate. Some would be worse off, because their future pay increases will be greater than the scheme's revaluation rate. However, the take home pay of existing scheme members would be affected by any rise in the employee contribution rate. A *tiered employee contribution rate* could also be considered for Options C1 and C2 in order to provide further encouragement to join to such individuals.

OPTION D: A new, hybrid scheme

Core structure: As for Options C1 or C2. Scheme members would also have a *one-off* choice of making extra contributions, on top of the contribution rate required for the career-average core structure, to obtain final salary linked benefits in retirement.

Secondary benefit improvements: Increased lump sum death in service benefit from two times to three times pay, partners' pensions for cohabitees (subject to the overarching legal position and timetable) and better targeted ill-health benefit provision on a two tier basis.

Benchmark cost: The benchmark *scheme* cost is as for Options C1 or C2, depending on which career-average structure is chosen. On the basis of the costing methodology applied, the final-salary linked option would cost around an additional 3% for those electing to receive final salary benefits.

Some further thought will need to be given to what fixed contribution rate should be set in the event that this option is chosen, and to whether a mechanism for reviewing the figure should be introduced in light of experience of take-up.

Evaluation against criteria:

1. Option D would be based on Option C1 or C2, so the evaluation for these options also applies here. Additionally, the final salary choice would mean that those existing scheme members who wished to continue in a final salary scheme, could, while not reducing the quality of the career-average scheme which could be provided for the majority of the workforce.

2. This flexibility would be valuable to employers in recruiting and retaining long serving, high progression staff, who stand to benefit most from a final salary scheme relative to a career-average scheme.

3. However, introducing choice into the LGPS will mean that some individuals may choose what could turn out to be "the wrong option" – because of their patterns of promotion and salary growth turning out to be different to how they had thought when they decided which option to enter. There would be a need for a clear communication to scheme members, which would set out their options, without advising, potentially incorrectly, on which to opt for at the point of decision.

4. The alternative would be to allow scheme members multiple opportunities to switch between the career-average and final salary options. However, this could result in the additional cost of the final salary option possibly rising to as much as 6% because of the effect of selection. As this cost would be likely to be prohibitive, scheme members should have one opportunity, possibly at the outset of their employment, to elect to pay extra contributions.

Chapter 7

Flexible and early retirement

7.1 Supporting extended working lives is a key intention of the proposals for reform of the state pension outlined in the Government's White Paper *Security in retirement: towards a new pensions system.* Giving Scheme members the opportunity to wind down towards retirement by gradually reducing the working hours and/or responsibilities is also a key reform aim for the LGPS. The traditional approach to retirement, where an individual goes from being in full-time employment to being in full-time retirement, over the space of a weekend, no longer meets the needs and expectations of many employees and employers.

Existing provisions

7.2 The *Local Government Pension Scheme (Amendment) Regulations 2006* have already introduced some provisions to support flexible retirement in the current scheme. These provisions allow scheme members to:

a. Retire before the scheme's normal retirement age of 65 from 60, or from 50 with employer consent. For scheme members with no 85 year rule entitlement, their pension will be reduced according to a set of cost-neutral early retirement factors, to reflect the fact that it is coming into payment earlier than expected and is likely to be in payment for longer than expected;

b. Take *flexible retirement* from 60, where the employer gives their consent, and where the employee takes a reduction in hours or grade. This will mean that the employee takes payment of their reduced pension before 65, while remaining in employment; or

c. Continue to accrue service in the LGPS beyond age 65. The pension must be drawn by the day before the member's 75th birthday. Benefits accrued before age 65, which are not taken at or before age 65, will be *increased* by cost neutral uplift factors, to reflect the fact that it is coming into payment later than expected and is likely to be in payment for shorter than expected.

Possible extensions for the new-look scheme

7.3 These amendments were made possible by the simplification of the taxation of pensions, as introduced by the Finance Act 2004. These provisions will continue in the new-look scheme from 1 April 20082, but we would now like to consider how to build on these improvements in the new-look scheme. The following extensions could be considered:

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;*

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);

c. Remove the requirement for employees to obtain employer consent for flexible retirement;

d. Remove the requirement for employees to take a reduction in hours or grade in order to take flexible 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.

Review of early retirement reduction factors

7.4 A separate review of the cost-neutral actuarial reduction factors is currently underway at the time of writing. This review responds to concerns which have been raised by LGPS scheme interests about these factors, which are considered now to be somewhat out-of-date in light of improvements in pensioner longevity. The intention is for the new factors to be available in the current scheme from 1 October 2006, to coincide with the date of removal of the 85 year rule from the scheme.

Chapter 8

Proposals for two-tier ill health pension provisions

Introduction

8.1 This paper summarises proposals for two-tier ill-health pension provisions for the Local Government Pension Scheme (LGPS) in England and Wales. It takes account of responses received from members of the ill-health working group to the discussion paper *Ill-Health Retirement Review: Two Tier Arrangement,* which was open to comment from the group between 26 May and 8 June 2006. This discussion paper is available in full on the DCLG LGPS website at **www.xoq83.dial.pipex.com**.

8.2 While the proposals will continue to be taken forward by the ill-health working group, comments are invited from all respondees on the proposals, and a list of specific questions follows in the technical response template at Annex 2.

8.3 HM Treasury published a *Review of Ill-Health Retirement in the Public Sector action plan* in October 2000, which included the requirement to introduce a two tier ill-health retirement pension arrangement. The ill-health working group, chaired by the then Office of the Deputy Prime Minister, was established to take forward the original action plan recommendation. The Government's intention is that the provisions which emerge from this process should come into effect on 1 April 2007, one year in advance of the new-look scheme. This would require a statutory consultation in the autumn of 2006.

General Principles

8.4 At present the ill-health retirement pension provisions within the LGPS award, in most cases, enhanced retirement benefits for life, regardless of future health and employment prospects. The underlying rationale of a two tier ill-health retirement pension arrangement is that it is better focussed and targeted compared to the present "one size fits all" arrangement.

8.5 Introducing a two tier arrangement will offer scheme employers a wider range of ill-health benefits that are more in tune with the circumstances that apply at the time employment has been terminated. Introducing a review facility would allow adjustment to the benefits in payment following subsequent changes in medical conditions, medical science and/or employment prospects. However, as we go on to discuss in paragraph 18, there would some substantial restrictions to such an approach.

The top tier

8.6 The *top tier* provision would cover those scheme members who are permanently unfit to perform the duties of their local government employment and whose incapacity is such that they are unlikely to secure gainful or regular employment again.

8.7 Consultees views are invited on what criteria should be used to define "regular employment". These criteria would need to take account of the diverse nature of the LGPS workforce. One example is the Firefighters' schemes, in which "regular employment" is defined as being "not less than 30 hours per week on average over a twelve month period".

8.8 Those ill-health retirees satisfying the top tier criteria would receive benefits based on an enhancement of their existing membership by 50% of their prospective service up to the scheme's normal retirement age of 65. Consideration could be given as to whether local authority employers should have the facility to award more than the 50% enhancement in individual cases where more generous awards can be justified on compassionate grounds.

The second tier

8.9 The *second tier provision* would cover those members who cease employment with a Scheme employer on the grounds of incapacity, but who are judged to be capable of undertaking other regular employment.

8.10 Those ill-health retirees satisfying the second tier criteria would not receive enhancement of their existing membership, but would receive immediate and unreduced payment of their accrued benefits.

Review arrangements

8.11 A key element of the two tier arrangement will be whether ill-health retirement cases are to be kept under review, with the entitlement to benefits being adjusted according to changes in circumstances. Such a review would need to be done by scheme employers in conjunction with their medical advisers and/or independent registered medical practitioners.

8.12 For the top tier it is therefore proposed that LGPS scheme employers should be given the same power to withdraw the enhanced pension if a person with a top tier pension again becomes capable of undertaking regular employment. These powers are available under the ill-health provisions of the Firefighters' Pension Scheme.

8.13 In these circumstances, it is proposed that the enhanced element of the benefit would be cancelled and substituted with one based on accrued service only up to the date of retirement.

8.14 It is recognised that 85-95% of LGPS ill-health retirees would be expected to fall within the second tier. Immediate payment of unreduced accrued benefits makes the exit gateway for these ill-health retirees easy to manage. However, retiring members would have a very wide range of incapacities, and prospective job opportunities.

8.15 One solution would be to break down the second tier into perhaps four or five different categories, each offering a different level of benefit. For example, at the top end of the second tier, immediate payment of the unenhanced benefits would be paid for life at the exit gateway. At the other end of the spectrum, immediate unreduced payment of deferred benefits would be paid for say 2 years. After two years, unreduced payment could be subject to review, and only remain if circumstances warranted the continued payment. The different categories would then allow for different review mechanisms for different sorts of incapacities and prospective opportunities.

8.16 In deciding whether or not to introduce a review mechanism, a balance needs to be struck between simplicity and ease of administration on the one hand, and the cost savings arising from a better targeted and flexible award system on the other.

8.17 A further complication stems from the requirements of the Finance Act 2004 which would need to be managed. Under the Finance Act, an enhanced benefit could be withdrawn in circumstances where an ill-health retiree no longer satisfies the criteria upon which the original ill-health benefit was based. However, it would not be possible to adjust the level of benefit paid where the degree of incapacity or ability to undertake regular employment varies further in the future.

8.18 Views are therefore sought from respondees as to whether the inclusion of a review structure would deliver a more appropriate two-tier ill-health provision for the LGPS.

Cost

8.19 The Government Actuary's Department (GAD) have carried out some analysis of the likely cost impact of the move to two-tier ill-health retirement provisions, based on the levels of retirement assumed by the funds at the 2004 valuations. There is some evidence that actuaries adjusted their assumptions at the 2004 valuations to take account of there being fewer ill-health retirements than previously anticipated.

8.20 As the cost of providing ill-health benefits has an effect on the total scheme cost, this needed to be built into the design of the new-look scheme. However, as past experience of ill-health retirement rates may be less relevant to the costing of the two-tier provision, and as experience varies greatly across different public service schemes, GAD applied a range of assumptions to their costings in order to produce an estimate as to the possible *range* of the cost impact on the new-look scheme. They also considered the effect of varying the number of ill-health retirements overall. This analysis has been carried out for each of the Options outlined in this paper. This is not included here for conciseness, but is available on request from DCLG via the contact information at Chapter 17.

8.21 However, in order to arrive at headline benchmark costings for the new-look scheme, some decision had to be taken as to which set of assumptions should be used for this purpose. We isolated the following:

a. 85% of ill-health retirements to fall under the second tier and 15% of ill-health retirements to fall under the top tier;

b. 10% uplift from second tier to top tier before NRA65 (assuming that such movement is to be permitted); and

c. 50% enhancement of prospective service for the top tier and immediate payment of unreduced benefits for the second tier.

8.22 The policy objective for introducing a two-tier structure is not to reduce the cost of the scheme. However, through the provision of better targeted benefits to those who need it most, it is clear that a significant saving is generated in comparison to the ill-health provisions currently available. Any saving provides more scope for benefit improvements within the target cost for the scheme.

8.23 This of course, is on the basis of the levels of take-up assumed at the 2004 valuations, from which experience may also differ. Additionally, in the case that the assumed behaviour is not experienced, or that the design of the two-tier provisions is altered, there will be an impact on the benchmark costings for the options, as would be the case with any assumption. Any request to extend ill-health provision should therefore take account of the impact on the rest of the benefit package post 2008.

Developing the proposals

8.24 This paper favours certain options that the Department has developed via the ill-health working group and that it is believed are appropriate to the circumstances of the LGPS. Consultees are, however, encouraged to suggest alternative proposals within the general two-tier framework outlined in this paper. In order to develop the particular proposals outlines here, consultees are also asked to consider and comment on a number of specific issues, which are detailed in Annex 3.

Chapter 9

The costing process

9.1 Neither the Department for Communities and Local Government (DCLG), nor the Government Actuary's Department (GAD), is in a position to produce average or representative costings centrally. But, in order to assess options for a new-look scheme, it is important for LGPS interests to be able to compare the costs of different options.

9.2 The Department's approach has therefore been to produce a benchmark set of costings, which enable comparisons to be drawn between the *difference in cost* of the various options for the new scheme and the current scheme, rather than the *absolute cost.* These differences can be used by individual funds, and their relevant employers, to assess the likely impact on their costs of changing to each of the different options in 2008. These outputs can help to add depth and data to individual responses to the consultation.

9.3 The individual funds, with their actuaries, are able to take an approach to valuation and administration which is appropriate to the local conditions, taking into account workforce age and pay profiles, investment and funding strategies and assumptions on (for example) life expectancy.

9.4 The Department developed an approach for costing options for a new-look scheme, in discussion with the Government Actuary's Department (GAD), LGPS fund actuaries and members of LGPS working groups, including the trades unions and the local government employers and their actuarial advisors. The basic principles of this actuarial approach are as follows:

a. The benchmark costings deal solely with future accrual. They do not take into account any past service deficits funds might have.

b. The new-look Scheme will apply to both existing members and new entrants groups. Appropriate valuation methodologies have therefore been used for each group, to provide costs both on an existing and new entrant basis.

c. The benchmark cost of the Scheme could be reasonably expected to tend from the existing member benchmark cost to the new member benchmark over time, as existing members move into retirement or leave local government employment with a deferred pension.

d. The benchmark costings are based on anonymised membership data from six un-named funds, as at 31 March 2004. Whilst they may not be entirely representative of the Scheme as a whole, they still provide a valid sample of possible typical average Scheme demographics.

e. The actuarial assumptions adopted are consistent with the approaches taken by the fund actuaries at the 2004 fund valuations, but make extra allowance for anticipated further improvements in pensioner longevity and assumes that 50% of scheme members (by value) will elect to commute pension at a commutation rate of 12:1 to obtain the maximum tax-free lump sum on retirement allowed by the Local Government Pension Scheme (Amendment) 2006 Regulations. The other 50% are assumed to take a lump-sum equal to the current automatic lump sum of 3/80ths pension.

f. A *Sensitivity analysis* has been carried out to assess the sensitivity of the benchmark costings to the demographic and actuarial assumptions adopted. This will enable funds and employers to assess the likely costs of the options, in the case of their own characteristics and approach.

9.5 Further details of the Department's approach, GAD's methodology, membership distributions and actuarial assumptions, and the resulting costings and sensitivity analysis, are available on request from DCLG, or from the DCLG LGPS website at **www.xoq83.dial.pipex.com**. These have been provided already to LGPS interests involved in developmental working groups.

Chapter 10

Summary tables of benchmark costs[3]

Table One: Calculating the target benchmark cost for the new-look scheme options

Benchmark costs	Existing[4]	New[5]
w. The scheme as at 1 October 2006	20.0%	17.6%
x. The scheme as at 30 September 2006	21.7%	19.0%
y. The scheme as at 30 March 2006	22.2%	19.4%
z. The scheme as assumed by many funds at the 2004 valuation	20.3%	17.9%
A target benchmark cost for the new-look scheme		
50% of the savings from the removal of the 85 year rule and commutation (y – w)	1.1%	0.9%
Target benchmark cost (w + 0.5 (y – w))	21.1%	18.5%
Adjusted benchmark cost (subtracting 0.2% for additional protections)	**20.9%**	**18.3%**

Table Two: Benchmark costings for the four options

Benchmark costs	Core cost		Total cost[6]	
	Existing	**New**	**Existing**	**New**
A. An updated current scheme	20.0%	17.6%	19.4%	17.3%
B. A new, final salary scheme with an improved accrual rate	21.5%	18.9%	20.9%	18.6%
C1. A new, career-average scheme (1.85% accrual rate and RPI revaluation)	21.2%	18.3%	20.6%	17.7%
C2. A new, career-average scheme (1.65% accrual and RPI + 1.5% revaluation)	21.1%	18.7%	20.5%	18.1%
D. A new, hybrid arrangement	As c, plus around an additional 3% for those who join the final salary arrangement			

3 These benchmark costs have been produced according to the approach outlined in Chapter 9.
4 “Existing” refers to the existing members cost, as a percentage of pensionable payroll.
5 “New” refers to the new entrant cost, as a percentage of pensionable payroll.
6 “Total cost” refers to the total cost of the core structure and the additional benefit improvements, as outlined in Chapter 6.

Note: The two-tier ill health pension provisions that are included in the benchmark costings for the Options A-D with additional secondary benefit improvements have, for the purposes of these costings, been based on the following particular set of assumptions:

- 50% enhancement of prospective service for the upper tier
- 85% of ill-health retirees retire under second tier;15% under top tier
- 10% uplift from lower tier to upper tier whilst benefits are in payment, and before NRA65

If a different set of assumptions are used, a different set of total scheme costs will be produced. This may affect whether or not the Options meet the target benchmark cost. In basing the costings on one particular set of assumptions, there can be no interference that this is the most appropriate set of assumptions to use. Further analysis will need to be done to evaluate the likely impact of the ill-health provisions on the new-look scheme costings. See Chapter 8 for more details.

Chapter 11

Employee and employer contribution rates

11.1 There is an initial difficulty in assessing employee and employer costs for each Option. The benchmark costings are neither funding recommendations, nor average or representative costings. They do not deal with any past service deficits funds might have. The actual cost will clearly depend on the fund and membership characteristics and the actuarial approach taken. It is also relevant to remember that the actual cost will also depend on how quickly existing members leave the scheme and new entrants join, as this will determine how the new entrant costs and existing scheme members costs are "blended" together.

11.2 The new-look scheme cannot and should not resolve differences between funds and scheme employers – the LGPS is independently managed and administered in 89 different funds in England and Wales, which each have their own funding approach, membership characteristics and many other distinctions.

11.3 A detailed discussion of employee and employer contribution rates is at Annex 1. This draws on the benchmark scheme costings and develops an analysis which will better enable the evaluation of each Option with respect to costs to employees and employers, until further assessment is available from funds and employers as to the likely impact on their costs, should any of the options detailed here apply from 2008.

Tiered contribution rates

11.4 Chapter 4 and Chapter 6 also raise the proposal of a tiered contribution rate for Options A and B, in order to equality-proof a final salary scheme for the modern workforce in and around local government. This could also be considered for Options C and D, especially if the employee contribution rate was to increase, as a way of ensuring the scheme remains affordable for the low-paid.

11.5 We can therefore start to consider possible tiered structures that would be likely to yield appropriate average employee contributions. Under a two-tier structure, employees would pay a reduced rate of contributions on pensionable pay **below** a certain cut-off point, and then an increased rate of contributions on pensionable pay **above** the same cut-off point. This cut-off point could be fixed to the point at which earnings are taxed at the basic rate of 22% rather than the starting rate of 10%. In 2006-07 this was set at £7,185 (the sum of the personal allowance of £5,035 and the starting rate income tax band of £1 – £2,150).

11.6 An alternative two-tier structure might not be linked to tax bands – it could be based on any cut-off point which would then rise with, for example, inflation or wage inflation. As the reason for introducing a tiered structure would be to make the scheme more affordable and attractive to the low-paid, the cut-off point would need to focus on this group. Therefore, a possible cut-off point in this scenario could be, for example, £12,000.

11.7 Annex 1 details a number of possible combinations of contribution rate for each two-tier structure. In the case that a tiered structure was to be implemented, it would need to be designed in order to generate the required average employee contribution rate for the new-look scheme. Consideration would also need to be

given to how this average might change due to changes in workforce demographics and the yearly revaluation of the cut-off point.

Chapter 12

Future cost sharing between employers and employees

12.1 Both the LGPS trades unions and the local government employers have considered the principle of introducing some mechanism to ensure that variations in the ratio of employer to employee contributions are limited. The LGPS is a funded scheme, with the risk of providing benefits to scheme members falling to the employers. Equally, the employer may receive the benefit of any experience gain through, for example, reduced future contribution rates.

12.2 It is realistic to consider increases in average employee contribution rates. However in recognition of rising liabilities and recycling of savings, it is not proposed to move away from a fixed contribution rate for employees. This approach is considered appropriate for a defined-benefit Government sponsored scheme such as the LGPS, and is consistent with the approaches being taken by the other public service pension schemes.

12.3 A number of potential ways to introduce some future cost sharing arrangement have been considered, with one specific mechanism emerging. For example, there could be a requirement for a review of demographic assumptions at every second/third tri-ennial valuation post 2007. If the assumptions had increased or decreased by some substantial amount since the last review, this could trigger a review of the fixed employee contribution rate to the prevalent employer contribution rate. Were this to be found to have increased or decreased by some substantial amount since the last review, an adjustment would be made to the employee contribution rate in order to re-establish the defined ratio, OR an adjustment would be made to the Scheme's benefit package to re-establish the ratio.

12.4 At the 2004 valuations the average funding level was 74%. Employers were increasing their contribution rates, predominantly on a stepped and phased basis, in order to recover any past service deficit over the period set out in their statutory Funding Strategy Statement. The average LGPS deficit recovery period is 21 years.

12.5 It will be necessary to bear this in mind when designing the new-look scheme. However, the reforms are not intended to address the cost pressures facing employers in relation to past service. What is important is that the new-look scheme has a future service cost that is affordable for employees and employers, as well as taxpayers. A future cost sharing mechanism will be one way of securing this affordability and thereby mitigating the likelihood of past service pressures building up in the future.

Discussion of the conflicts between the nature of the LGPS and a future cost sharing mechanism

12.6 Any future cost sharing mechanism would need to be conducted nationally, as the LGPS is a national scheme. This would lead to adjustments being made to employee contributions or to Scheme design on a national level, as is appropriate to a national scheme.

12.7 However, as the funded LGPS is regulated nationally but managed and administered locally by 89 separate funds in England and Wales, the employer rate will vary locally, due to different approaches to valuation and funding, and differing local membership. This will mean that any adjustment following review would have a different effect on separate funds and employers.

12.8 These substantial issues would therefore need to be satisfactorily addressed before the Department could even consider the implementation of such a future cost sharing mechanism. Were this to be considered, a number of questions might arise. These are detailed in Annex 3.

Reviewing the take-up of additional commutation in the context of a future cost sharing mechanism

12.9 The trades unions and local government employers have raised with the Department the merits of keeping the assumptions about commutation savings under review. This would mean that discussions could be held to consider the recycling of any extra savings resulting from more members than expected commuting more of their pension for tax-free cash at retirement. Conversely, were fewer scheme members to commute, discussions would proceed to consider what adjustments might be made to the scheme's benefit package and/or the employee contribution rate, to assure the scheme's affordability in this specific regard. The Department is not proposing that such a review be implemented at this stage. However, in light of the views of the local government employers and the trades unions we are inviting comments from respondees on this specific matter.

Chapter 13

Existing scheme members in the new-look Scheme

13.1 Subject to the outcome of this consultation exercise, it is intended that the new look scheme be available to all new entrants and existing scheme members from 1 April 2008. It is not proposed to run two different schemes (i.e. one for existing members and one for new entrants) nor that existing scheme members have different contribution rates from new entrants.

13.2 All scheme members would accrue membership from 1 April 2008 under the new-look scheme, and they would therefore receive benefits under the terms of the new-look scheme at retirement. However, the practical way in which the *accrued* benefits of existing scheme members at 1 April 2008 are to be calculated at their retirement date some time afterwards, has not yet been decided. Possible transfer methods are:

A. Give all existing scheme members at 31 March 2008 an actuarially equivalent period of service in the new-look scheme, according to a formula to be provided by GAD.

B. Give existing scheme members at 31 March 2008 more credit in the new look scheme than they would receive under method A.

C. Treat all accrued service of existing scheme members as 31 March 2008 as a benefit to be payable on retirement, under the terms of the current scheme, based on the final salary at retirement.

13.3 Each method has advantages and disadvantages. In assessing which option is the most suitable for the LGPS, the following criteria may be useful:

a. Cost, and impact on the new-look scheme;

b. Impact on existing scheme members;

c. Implementation of transitional protections from the current scheme in the new-look scheme; and

d. Ease of administration.

13.4 Under **method A**, because the future career progression and date of retirement of the individuals would not be known, some scheme members might benefit more from this transfer than others, as even though it would be on a cost neutral basis this could not allow for all variations on personal circumstances. Ensuring no scheme member “lost out” in the transfer would not be cost neutral, as an *underpin* would need to be provided and this would reduce the funds available for the new-look scheme. This would mean that, other things being equal, the new-look scheme would need to be less attractive in order to implement this transfer.

13.5 **Method B** would suffer similar complications, but would additionally provide extra benefits to existing scheme members, which would go some way to smoothing transition to the new-look scheme. However, this would further reduce the available funds in the new-look scheme. Therefore, although at first glance **methods A and B** might lead to simpler administration, ensuring that no scheme member "lost out" in this method would lead to extra costs being incurred. Infact, implementation would also be complicated by the protections for existing scheme members at 30 September 2006 from the removal of the 85 year rule, as these extend beyond 1 April 2008, when the new-look scheme is to come into effect.

13.6 **Method C** might, therefore, be considered to be the more attractive option, as it would not change the expectations of existing scheme members in respect of their accrued service at 1 April 2008. As these benefits will have already been funded by employers under the terms of the current LGPS. There should therefore be no impact on the funds available for the new-look scheme. However, although this might simplify short term administration but would perhaps involve long term administration issues rather than methods A or B, as a record would need to be kept for each scheme member to detail their pre-1April 2008 service. Neither would it provide the opportunity to simplify the complicated protections of various groups of scheme members in the current scheme, which are difficult to administer. If changes are made to the ill-health, death in service and partners' pension provision, there will be an added complication in assessing benefits for existing scheme members post 1 April 2008, as they will effectively have two sets of entitlements.

13.7 This method might also provide an alternative way to implement the transitional protections. As pre-1 April 2008 service is to provide benefits at retirement based on the current scheme, direct account can be taken of accrued 85 year rule rights at 1 April 2008. However, it is not as straightforward to account for post 1 April 85 year rule rights for a scheme member who is eligible for transitional protections between 1 April 2008 and 1 April 2020, as these rights will have been accrued in the new-look scheme. The following possibilities could be considered:

i. A member who is eligible for protections between 1 April 2008 and 31 March 2013 could receive unreduced pre-1 April 2008 benefits under the terms of the current scheme, and unreduced post-1 April benefits under the terms of the new-look scheme; or

ii. A member who is eligible for protections between 1 April 2008 and 31 March 2013 could receive unreduced benefits under the terms of the current scheme for all his pre 1 April 2020 service; or

iii. A member who is eligible for protections between 1 April 2008 and 31 March 2013 could receive unreduced pre-1 April 2008 benefits under the terms of the current scheme, and unreduced post-1 April benefits under the terms of the new-look scheme, but on an *actuarially equivalent basis* to the benefits he *would have* received in post-1 April 2008 service, had the current scheme been in place.

13.8 However, all of these ways except ii would have a cost impact on the new look scheme because, as with methods A and B, ensuring no scheme members "looses out" would lead to extra costs being incurred, and therefore would require a reduction in the cost of the new-look scheme, other things being equal.

13.9 A number of questions associated with these issues are detailed at Annex 3.

Chapter 14

Scope of scheme employers' discretions

14.1 Several LGPS administering authorities, in the light of their relatively more beneficial funding position, have suggested that specific optional scope could be provided in the new-look Scheme for LGPS employers. This would allow employers to opt to provide specific, additional benefits over and above the national benefit package for the Scheme.

14.2 Such benefits could be provided, on an individual employer basis, where the employer has satisfied itself of its ability to manage any extra liability accruing as a result, on a defined-benefit basis, over the period of appointment. The employer would also have to satisfy themselves that their policy would meet any discrimination and equality requirements arising in employment law.

14.3 Consultees views are invited on whether such a discretionary approach could or should be available to LGPS employers in any new-look scheme.

Chapter 15

Recap of recent changes to the LGPS

Background

15.1 The Secretary of State for Communities and Local Government is responsible for policy development and overall regulatory stewardship of the Scheme in England and Wales and, using the powers under the Superannuation Act 1972, sets the statutory framework within secondary legislation for the management, investment and administration of the Scheme.

15.2 The Scheme is run locally, and administered by 89 separate (predominantly) local authorities, each with the own pension fund. Within each pension fund there will be a number of separate employers, possibly including other local authorities, schools, further and higher education colleges and contractors.

15.3 The LGPS is available to all employees in Local Government, or in other organizations that have chosen to participate in it. Teachers, police officers, firefighters and employees eligible to join another statutory pension scheme are not allowed to join the LGPS. Employees of Local Government (other than Town and Parish Councils, to which special arrangements apply), automatically become members of the LGPS unless they opt not to join or have previously opted out, or are a casual employee.

The removal of the 85 year rule

15.4 The *Local Government Pension Scheme (Amendment) Regulations 2006* removed the 85 year rule from the LGPS with effect from 1 October 2006, and introduced transitional protections for those existing active scheme members at 30 September 2006 who will be 60 and would otherwise have satisfied the 85 year rule by 31 March 2013.

15.5 The 85 year rule previously allowed scheme members to retire before the Scheme's normal retirement age of 65 (from 60 or from 50 with employer consent) on an unreduced pension if their age plus service equalled 85.

15.6 As a reference point, at 30 September 2006, the 85 year rule was effectively still part of the Scheme's benefit package.

The introduction of the facility to commute pension for tax-free lump sum on Retirement

15.7 Provisions contained in the *Local Government Pension Scheme (Amendment) Regulations 2006,* allow Scheme members, in accordance with the new simplified HM Revenue and Customs (HMRC) tax regime, to take *larger* lump sums on retirement – up to 25% of the capital value of the pension.

15.8 Before these amendments came into effect, LGPS scheme members could only take the automatic 3/80ths tax-free lump sum on retirement that was stipulated by the scheme's regulations.

15.9 As a reference point, at 30 March 2006, the commutation arrangements were effectively confined to the automatic tax-free lump.

The current scheme

15.10 As a reference point, the current scheme can be considered that as of 1 October 2006.

15.11 Employees pay 6%, but some existing scheme members have a protected right to pay 5%. Across the LGPS as a whole, employee contributions average 5.8% of pensionable pay.

15.12 Normal retirement age of 657.

15.13 Accrual rate of 1/80th of final pay.

15.14 Index-linked benefits.

15.15 An automatic tax-free lump sum of three times pension.

15.16 Option to elect to commute part of annual pension for additional tax-free lump sum, at a commutation rate of 12:1 in accordance with the Finance Act 2004.

15.17 ill health pension from any age.

15.18 a death in service lump sum of two times final pay.

15.19 a widow's, widower's or civil partner's pension.

15.20 children's pensions.

15.21 immediate payment of unreduced pension in the case of redundancy from 50 onward.

15.22 DCLG launched a consultation on 8 May to amend the provisions to comply with age discrimination. The proposals replace the current provisions with discretion for employers to award up to 2 years pay on early termination of employment.

The current consultation (from 26 May to 3 July 2006) on the draft Local Government Pension Scheme (Amendment) (No.2) Regulations 2006

15.23 The proposals under consultation between 26 May and 3 July 2006 in the draft *Local Government Pension Scheme (Amendment) (No.2) Regulations 2006* would have the following effects:

a. existing active scheme members at 30 September 2006 would continue to accrue service under the 85 year rule until 31 March 2008, in order to provide continuity with the start of the new-look scheme;

b. protection for existing members who will be 60 and satisfy the 85 year rule would be extended from 31 March 2013 to 31 March 2016; and

c. the "cliff-edge" that would then exist between 31 March 2016 (at which eligible members would suffer no reduction to their pension) and 1 April 2016 (at which members would suffer full reduction on service accrued after 1 April 2008) would then be smoothed, by applying *tapering reductions* on a linear basis from 0% reduction at 31 March 2016 to 100% reduction at 1 April 2020.

15.24 GAD have estimated that these additional protections will each cost:

a. £0.5 billion;
b. £0.5 billion; and
c. £0.35 – 0.4 billion.

15.25 The cost of the protections until 31 March 2013 was, in most cases, taken into account in the 2004 valuations, and therefore does not need to be taken into account in this context.

15.26 In calculating the cost pressures in the new-look scheme of these proposals, we need to compare the cost of these extensions with the *accrued savings* already available in the current LGPS. These accrued savings have been generated by the introduction from 1 April 2006 of a provision which would allow scheme members to *commute* some of their pension per annum (which accrues at a rate of 1/80th per year of service) for additional tax-free lump sum on retirement.

15.27 Before 1 April 2006, LGPS scheme members could only take the automatic 3/80ths tax-free lump sum on retirement that was stipulated by the scheme's regulations. The 1 April changes, contained in the *Local Government Pension Scheme (Amendment) Regulations 2006,* allow, in accordance with the new simplified HM Revenue and Customs (HMRC) tax regime, Scheme members to take *larger* lump sums on retirement – up to 25% of the capital value of the pension.

15.28 Where Scheme members chose to increase their tax-free lump sum above the automatic 3/80th provision which still remains post 1 April 2006, this increase would be paid for by the Scheme member swapping pension for tax-free cash at a certain *commutation factor*. The commutation factor is 12:1, which means for every £1 of pension foregone, the Scheme member would receive an additional £12 tax-free as a lump sum payment on retirement.

15.29 The Government Actuary's Department (GAD) have calculated that this provision could result in an overall saving to the LGPS. This is because, very broadly, a typical scheme member who has commuted some of their pension to lump sum on retirement might, on average, expect to live to receive more than 12 years worth of pension instalments.

15.30 The calculation is necessarily based on a number of assumptions, most importantly that 50% of Scheme members would continue to only take the 3/80th lump sum and that 50% would take the new maximum permissible under the new tax regime. The Final Regulatory Impact Assessment (RIA) which accompanied the Local Government Pension Scheme (Amendment) Regulations 2006 details that the capital value of savings relating to the accrued service of existing scheme is estimated to be £11.4 billion8. The Final RIA also explains that some of these savings were to be used to pay for the extra 18 months of service for all scheme members under the 85 year rule, as a result of the revocation of the *Local Government Pension Scheme (Amendment) (No.2) Regulations 2004.* The cost of revocation was calculated to be some £520 – 590 million.

15.31 As explained in Chapter 5, the new-look scheme options have been designed with reference to a target scheme cost which recycles 50% of the savings from the removal of the 85 year rule and commutation in respect of future service costs for existing members and new entrants. However, it will also be possible to use some or all of the accrued savings for existing scheme members from commutation to pay for either benefit improvements in the new-look scheme, or protections for existing scheme members from the removal of the 85 year rule from the current scheme.

15.32 The total cost of the additional protections and the cost of revocation is £1.9 – 2.0 billion, i.e. some £0.65 – £0.75 billion in excess of the £ 11.4 billion accrued commutation savings. Therefore, should these additional protections be implemented, it will be necessary to “eat into” the future savings by this amount. Over a period of 20 years, based on a pensionable payroll of £25bn, this is equivalent to around 0.16% – 0.18% a year of pensionable payroll.

15.33 As the new-look scheme costings are provided to one decimal place, it will therefore be reasonable to reduce the target new-look benchmark cost by 0.2%, should these additional protections be implemented. The new-look scheme options have therefore been designed to have a benchmark cost equal to this adjusted target cost, as can be seen in Chapter 10.

Chapter 16

Timetable for reform

16.1 **The new-look scheme:** It is intended that the new-look scheme comes into effect on 1 April 2008 with regards to both new entrants and future accruals for existing scheme members. In order to meet this demanding timetable, the following programmed steps will be necessary:

29 September 2006	Deadline for responses to this consultation paper
Late Autumn 2006	Consultation on draft regulations for the new-look scheme begins and extends into early 2007
1 April 2007	Regulations for the new-look scheme to come into force
1 April 2008	Regulations governing the new-look scheme take full effect

16.2 **Two-tier ill health pension provision:** Proposals are being developed for the new-look scheme and these are included at Chapter 8 for information. Comments are invited by 29 September, alongside comments on the options for the new-look scheme and the technical response template contains a series of questions on the ill-health proposals for this purpose. The ill health pension provision reforms will be subject to a separate statutory consultation in the autumn of 2006, before coming into effect in April 2007 in advance of the new look scheme.

16.3 In parallel to this work, a number of other workstreams are proceeding. Separate working groups have been underway in recent months to develop proposals for reform, subject to the outcome of these discussions and any consultation, of the administration, access by means of admission agreements and governance arrangements of the Scheme. These developments are proceeding according to separate but parallel timetables.

16.4 **Admission:** A policy discussion document was circulated for comment to the working group on admission agreements in March, following initial discussions with key stakeholders in the contracting-out process. Comments are being considered. A more detailed consultation paper, setting out principles for possible regulatory development of the Admitted Body Status provisions, is expected to be produced and circulated shortly.

16.5 **Administration:** The working group on scheme administration has developed a set of proposals that are currently being used as a basis for preparing a draft, free-standing statutory instrument for consultation later in 2006. A key feature of this workstream will be the preparation and publication of Statutory Codes of Practice to underpin the policy objectives set out in the statutory instrument.

16.6 **Governance:** Plans are well advanced to issue a detailed discussion paper outlining the findings of the Trusteeship working group. The paper will be issued to the working group and other interested parties for comment with the view of firming up on proposals in the autumn. The paper will include the results of a survey undertaken by DCLG into the Governance Policy Statements that LGPS administering authorities were required to publish by 1st April 2006.

16.7 Further information on the ill-health, administration, admission and governance and representation arrangements are available from DCLG on request via the contact information in Chapter 17.

Chapter 17

Consultation responses

17.1 Responses are requested by 29 September 2006, in writing or electronically. We request that, where possible and appropriate, you follow the core and/or technical response templates at Annexes 2 and 3 when you respond. Responses should be sent to Nicola Rochester in the first instance at:

DCLG, Zone 2/E8, Ashdown House
123 Victoria Street, London, SW1E 6DE

lgpensions@communities.gsi.gov.uk

17.2 Requests for further clarification or information in respect of this document should be directed to Myfanwy Taylor at the address above, or at myfanwy.taylor@communities.gsi.gov.uk

17.3 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

17.4 In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department. The Department will process your personal data in accordance with the DPA and in the majority of circumstances; this will mean that your personal data will not be disclosed to third parties.

17.5 A summary of responses to this consultation will be published within three months of the close of consultation at the DCLG LGPS website, **www.xoq83.dial.pipex.com**.

17.6 The Government has adopted a code of practice on consultations. The criteria below apply to all UK national public consultations on the basis of a document in electronic or printed form. They will often be relevant to other sorts of consultation. Though they have no legal force, and cannot prevail over statutory or other mandatory external requirements (e.g. under European Community Law), they should otherwise generally be regarded as binding on UK departments and their agencies, unless Ministers conclude that exceptional circumstances require a departure.

1. **Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.**

2. **Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.**

3. **Ensure that your consultation is clear, concise and widely accessible.**

4. **Give feedback regarding the responses received and how the consultation process influenced the policy.**

5. **Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.**

6. **Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.**

The full consultation code may be viewed at
www.cabinetoffice.gov.uk/regulation/Consultation/Introduction.htm

17.6 Are you satisfied that this consultation has followed these criteria? If not, or you have any other observations about ways of improving the consultation process please contact:

Adam Bond, Department for Communities and Local Government Consultation Coordinator, Room 2.19, 26 Whitehall, London, SW1A 2WH;

or by e-mail to:

adam.bond@communities.gsi.gov.uk

Annex 1

Further analysis of employee and employer contribution rates9

1. In this section, we initially consider employee and employer contribution rates on the basis of the target scheme cost for simplicity. We then consider how the conclusions would vary with the benchmark costs of Options A-D, in order that each Option can be evaluated on the basis of costs to employees and employers.

2. There is an initial difficulty in assessing employee and employer costs for each Option. Although the benchmark costs of the options (including the cost of the additional transitional protections currently being consulted on) are around 21.1% (18.5%), this does not necessarily mean that they will cost 21.1% (18.5%) to all funds or all employers. The benchmark costings are neither funding recommendations nor average or representative costings. They do not deal with any past service deficits funds might have. The actual cost will clearly depend on the fund and membership characteristics and the actuarial approach taken. It is also relevant to remember that the actual cost will also depend on how quickly existing members leave the scheme and new entrants join, as this will determine how the new entrant costs and existing scheme members costs are "blended" together.

3. The new-look scheme cannot and should not resolve differences between funds and scheme employers – the LGPS is independently managed and administered in 89 different funds in England and Wales, which each have their own funding approach, membership characteristics and many other distinctions.

4. It is therefore relevant to compare the benchmark scheme cost at the last valuation in 2004 (which set employer contributions for 2005-06, 2006-07 and 2007-08) with the target benchmark cost. At the time of the 2004 valuations, the then Office of the Deputy Prime Minister (ODPM) was consulting on proposals to remove the 85 year rule from the Scheme from 1 April 2005. Many actuaries therefore assumed that this removal would take place and set employers contribution rates on this basis. The relevant baseline costing for comparative purposes can therefore be taken to be that for the scheme without the 85 year rule and without commutation. This is some 20.3% (17.9%).

5. The target benchmark cost (including the cost of the additional transitional protections currently being consulted) is therefore some 0.8% (0.6%) more than the benchmark cost for the scheme at the 2004 valuations. We can consider that, as a starting point and all other things being equal, employer contributions might need to go up by an average of some 0.8% (0.6%), in relation to those set at the 2004 valuations.

6. Of course, the actual outcome for each fund will vary according to the profile of the fund and the assumptions adopted by each fund's actuary. It is therefore essential for funds and employers, drawing on the benchmark costings in this paper, to assess the likely impact on the scheme cost, and therefore on employer contributions, in the case that each of the options be implemented. With this information, the Department will be best able to set an appropriate employee contribution rate so as to ensure affordability for scheme employers and employees.

7. However, it has been demonstrated that we can assume, as a starting point, and all other things being equal, that the sum total of employee and employer contributions might need to go up by an average of some 0.8% (0.6%), in order to pay for a new-look scheme with a cost equal to the target benchmark cost. The starting point for employers' contributions are those set at the 2004 valuations, when total employer contributions (as a percentage of total pensionable pay10) were, on average, 12.5% – 13.5% in 2005-06, 14% – 15% in 2006-07 and 16% – 17% in 2007-08. These relate to both future service costs and extra payments in respect of past service deficits. The starting point for employees' contributions is 5.8%. Scheme members currently pay contributions of 6% of their pensionable pay, but some existing scheme members have a protected right to pay 5% contributions, which leads to an effective average employee contribution rate of some 5.8% for existing scheme members. New entrants currently pay 6%.

8. We can proceed to consider the following possible employee contribution rates for existing members (new entrant contribution rates will need to equal existing member contribution rates):

   a. Around 6.6%, in order to maintain the employer contribution rates set in 2004 (all other things being equal);

   b. Around 7.1%, in order to achieve a reduction of 0.5% in the employers' contributions in relation to those set in 2004 (all other things being equal);

   c. Around 7.6%, in order to achieve a reduction of 1% in the employers' contributions in relation to those set in 2004 (all other things being equal); or

   d. Around 8.1%, in order to achieve a reduction of 1.5% in the employers' contributions in relation to those set in 2004 (all other things being equal).

9. These costings explore employee rates that would, other things being equal, maintain or reduce employer rates. We have proceeded on this basis because it is crucial that contribution rates must remain affordable to employers in order to ensure the scheme's long-term sustainability as a defined benefit, government sponsored scheme. A rise in employee contributions might be considered reasonable, given that the target benchmark cost recycles 50% of the savings from the removal of the 85 year rule and commutation, and is therefore more expensive than the scheme with no 85 year rule and no commutation.

10. **Option A** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 19.4% for existing members. This is some 1.5% less than the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates could be reduced by 1.5% in order to achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8, all other things being equal.

11. **Option B** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 20.9% for existing members. This is equal to the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates set out in paragraph 8 would achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8, all other things being equal.

12. **Option C1** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 20.6% for existing members. This is some 0.3% less than the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates could be reduced by 0.3% in order to achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8 all other things being equal.

13. **Option C2** has a benchmark total cost (excluding the cost of the additional transitional protections which are currently being consulted on) of 20.5% for existing members. This is some 0.4% less than the target benchmark scheme cost (adjusted for the cost of the additional transitional protections). Therefore, the possible illustrative employee contribution rates could be reduced by 0.4% in order to achieve the same stabilisation/reduction of employer contribution rates as set out in paragraph 8, all other things being equal.

14. Costings for **Option D** are as for Options C1 or C2, depending on which career-average core is chosen. Those employees who choose to receive final salary linked benefits would pay an additional fixed contribution rate of approximately 3%. There would be no extra contribution from the employer.

15. We intend to have one contribution rate for existing scheme members and new entrants in the new-look scheme from 1 April 2008. Consideration will need to be given to the treatment of those existing scheme members with protected rights to pay 5% contributions. Additionally, an assessment will be needed of the actual employee rate which will be required to achieve affordability overall, particularly as some of these illustrative arguments produce different employee contributions for new entrants and existing scheme members on the basis of these benchmark costings.

Possible average employee and employer contribution rates

16. The above analysis has shown that there is some flexibility surrounding the cost sharing of each of the new-look scheme options between employees and employers, drawn up from comparisons between benchmark costings. We summarise the possible employee and employer rates for each Option in the table below, based on a scheme cost equal to the benchmark costings for each option.

Table 1: Existing members (current average contribution rate 5.8%)

Option	Benchmark Cost	Employee Contributions	Benchmark Employer Contributions	& change with respect to the 2004 valuations
A	19.4% + 0.2%	5.1% 5.6% 6.1% 6.6%	14.5% 14% 13.5% 13%	0% -0.5% -1% -1.5%
B	20.9% + 0.2%	6.6% 7.1% 7.6% 8.1%	14.5% 14% 13.5% 13%	0% -0.5% -1% -1.5%
C1	20.6% + 0.2%	6.3% 6.8% 7.3% 7.8%	14.5% 14% 13.5% 13%	0% -0.5% -1% -1.5%
C2	20.5% + 0.2%	6.2% 6.7% 7.2% 7.7%	14.5% 14% 13.5% 13%	0% -0.5% -1% -1.5%
D	Employees who elect for final salary linked benefits pay an additional approximately 3%. Otherwise, costings are as for Option C1 or C2			

17. We must continue to ensure that the scheme remains affordable for employees, especially for those part-time and lower-paid workers who tend to have less disposable income. The scheme must be attractive and encourage saving. Due consideration should therefore be given to what the average employee contribution rate should be, bearing in mind the implications this will have for the employer contribution rate, as set out above.

Tiered contribution rates

18. Chapters 4, 10 and 11 explain the context for considering a tiered contribution rate for Options A and B, in order to equality-proof a final salary scheme for the modern workforce in and around local government; and for Options C and D, if, for instance, the employee contribution rate was to increase, as a way of ensuring the scheme remains affordable for the low-paid. Based on the figures set out in Table 1, we can therefore start to consider possible tiered structures that would be likely to yield appropriate average employee contributions for the new-look scheme. Consideration would also need to be given to how this average might change due to changes in workforce demographics and the yearly revaluation of the cut-off point.

19. Under a two-tier structure, employees would pay a reduced rate of contributions on pensionable pay **below** a certain cut-off point, and then an increased rate of contributions on pensionable pay **above** the same cut-off point. This cut-off point could be fixed to the point at which earnings are taxed at the basic rate of 22% rather than the starting rate of 10%. In 2006/07 this was set at £7,185 (the sum of the personal allowance of £5,035 and the starting rate income tax band of £1 – £2,150).

20. An alternative two-tier structure might not be linked to tax bands – it could be based on any cut-off point which would then rise with, for example, inflation or wage inflation. As the reason for introducing a tiered structure would be to make the scheme more affordable and attractive to the low-paid, the cut-off point would need to focus on this group. Therefore, a possible cut-off point in this scenario could be, for example, £12,000.

21. Tables 2 and 3 detail a number of possible combinations of contribution rate for each two-tier structure. These have been chosen to generate a range of average employee contribution rates from 5% to 8%, in order to cover all scenarios explored in Table 1. These figures are illustrative only and are based on full-time equivalent (FTE) data from a sample of funds, for employees who currently pay 6% contributions.

Table 2: Possible two-tier structures with a cut-off point of £7,185

Lower Band	Upper Band	Weighted rate (1 decimal place)
4.0%	5.5%	4.9%
3.5%	6.0%	5.1%
4.5%	6.0%	5.4%
3.0%	7.0%	5.5%
5.0%	6.5%	5.9%
3.5%	7.5%	6.0%
4.0%	8.0%	6.5%
5.0%	7.5%	6.6%
6.0%	7.5%	6.9%
5.5%	8.0%	7.1%
6.5%	8.0%	7.4%
6.0%	8.5%	7.6%
7.0%	8.5%	7.9%
6.5%	9.0%	8.1%

Table 3: Possible two-tier structures with a cut-off point of £12,000

Lower band	Upper band	Weighted rate (1 decimal place)
3.0%	8.0%	4.9%
4.0%	6.5%	5.0%
4.0%	8.0%	5.6%
5.0%	6.5%	5.6%
5.0%	7.5%	6.0%
5.5%	7.0%	6.1%
6.0%	7.0%	6.4%
5.5%	8.0%	6.5%
6.5%	7.5%	6.9%
6.0%	8.5%	7.0%
7.0%	8.0%	7.4%
7.0%	8.5%	7.6%
7.5%	8.5%	7.9%
7.5%	9.0%	8.1%

Annex 2

Core response template

Consultees who wish to respond to the core issues raised in this paper are encouraged to refer to the core response template below. A technical response template is at Annex 3 for those who wish to respond to the more technical aspects of the paper. Note is also made of the Chapters which are most relevant to each series of questions.

This template provides a list of questions which the Department believes to be particularly relevant to the successful development of a new-look scheme. The use of this template is not compulsory and nor are respondees limited to commenting on the specific issues it raises.

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?

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?

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?

Employee and employer costs

Relevant Chapters: Chapters 1-6, 11

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

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?

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?

Annex 3

Technical response template

Consultees who wish to respond to the more technical aspects of this paper are encouraged to refer to the technical response template below. Note is also made of the Chapters which are most relevant to each series of questions.

The template provides a list of questions which the Department believes to be particularly relevant to the successful development of a new-look scheme. The use of this template is not compulsory and nor are respondees limited to commenting on the specific issues it raises.

The four options

Relevant Chapters: 1-2, 5-8

T1 For scheme employers: What assessment have you made of the likely impact of each of any / all of the four options on the employer contributions you would otherwise have be required to make (or would otherwise have recommended that fund employers make) under the current scheme?

T2 For LGPS funds: What assessment have you made of the likely impact of any/all of the four options on the employer contributions you would otherwise have recommended that the scheme employers in your fund make under the current scheme?

Flexible and early retirement

Relevant Chapters: 2, 3, 7

T3 For scheme employers: How would the introduction of any/all of these extensions affect your ability to manage your workforce?

T4 For scheme employers: What policies and/or provisions would you need to put in place to ensure fair and effective application and management of any/all of these extensions?

Employee and employer costs

Relevant Chapters: 2-6, 9, 11, Annex 1

T5 If you do support a tiered employee contribution rate which of the tiered structures contained in Annex 1, or variations on them, would you support or oppose? Does your view depend on which Option is implemented, and if so how and why?

T6 On the basis of your answers to C4 and C6, is it likely that the recommendation you made in C2 could be implemented? If not, how would you adjust your answers to C2, C4 and C6 in order for your recommendation to be affordable?

Two-tier ill-health pension provisions

Relevant Chapters: 8

T7 Do you support or oppose the proposal to move to a two-tier basis for ill-health pension provision? Why? The following additional questions might be relevant:

a. What criteria should be used to define “regular employment”?

b. By what percentage of prospective service should a member’s accrued service be enhanced?

c. Should employers’ retain the discretion to award up to 100% enhancement?

d. What criteria should be used to judge “capability to undertake other regular employment?”

e. Do you agree that ill-health retirements under the second tier should not receive any enhancement?

f. Should the immediate payment of unreduced benefits be: subject to review, subject to abatement in the event of improvement, not subject to review, but payable for a fixed period of time or not subject to review, and payable until death?

g. In the case that the second tier is to be subject to review, should it be divided into different categories according to extent of incapacity and prospective opportunities, with each category subject to different review procedures?

h. Should any movement to the top tier be allowed?

i. Should a scheme member be able to apply for ill-health retirement?

j. How should ill-heath retirees be assessed?

T8 Do you have proposals for alternative two-tier ill health pension provisions?

A future cost sharing mechanism

Relevant Chapters: 12

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

T10 Do you support the approach outlined in Chapter 12, or do you have alternative suggestions for other mechanisms?

T11 Do you support or oppose the idea of keeping the assumptions about commutation savings under review, as part of any cost sharing mechanism?

T12 How might the conflict between the nature of the LGPS and a future cost sharing mechanism might be resolved? The following questions may be relevant:

- **a.** How might the introduction of this mechanism tend to change the actuarial approach taken to valuation, and therefore scheme employers' costs?
- **b.** Who should conduct the national review?
- **c.** What proportion of funds should this be based on?
- **d.** What, if any, additional provision of data or reporting would need to be required from funds or employers?
- **e.** How often should the review take place?
- **f.** Which demographic assumptions should be subject to review?
- **g.** What size increase/decrease in these assumptions should trigger a review?
- **h.** What should the defined ratio of employee: employer contributions be?
- **i.** What size increase/decrease in this ratio should trigger a review?
- **j.** How, if at all, might the regulatory framework governing the management and administration of funds need to adjust, if at all?
- **k.** How, if at all, might the regulatory framework governing the management and administration of funds need to adjust?
- **l.** By what, if any, national consultative processes would the benchmarks and triggers be agreed?
- **m.** By what, if any, national consultative processes would any resulting change in employee contribution rate or Scheme design be agreed?

Existing scheme members in the new-look scheme

Relevant Chapters: 13

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

T14 How should protections for existing scheme members from the removal of the 85 year rule be dealt with in the new-look scheme post 1 April 2008?

T15 Do you have proposals for alternative methods of transfer?

T16 Bearing in mind the criteria for evaluation, which method would you recommend be taken forward for the new-look scheme?

Scope of scheme employers' discretions

Relevant Chapters: 14

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?

APPENDIX C

A BLUEPRINT FOR GOVERNANCE ARRANGEMENTS IN THE LOCAL GOVERNMENT PENSION SCHEME IN ENGLAND AND WALES

Background

1. The purpose of this paper is to outline principles and propositions for the future governance and stewardship of the Local Government Pension Scheme in England and Wales and, in particular, how a consistent level of effective representation of key stakeholders on LGPS pension/investment issues can be achieved.

2. The paper is divided into the following sections :

   the first section of this paper describes the outcome of the recent survey of Governance policy statements that LGPS fund authorities were required to publish by 1 April 2006.

   the second section explains the context of the LGPS and how this impacts on the governance and representation arrangements that local authorities with statutory responsibilities under the scheme are able to adopt.

   the third section outlines the proposals submitted by UNISON;

   the fourth section sets out the proposals for the introduction of a new Pensions Representation Panel where appropriate; and

   the fifth section describes the steps to be taken to achieve this aim.

Section I - The Present Position

3. In response to an informal consultation paper issued in 2004, the then ODPM undertook to introduce amending regulations to require LGPS administering authorities to prepare, publish and maintain Governance Policy Statements as a means of introducing greater transparency and openness about these arrangements and also to allow the Department to undertake a detailed survey of the democratisation of LGPS committees. These regulations came into force in November 2005 and in March 2006, administering authorities were asked to submit copies of their statements to the Department for analysis, the results of which, are summarised below.

How many committees include scheme member or trade union representatives?

4. According to the survey of Governance policy statements that LGPS administering authorities were required to publish by 1st April 2006, 84%have scheme member representation on their formal pension/investment committee or advisory panel. Of that 84% , 74% are represented on the main committee with the remaining 9% sitting on advisory panels. Of the 17% of fund authorities with no scheme representation, 4 are county councils, 6 are London Boroughs and 5 are Welsh authorities. A more detailed analysis of the survey is attached at annex A.

5. The survey confirmed that a significant discrepancy exists in the size of LGPS formal pension committees, ranging from 3 to 20 and also the frequency of their meetings, between 2 and 6 per annum. The survey also shows that there is no direct link between the level of representation and either funding levels or investment performance indicated by the rate of investment return. There are, however, significant variations amongst the fund authorities included in the survey, but the evidence suggests that these are attributable to factors other than the level of representation.

How many have conferred voting rights on lay members?

6. Of the [86] fund authorities who responded to the survey, only 4 have conferred voting rights on scheme member representatives who sit on the main pension/investment committee. It is interesting to note that of these four authorities, two are principal local authorities whilst the other two are strategic pension authorities. A further five fund authorities have introduced a system of voting for all members who sit on their advisory panel

Section II - The LGPS context : Status and Legal Frameworks

7. As a statutory, public service scheme, the LGPS has a different legal status compared with trust based schemes in the private sector. Matters of governance in the LGPS therefore need to be considered on their own merits and with a proper regard to the legal status of the scheme. This includes how and where it fits in with the local democratic process through local government law and locally elected councillors who have the final responsibility for its stewardship and management. The LGPS is also different in the respect that unlike most private sector schemes where scheme members bear some, if not all, of the investment risk, the benefits paid by local authorities are guaranteed by statute and, perhaps more importantly, are paid out of local authority revenue and not from the pension funds themselves. On this basis, it is the local authority itself, and local council tax payers, who are the final guarantors of the scheme. In coming forward with these proposals, the paper recognises the particular status in law of local authorities in comparison with non-statutory bodies and institutions, and flowing from that, the constraints arising from the statutory nature of the LGPS, compared with trust based schemes in the private sector, and the body of law that dictates the composition of local authority committees and the status of lay members on such committees.

What is a "trustee"

8. The word "trustee" is often used in a very general sense to mean somebody who acts on behalf of other people but in pensions law it has a more specific meaning. Certain occupational pension schemes, primarily in the private sector, are established under trust law. Under a trust, named people ("trustees") hold property on behalf of other people (called beneficiaries). Trustees owe a duty of care to their beneficiaries and are required to act in their best interests, particularly in terms of their investment decisions. Although those entrusted to make statutory decisions under the LGPS are, in many ways, required to act in the same way as trustees in terms of their duty of care, they are subject to a different legal framework and to all the normal duties and responsibilities of local authority councillors. But they are not trustees in the strict legal sense of that word.

Why are trustees required in the private sector but not in statutory schemes like the LGPS?

9. Trustees are needed in the private sector to help ensure better scheme security by compliance with the necessary legislation; prevent employer-led actions which could undermine a scheme's solvency and to ensure that investment decisions are not in any way imprudent. But in a statutory scheme like the LGPS, benefits are guaranteed by statute, regardless of investment performance and scheme members in the LGPS bear none of the investment risk. The entitlements and benefits payable to scheme members in trust based schemes are, potentially at least, more volatile and dependent ultimately on the effectiveness and stewardship of their trustees. It is because of this greater risk to security that the Pensions Act 1995 first introduced the concept of member nominated trustees to ensure that scheme beneficiaries are part of the decision making process and a raft of other legislation. But even member nominated trustees must act in the interest of the fund/scheme and must not take decisions out of self-interest. The Pensions Act 2004 extends that status.

Who is responsible for the stewardship of the LGPS?

10. Elected councillors have legal responsibilities for the prudent and effective stewardship of LGPS funds and in more general terms, have a clear fiduciary duty in the performance of their functions. Although there is no one single model in operation throughout the 89 LGPS fund authorities in England and Wales, most funds are managed by a formal committee representing the political balance of that particular authority. Under section 101 of the Local Government Act 1972, a local authority can delegate their pension investment functions to the Council, committees, sub-committees or officers, but there are a small number of LGPS fund authorities which are not local authorities and therefore have their own, distinct arrangements.

How is membership of these committees regulated?

11. Under section 102 of the Local Government Act 1972, it is for the appointing council to decide upon the number of members of a committee and their terms of office. They may include committee members who are not members of the appointing council and such members may be given voting rights by virtue of section 13 of the Local Government and Housing Act 1989. On this basis, it is open to pension committees to include representatives from district councils as voting members on the committee and also to include trade union and other lay member representatives, with or without voting rights, provided that they are eligible to be committee members (eligibility rules are set out in section 15 of the Local Government and Housing Act 1989).

Should the law be changed to require lay member representation on LGPS committees?

12. The Secretary of State's power to make regulations in respect of local government employees is limited by section 7 of the Superannuation Act 1972 to matters relating to pensions, allowances or gratuities. Schedule 3 of that Act adds more detail to the range of subjects on which the Secretary of State is able to regulate in terms of the LGPS but the composition of local authority committees and the conferring of voting rights and other governance matters are excluded because these are properly matters to be considered and decided under the Local Government Act 1972, the Local Government and Housing Act 1989 and their subordinate legislation. It is not therefore possible for the LGPS regulations to regulate the composition of pension committees or who should be allowed to vote on them. These are constitutional, not pension issues, and remain matters in most respects for local government. Amending the primary legislation relating to the constitution of local government committees to allow for member nominated trustees with voting rights would be problematical given the legal requirement for a local authority to maintain political balance on its formal committees.

13. Removing these constitutional constraints from LGPS committees could, in theory at least, be achieved in two ways. Governance of the scheme could either be undertaken by independent, non-local authority bodies but still governed by statute, or by formal trustee boards as if operating under a private sector, trust based scheme. In both cases, however, severing the link with local government in this way would open up the scheme to provisions of the Pensions Act from which it is presently exempt, for example, the Pensions Protection Fund, formal deficit recovery plans and more stringent Funding Strategy Statements. The implications for employers' costs and, potentially, council tax payers, would be significant.

Section III - A Trades Unions' Perspective

14. In their letter dated 14 June 2006, UNISON set out its response to the Department's letter of 23rd January 2006 which had asked the local government trades unions to clarify their position on a number of issues. In their response, UNISON recognised that the vast majority of funds now have some form of member representation and that a number of funds have delegated decision-making in a variety of ways, in arrangements that are working well. They confirmed that their aim would not be to undermine existing good practice, but provide a model to ensure that members are represented consistently and effectively across all of the 89 LGPS funds.

15. In particular, UNISON raised the following issues :-

    There should be delegation by the administering authority of all pension fund activities to one pension sub committee;

    There should be one pensions and investment committee - for all administration of the fund and investment activity, including investment allocation and management;

    Working parties should exist to deal with dispute resolution and discretion policies.

    Each of these bodies should be based upon no less than 50% Member Nominated Representatives (MNRs), with full voting rights;

50% of admitted body representatives should be MNRs;

There should be a national forum for LGPS stakeholders, which meets to continually review governance arrangements;

There should be a model constitution, with, for instance, an MNR as vice chair, and AGM, and regular reports to members;

MNRs should be afforded facility time, training and other resources necessary for their effective performance;

UNISON believes that with greater involvement of MNRs, the better managed the scheme will be;

MNR's give greater management stability for the funds as councillors are subject to regular democratic challenge and potential removal from office;

Trade Union nominated MNRs offer greater potential for compliance with the Myners' code on consultation with LGPS contributors and beneficiaries;

All LGPS funds are covered by the Myners' recommendations on training. Therefore, full training, particularly on asset allocation and management should be made available or be provided by trade union bodies themselves, and

All governance arrangements should be subject to an equality impact assessment and comply with the forthcoming equality duties for the public sector.

Section IV - The Proposals

16. Taking into account the outcome of the survey in Section I and the constraints described in Section II the approach to improving governance within the LGPS needs to be targeted at the very small minority of LGPS administering authorities who continue to exclude, in any form, scheme member representatives and other key stakeholders from their governance arrangements. We are satisfied that the overwhelming majority of fund authorities are operating good quality committee structures which affords scheme member representatives the opportunity to participate in the decision making process, either as observers or, in the small minority of cases, as lay members with voting rights.

17. The proposals which follow are, therefore, intended to ensure that all LGPS fund authorities in England and Wales operate governance arrangements at or above best practice standard. With this “light-touch” approach, those fund authorities which already operate open and transparent governance arrangements, will be unaffected by these proposals. Other authorities would need to implement change to bring their governance arrangements to a best practice standard. But for the reasons set out in Section II, it is not intended to prescribe the composition of formal pension/investment committees to include a set quota of lay members with voting rights.

18. At present, the law does allow LGPS fund authorities to confer voting rights on lay members and there is no intention to amend this arrangement. It follows that we do not envisage the introduction of any provisions requiring fund authorities to include “member nominated trustees” with voting rights on their formal pension or investment committees.

19. On balance, it would appear that the interests of scheme members and their representatives would best be served outside the formal committee process but with clear links to such committees. This would allow fund authorities to establish Advisory Panels or Pension Representation Panels whose primary function would be to make recommendations to the main committee and to advise on key issues including investment, scheme administration, dispute resolution and discretionary policy issues.

20. Having a panel outside the formal committee structure would have several advantages. As shown in Section I, the concept of a formal pension/investment committee, underpinned by an Advisory Panel, has been adopted by a number of fund authorities with a high degree of success. Over time, different models of this two tier arrangement have evolved and a few examples are shown at Annex A to illustrate the flexibility and choice that such a system can offer.

Conclusions

21. Although the previous policy of encouraging fund authorities to adopt open and transparent representation arrangements has, in the main, been a success, there remains a minority of cases where standards could be criticised. **The most appropriate way forward, perhaps, could be to introduce amending regulations that would require each fund authority in England and Wales to review their governance arrangements against a best practice model and to state in their Governance Policy statement the extent of compliance. In cases of non-compliance, one option would be to require the fund authority to state the reasons why.**

22. The current proposition, therefore, is that the regulations could spell out the outline criteria for a fund authority to set up a Pensions Representative Panel but would not prescribe in detail the arrangements that would then need to be implemented to establish such a body. Instead, the proposal is that the level of detail should be included in either a Statutory Code of Practice or best practice guidance published, for example, by CIPFA. But whatever form the guidance takes, it is clear that the following issues would need to be included :-

    the composition of the panel;
    the frequency of meetings;
    arrangements for voting rights;
    scope and remit;
    access to committee papers and scheme information;
    relationships and communications with main committees
    constitutional issues, Chairmanship, etc;
    costs, accommodation, facility time, etc.
    publicity

22. This list is not intended to be exhaustive, but is offered as an indication of the range of issues that would need to be discussed and agreed before any amending regulations could be introduced.

23. Steps might also be taken to ensure that the views of key stakeholders, including, for example, scheme members and their representatives, employers and admitted bodies, are taken into account by formal LGPS committees when all key policy decisions are being considered. Regulations 73A and 76A of the 1997 LGPS Regulations already require consultation on the preparation, maintenance and publication of Governance Policy Statements and Funding Strategy Statements respectively and additional proposals would simply be an extension of those existing powers to specify both the categories of consultees and the range of decisions to fall within the requirement to consult with key stakeholders.

24. Although decision-making committees would remain wholly responsible and accountable for their statutory decisions, the transparency of the process by which the scheme is governed and administered would be improved by providing for stakeholders to have their views and concerns fully considered by decision-making committees.

Section V - Next Steps

25. It is proposed that the merits of these initial proposals should be discussed in detail by the Governance Working Group as soon as possible.

26. Subject to the views of Ministers, we envisage a statutory consultation exercise later in the year on specific proposals.

Department for Communities and Local Government
Local Government and Firefighters' Pension Schemes Division
July 2006

APPENDIX D

Rita Greenwood CPFA
Executive Director
Finance and Commercial

London Borough of Havering
Town Hall
Main Road
Romford, RM1 3BB

	01708 432218
Telephone	01708 432257
Fax:	rita.greenwood@havering.gov.uk
e-mail:	01708 434343
Switchboard:	01708 433175
Minicom:	*(for the hard of hearing)*

5th October 2006

Bob Holloway
Head of LGFPS2 Branch
Local Government and Firefighters' Pensions
Schemes Division
Zone 2/F6
Ashdown House
123 Victoria Street
London
SW1E 6DE

Dear Bob

We welcome the interest shown in ensuring proper governance arrangements in respect of Pensions Funds.

This authority takes its responsibilities very seriously and has given due consideration to the "blueprint" paper. It makes the following comments:

- It is important that the Committee includes scheme member or trade union representation.

- Employer costs relating to the Pension Fund fall on the Council Tax payer who is represented by Councillors – it is therefore essential Councillors and only councillors vote on matters which have financial implications for Council Tax payers.

- There is a need to have due regard to the fact that trade union representation does not constitute representation of all scheme members as well as the points made in the paper the implications of.

- Removal of constitutional constraints from LGPS committees must be considered more widely e.g. freedom to increase the employee's rate and a further widening of understanding and accountability of Council Tax and local authority services.

- Authorities have difficulties in getting admitted and scheduled bodies engaged with Pension committee activity and a requirement to have a Member representative from this group would assist in this as well as improve accountability given the financial implications that these bodies would incur.

- There should be no requirement to have Panels outside of the formal committee process if they are represented on the Committee i.e. to increase bureaucracy.

The Audit Commission have a self assessment code of Governance for Pension funds which some authorities have been asked to complete. It would be helpful if DCLG would liaise and agree with the Audit Commission a single review approach.

Yours sincerely

Rita Greenwood
EXECUTIVE DIRECTOR
FINANCE AND COMMERCIAL

APPENDIX E

CONSULTATIVE DISCUSSION PAPER ON ADMITTED BODY STATUS

1. As foreshadowed in paragraph 16.4 of the Department's recently-published consultation document "Where next? - Options for a new look Local Government Pension Scheme in England and Wales", I am now writing to seek views on some principles for possible regulatory development of the Admitted Body Status (ABS) provisions. These have been drawn up following discussions by the working group comprising key stakeholders in the contracting-out process.

ABS – Policy context and intention

2. The existing ABS provisions provide for administering authorities to enter into admission agreements with transferee admission bodies - predominantly profit-making private sector contractors dealing with functions which have been outsourced from local government under best value - to allow specified groups of employees to have continued access to the LGPS. They were originally introduced in 1999; in their current form they date from 2003.

3. It is important to set the arrangements in the context of Government policy on outsourcing, best value, and the fair deal for staff.

   - There is a commitment to partnership, diversity and plurality among providers
   - There are no ideological preferences between providers
   - The aim is to drive up performance standards
   - Fair deal means protection of workforce pay and conditions, including pensions.
   - Pensions protection can be provided either through a broadly comparable pension scheme, or through continued access to the existing public service scheme.

4. In the LGPS, ABS was introduced to allow contractors who took on local authority contracts to retain members of the Scheme in that arrangement, allowing them to continue to accumulate benefits under the one scheme whilst their employment is transferred between different contractors. It enables contractors to tender on a small scale where they could otherwise find setting up a broadly comparable scheme disproportionately expensive. In essence, its introduction in 1999 was intended, in pension policy terms, to provide a seamless transfer in an outsourcing contract context.

The current provisions

5. The existing provisions were drawn up in discussion with the key stakeholders: the contractors' representatives, the employer interests and the Trades Unions. The regulatory provisions are primarily set out in regulations 5A and 5B and Schedule 2A to the LGPS Regulations 1997, with some other regulations (e.g. 75, 78) impinging on them.

6. Transferee Admission Bodies are treated as if they were scheme employers in relation to their employees in the LGPS, but their participation is contractual, not statutory. They are subject to the standard scheme employer requirements and certain additional provisions intended to deal with particular issues likely to arise from their different status. Among these are the liability to pay employers' contributions based on actuarial valuations, the potential for these to be higher than the common rate as for a short-life body the normal spread recovery period for recovering any fund deficits may be inappropriate, the requirement for a terminal valuation with the potential to have to pay an exit charge to meet any capitalised deficit, and the requirement for a risk assessment which will often require a bond or guarantee to be given to protect the fund in the event of commercial failure.

7. Under ABS, contractors are actuarially allocated assets in the relevant LGPS fund equal to the members' accrued liabilities at the start of the contract. These assets are rolled up in line with investment returns and contributions over the contract period, with the contractor liable to meet any shortfall between accumulated assets and accrued liabilities when the contract ends.

Need for a Review

8. In the view of the working group (and it is a view held more widely still), ABS remains in principle an attractive and useful mechanism for dealing with pensions in the contracting-out process; there is nothing in the fundamental concept which needs to be changed.

9. It is recognised that ABS provides pensions stability throughout the contracting-out process when contracts and the workforce may over time pass to successive generations of different contractors. It can promote good employee relations because pension benefits are independent of the contractor. Contractors do not have to make arrangements for a broadly comparable scheme and subsequent generation contracts are simpler to effect with no transfer of liability between contractors' schemes. Contractors' liabilities cease on crystallisation when the contract ends, and contractors are exempted from the Pension Protection Fund in respect of those members.

10. However, in the light of experience, concerns have been expressed – principally by the contractors – that the detailed arrangements are not being implemented as they were originally envisaged when first drawn up, and that this is beginning to affect the inherent qualities of the ABS regime and its best value context.

11. Perceived problems which have been identified are:

- some authorities are apparently specifying ABS as a contractual condition, whereas it has only ever been intended to be a matter of contractor choice;
- contractors have no direct control over costs, which are often volatile with significant increases in contributions rates during the contract; they lack any input into investment strategy, actuarial assumptions, or deficit spreading;
- contractors are expected to bear all the risk, including asymmetric risk at end of the contract where they are liable for any shortfall but cannot benefit from any surplus; potential debt charges on exit may thus make broadly comparable schemes more attractive to contractors;

- contrary to policy intentions, contractors may inherit significant past service liabilities with asset variations or changes in actuarial assumptions during the contract therefore having a disproportionate effect;
- the effect of FRS17 / IAS19 on contractors' balance sheets and the consequent impact on their ability to tender for new contracts;
- unnecessary additional costs arising from provision of indemnity bonds;
- consequent dangers of deterring reputable contractors from bidding or inducing overpriced bids for safety's sake; the number of contractors prepared to tender where ABS is a contract requirement and debts must be paid on exit may be limited;
- informed contractors will price pension risk into the contract, passing the risk back to the authority and obscuring the pricing of the tendered service; uninformed contractors may underprice the pension risk and default, creating the need to re-tender;
- informed contractors may be consistently eliminated at the early stage of bids, and that there is a consequential possibility that authorities may end up with poorer quality services, albeit at a lower price (although service level specification and monitoring procedures should ensure adequacy);
- informed contractors may initially bid low and address risk issues at preferred bidder stage to avoid early elimination; this runs the danger of authorities wrongly eliminating other contractors who do price in the risk at the outset and tender a marginally higher initial bid;
- there are thus potential higher costs to authorities either from paying more for the contract than strictly necessary or from accepting a lower bid from a less well-informed contractor who subsequently defaults.

12. On the other hand, it is reasonable to assume that the existing arrangements still offer financial advantages to local authorities in a market where there are uninformed as well as informed contractors. In the competitive market, authorities should be free to achieve the best deal possible for council tax payers and the transferring employees, without undue restrictions, and currently authorities may be able to maximise the potential outsourcing savings where the pensions risk is transferred to the contractor and uninformed contractors under-estimate it. However, this only applies while there is a significant body of uninformed bidders; as later generations of contracts are let and the pensions dimension is more widely recognised, under-estimating pensions costs is likely to become less common, and earlier savings based on such under-estimates are unlikely to be replicated. In considering options for the future development of the LGPS, the Department needs always to take the longer-term view.

Possible future approach

13. It is the Department's view that either ABS or a broadly comparable scheme should remain as available options to contractors. This reflects the Government's approach, in overall policy terms, to public sector outsourcing arrangements and the commitments under the Fair Deal for staff. While recognising that there will always be circumstances where a broadly comparable scheme will be a contractor's chosen route, the aim should be to make the advantages of ABS sufficiently attractive for it to be the scheme of contractor choice in the majority of cases. The Department therefore needs to ensure that the arrangements are robust and work well, are not unfairly disadvantageous to contractors, contracting authorities, other employers in the fund, or members, and that ABS properly supports the best value regime and, through it, council tax payers.

14. There do appear to be some potential weaknesses with ABS as it currently operates: risks of fewer bidders, unnecessary elimination of good contractors, higher costs, poorer quality services, and, in extremis, contractor failure. One potential solution which has been proposed by the working group to address these weaknesses and improve the attractiveness of ABS would be to develop pass-through arrangements.

Overview of pass-through arrangements

15. Pass-through would effectively remove pension risk from the equation. The contractor would pay contributions at a rate specified at the outset of the contracting process, with subsequent variations only for common factors (e.g. changes in mortality assumptions) or those within their control (e.g. abnormal pay movements), and the letting authority would retain and meet the actual cost of all the investment risk. Contractors would contribute only for membership accrued during the contract and would have no past service liabilities, nor ongoing liability at the end of the contract. The letting authority would effectively meet the actual cost of pensions rather than the cost inflated either by over-cautious risk assumptions or by the price of contractor failure in terms of quality delivery or financial performance. However, it would deprive authorities of the potential benefit of a lower bid, where the contractor has priced the pensions element at less than the true cost.

16. The potential advantages of such an arrangement are seen to be:

- The pensions element would be stabilised;
- contractors would compete on a level playing field, concentrating on the services tendered without the distraction of volatile pension costs potentially leading to outsourced services which are either too high on cost or too low on quality.
- contractors would price their bids more realistically without a margin for pensions risk;
- a level playing field could lead to increased competition;
- pass-through arrangements could ameliorate contractor concerns about back-door compulsion, since bidders' reservations about ABS in the LGPS largely stem from the total transfer of risk, and lack of control over costs with its unquantifiable effects;
- contractors might be more willing to adopt ABS, which outsourcing authorities and the trade unions might prefer;
- once all bidders were sufficiently informed as to load their bids to hedge against investment risk under the present system, pass-through could result in savings to authorities.

17. Explicit features of a pass-through arrangement might include:

- No transfer of past service liabilities;
- The outsourcing authority would set the future accrual rate at the outset, to be included in all bidders' tender prices;
- Subsequent actuarial valuations would distinguish between fluctuations due to common factors, those within the contractor's control and those due to fund performance;
- Increased costs arising from investment risk would be met by the contracting authority passing through the costs to the letting authority by adjustments to the contract price (possibly, as an alternative, through adjustments to the letting authority's own contribution rate);
- The contractor would meet the cost of contributions increases due to common factors such as increased longevity, and those due to factors within their control such as abnormal pay increases and abnormally high levels of ill-health retirements or redundancies;
- The letting authority would need safeguards to protect them from the effects on past service liabilities arising from factors within the contractor's control;
- No increase in contractor's contribution rate to reflect the short life of a contract and no crystallisation of liabilities or termination payments (exit charges) when the contract ends. Such increase and charges are inappropriate because the contract (and the staff) would either be taken over by a new contractor or revert to the local authority;
- Arrangements should equally suit open or closed agreements.

18. Current provisions require a risk assessment with, where necessary, a bond or indemnity to be provided. With a pass-through arrangement, there might be less need for a bond or indemnity (which contractors tend to regard as an unnecessary expense), but the Department's current view is that a risk assessment should still be required to examine whether contractor failure or default might place an additional strain on the fund and so on public finances.

Implementation

19. The original ABS provisions were set out in the LGPS regulations and backed up by non-statutory guidance. A move to pass-through arrangements would need to be reflected in revisions to contract provisions. Some amendment to the LGPS regulations would be necessary. Either detailed amendments could be made to the regulations, with revised non-statutory guidance to back them up, or less detailed regulatory provisions backed up by statutory guidance could be developed. In any event, in the light of concerns about compulsion, contribution hikes and exit charges, the Department and the LGE will, in the interim, review the original guidance material produced when the regulations first came into force.

Comments

20. Views are invited on the issues discussed in this paper. In particular, in addition to general comments, it would be useful to have specific views on the following questions:

    - Are there compelling reasons for retaining the existing arrangements without amendment?
    - Are they just in need of amendment?
    - Is pass-through a satisfactory way of dealing with the perceived operational problems?
    - Are there particular disadvantages to pass-through not identified in this paper?
    - Are there other options (statutory or non-statutory) which could usefully be considered?
    - If pass-through were adopted, are the features outlined above appropriate?
    - Is the proposed apportionment of costs between contractors and letting authorities reasonable?
    - Are there sufficient safeguards for contracting authorities?
    - If other necessary safeguards are identified, how can these best be provided?
    - Are there other features which need to be identified?
    - Is a risk assessment necessary?
    - How would such arrangements best be implemented?

Next steps

21. In the light of views expressed in response to this document, revised draft regulations and or guidance will be drawn up as appropriate. Any proposed amendments to the LGPS regulations will be subject to statutory consultation with all interested bodies in the normal way.

Responses

22. Comments on this paper should be sent to Lynn Corner, DCLG, Zone 2/F7 Ashdown House, 123 Victoria Street, London SW1E 6DE by 6 October 2006. Electronic responses should be addressed to Lynn.corner@communities.gsi.gov.uk

23. A summary of responses to this consultation will be published within 3 months of the close of consultation at www.xoq83.dial.pipex.com

24. This consultation follows the Government code of practice on consultations, which can be accessed at www.cabinetoffice.gov.uk/regulation/consultation/code/index.asp

25. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

26. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, or itself, be regarded as binding in the Department.

27. The Department will process you personal data in accordance with the DPA and, in the majority of circumstances, this will mean that your personal data will not be disclosed to third parties.

Department for Communities and Local Government

July 2006

MEETING	DATE	ITEM
PENSIONS COMMITTEE	21September 2006	9

REPORT OF THE CHIEF EXECUTIVE

SUBJECT: REVIEW OF THE PENSION FUND CUSTODIAN

SUMMARY

This report reviews the annual performance of the Custodian, State Street, for the period April 2005 to March 2006.

RECOMMENDATION

It is recommended that the Committee: -

- Notes the views of officers on the performance of the Custodian and makes any comment on the report which it considers appropriate.

REPORT DETAIL

1.1 At its meeting of 8th September 2004, Members were informed that following a competitive tender process, State Street had been appointed via a Chairman's decision to provide an investment custodial service to the Havering Pension Fund. State Street were appointed for the period from 31st December 2004. The Council may terminate this agreement by giving at least 28 days notice. The Custodian may terminate the Agreement by giving at least 90 days notice.

1.2 This is the first formal assessment of the custodial service by this Committee.

2. REVIEW OF THE CUSTODIAN'S PERFORMANCE

2.1 The Global Custodian State Street operate a wide range of functions. This falls into two main categories:

- Safe Keeping and Custody
- Investment Accounting and Reporting.

- **Safe Keeping and Custody**
  This refers to the maintenance of accurate records and certificates of the ownership of stock and ensuring that dividend income and other distributions are received appropriately. The Custodian also manages the tax position of the fund, claiming back any recoverable overseas withholding tax paid on dividends received and maintaining the tax records of the fund.

- **Investment Accounting and Reporting**
  State Street produce accounting reports that are similar to those the investment managers produce for the fund. They keep a record of the book costs in the various asset classes and also provide a market valuation of the fund. This is done for each of the investment managers' portfolio as well as at the total fund level. State Street records are therefore considered to be master records.

The review shown below follows the style adopted when the Investment Committee reviewed the Investment Adviser.

CRITERIA	ASSESSMENT
What is important to the Authority	It is important that the Pensions Committee and officers have confidence that all assets are secure and have been properly accounted for. It is important that accurate accounting records are maintained and appropriate reconciliations are provided with the numerous fund managers, investment advisers and performance measurers. Officers have confidence that the assets are secure. There has however been difficulties in pricing and timing of valuations that have often meant a variance between the valuations provided by the fund managers and that provided by State Street. State Street prepare their reports independently from the valuations provided by fund managers. Therefore differences due to pricing and timing methodologies may occur between State Street and the fund managers.

CRITERIA	ASSESSMENT
The level of proactivity expected from the Custodian.	The advisers have in the officers' opinion not been as proactive as they would wish. There are a number of issues, which have not been brought to the attention of officers which proved to be worthy of notification. State Street has recognised this deficiency, and has restructured the client service team as a means to providing a more responsive service. Action has also been taken to develop and improve the relationship between custody staff and Council officers, through regular meetings.
Safe keeping and custody	This relates to the core functions of the custodian. Officers are appreciative of how this role is performed and believe that this is a high quality service.
Prompt and responsive service	It is accepted by State Street that in the past response times to officers' queries have generally been poor. The restructure of the client services team will address this issue. Officers are however pleased with the quality of advice given, and believe that the necessary steps are being taken to improve response times.
Good communication	Monthly reports are normally produced regularly and on time. These reports are comprehensive but require improved indexing and referencing in order to make these documents more user-friendly. State Street are in the process of developing year end statements that follow the format recommended by the Statement of Recommended Practice (SORP). Officers view this development as an important contribution to the closure of accounts process. It is planned for a pilot report to be produced by State Street during December 2006.
Provision of National Statistics Office Returns	In the past there have been difficulties in meeting deadlines and maintaining accuracy. Officers are appreciative of the support given although both parties recognise the need to make improvements. The client services restructure previously mentioned should significantly improve this service.

CRITERIA	ASSESSMENT
Transition from one fund manager to six, and from a latent custodian to an active custodian.	Though outside the remit of the Custodian Review, officers would like to take the opportunity to thank State Street for their invaluable role in the transition period. In particular the work on the implementation of the Investment Strategy and restructure of the investment fund management has led to an invaluable progress of the Best Value Action Plan and the future direction of the Pension Fund.
Overall Summary	Officers are pleased with the overall performance of State Street, and appreciate their efforts to improve those services where performance may have been below par.

3. CONCLUSION

3.1 Officers are pleased with the core custodian services provided by State Street. Where there has been an element of underperformance, State Street have identified the issues, and restructured and developed processes in order to combat any deficiencies.

Financial Implications and risks:

The cost of custodian services for the year to 31st March 2006 was £133,000. These costs are paid directly from the Pension Fund and not the General Fund. The costs cover administration costs and custody fees based on a pre agreed unit price applied to the value of the individual fund's assets.

Legal Implications and risks:

There are no legal implications in this report.

Human Resources Implications and risks:

There are no human resources implications in this report.

Equalities and Social Inclusion Implications and risks:

There are no social inclusion implications in this report

Staff Contact: Victor Wilson Designation: Interim Pension Fund Accountant

Telephone No: 01708 432569 E-mail address: victor.wilson@havering.gov.uk

STEPHEN EVANS
Chief Executive

Background Papers List

Working papers held within Corporate Finance

Principles for Investment Decision Making in the Local Government Pension Scheme in the UK" - Published by CIPFA

Best Value Report