

LOCAL GOVERNMENT PENSION SCHEME EARLY RETIREMENT COSTS



Background

In 1997 the Audit Commission issued a report called 'Retiring Nature – early retirement in local government'. The main purpose of the report was to highlight the changing face of retirement in local government and to publish the findings of a study into when local government employees retire and the cost to pension funds of releasing pension entitlements earlier than the normal retirement age.

The report stated that 'the majority' of staff retired early and that there were growing concerns about the cost of pensions, the impact of early retirement on pension funds and, in some areas, the large number of ill health retirements from the Local Government Pension Scheme (LGPS).

The Audit Commission put forward a number of recommendations:

- Seeking alternatives to early retirement;
- Identifying the true cost of early retirement; and
- Ensuring the continued health of pension funds.

As a direct result of this report, changes were made to LGPS regulations and employers became directly responsible for meeting pension fund costs arising from their decisions to release early the retirement benefits of their employees.

Since 1998, all employers associated with the Royal County of Berkshire Pension Fund have been required to meet the costs (known as strain costs or capital costs) of releasing benefits early on the grounds of redundancy, business efficiency, with employer consent or as a result of flexible retirement.

The Local Government Pension Scheme Regulations

Regulation 41(2) ('Employer's further payments') of the LGPS (Administration) Regulations 2008 (as amended) states:

"The appropriate administering authority may require the employing authority concerned to make additional payments to the appropriate fund in respect of any extra charge on the fund resulting from retirement benefits becoming payable immediately to a member under regulation 18 or 19 of the Benefits Regulations, including the cost, as calculated by the fund's actuary, incurred by the fund as a result of a waiver of such reduction as referred to in regulations 18(2) of those Regulations".

For reference the Benefits Regulations mentioned above refer to the LGPS (Benefits, Membership and Contributions) Regulations 2007 (as amended) and the relevant sections of the specific regulations are reproduced below:

Regulation 18 'Flexible retirement':

Paragraph (1) "A member who has attained the age of 55, and who, with his employer's consent, reduces the hours he works, or the grade on which he is employed, may make a request in writing to the appropriate administering to receive all or part of his benefits under these Regulations, and such benefits may, with his

employer's consent, be paid to him notwithstanding that he has not retired from that employment."

Paragraph (2) *"If the payment of benefits referred to in paragraph (1) takes effect before the member's 65th birthday, the benefits payable are reduced in accordance with guidance issued by the Government Actuary"*.

Paragraph (3) *"But the employer may agree to waive, in whole or in part, any such reduction as is referred to in paragraph (2)"*.

Regulation 19 *'Early leavers: inefficiency and redundancy'*

Paragraph (1) *"Where:*

- a) a member is dismissed by reason of redundancy; or*
- b) his employing authority has decided that, on the grounds of business efficiency, it is in their interest that he should leave their employment; and*
- c) in either case, the member has attained the age of 55,*

he is entitled to immediate payment of retirement benefits without reduction".

It is also important at this point to mention regulation 30, *'Choice of early payment of pension'*, of the LGPS (Benefits, Membership and Contributions) Regulations 2007 (as amended) as follows:

Paragraph (1) *"If a member leaves a local government employment before he is entitled to the immediate payment of retirement benefits, once he has attained the age of 55 he may choose to receive payment of them immediately"*.

Paragraph (2) *"A choice made by a member aged less than 60 is ineffective without the consent of his employing authority or former employing authority"*.

Paragraph (3) *"If the member chooses, he is entitled to a pension payable immediately"*.

Paragraph (4) *"His pension must be reduced by the amounts shown as appropriate in guidance issued by the Government Actuary"*.

Paragraph (5) *"A member's employing authority may determine on compassionate grounds that his retirement pension should not be reduced under paragraph (4)"*.

How costs arise

Redundancy and business efficiency

When a scheme member is retired early with the immediate release of pension benefits there are two potential costs that can arise, the capital cost and an augmentation cost. A capital cost arises as a result of the member's statutory benefits being released early i.e. the accrued benefits as at the early retirement date. This is sometimes referred to as the strain cost i.e. there is a strain on the pension fund to pay benefits early (i.e. before normal retirement age) and therefore for a number of years longer than anticipated.

Augmentation costs are in addition to the capital costs and arise when an employer awards additional benefits to a scheme member in accordance with either Regulation 12 of the LGPS (Benefits, Membership and Contributions) Regulations 2007 (as amended), *'Power of*

employing authority to increase total membership of active scheme members' or Regulation 13 of the LGPS (Benefits, membership and Contributions) Regulations 2007 (as amended), '*Power of employing authority to award additional pension*'. In both cases, an employer should have published a policy statement in accordance with Regulation 66 of the LGPS (Administration) Regulations 2008 (as amended), as to how they intend to use these powers. Augmentation costs are calculated at a significantly higher rate than capital costs as no previous funding will have been made toward the cost of the additional benefits being provided.

It is important to note, scheme regulations dictate that benefits cannot be actuarially reduced when the reason for their early release is redundancy or business efficiency.

A capital cost will always be calculated where:

- i) A member is retired on the grounds of redundancy or as a result of business efficiency; and
- ii) The member is aged between 55 and 60; OR
- iii) A member is retired on the grounds of redundancy or as a result of business efficiency; and
 - i) The member is aged between 60 and 65; and
 - ii) The member has not reached his eligible retirement age i.e. the date at which the member achieves the 85-year rule under protections afforded by previous scheme regulations.

The 85-year rule was removed from the pension scheme regulations in October 2006 but scheme members who continue to contribute to the scheme since before that date have certain protections built into their retirement date. Basically, the 85-year rule states that when a member's age in whole years added to their membership in whole years equals 85, that is the date from which the member can draw their pension benefits without suffering any actuarial reduction. For example, a member aged 60 with 25 years of membership can elect to draw their benefits from the age of 60 without having their benefits actuarially reduced.

The 85-year rule can be achieved before or after the age of 60. However, a scheme member cannot elect to draw their benefits before the age of 60 without employer consent.

IMPORTANT NOTE: A scheme member aged between 60 and 65 who qualifies for the release of benefits under the 85-year rule can choose to have their unreduced benefits released from their '85-year rule' date. Therefore, if that member is made redundant or retired early by their employer either on the date that the 85-year rule is achieved or later, no capital cost will be calculated as the pension fund would have anticipated the accrued benefits being released from the 85-year rule date. If, however, a scheme member is made redundant or retired early from the age of 60 but before the date from which their 85-year rule applies, a capital cost will be calculated as the benefits being released cannot be actuarially reduced thereby creating a strain on the pension fund.

Employer consent and flexible retirement

Where an employer agrees to release a scheme member's pension benefits early, either with employer consent or as a result of flexible retirement, the benefits will be subject to actuarial reduction unless the member has achieved their eligible retirement date i.e. subject to the 85-year rule.

The question as to whether or not a capital cost arises will depend upon the member achieving the 85-year rule and whether or not the employer uses its discretion to waive any actuarial reduction to be applied to the member's benefits.

For example, where the member is aged 55 or over and under the age 65 and does not meet the 85-year rule at the date of release of their benefits, an actuarial reduction will be applied to those benefits. In some cases that actuarial reduction will be sufficient to extinguish any capital cost to the employer. However, this is not always the case and in some instances a capital cost, albeit somewhat reduced, may still arise despite the member's benefits being subject to actuarial reduction.

Where an employer uses their discretion to waive any actuarial reduction applied to a scheme member's benefits, a capital cost will always be calculated because the same benefits will be brought into payment as if the member had been made redundant or retired due to business efficiency.

IMPORTANT: An employer should always request an estimate of the likely capital cost that may arise before making their decision to grant an employee early or flexible retirement.

Calculating capital costs

A standard approach to calculating capital costs has been devised by the Association of Consulting Actuaries so that there is a consistent method of determining the costs at a national level.

There are a number of factors that go into each calculation and employer's are advised to obtain details of any potential capital costs when requesting estimates of benefits from the pension administrators for members who they are looking to make redundant, retire on business efficiency grounds, retire early with employer consent or allow to draw benefits as result of flexible retirement.

Paying the capital cost to the pension fund

Once the member's final benefits have been calculated an invoice will be raised by the pension administration team and emailed to the employer's pension liaison officer (or alternative officer where agreed between the employer and the pension fund).

The payment due has to be paid in full and within 21 days from the date of the invoice.

Disclaimer

The information contained in this Bulletin has been prepared by the Royal County of Berkshire Pension Fund. It should not be treated as a complete and authoritative statement of the law. Readers may wish, or will need, to take their own legal advice on the interpretation of any particular piece of legislation. No responsibility whatsoever will be assumed by the Pension Fund for any direct or consequential loss, financial or otherwise, damage or inconvenience, or any other obligation or liability incurred by readers relying on information contained in this Bulletin. Whilst every attempt is made to ensure the accuracy of the Bulletin, it would be helpful if readers could bring to the attention of the Pension Fund any perceived errors or omissions. Please contact:

Royal County of Berkshire Pension Fund
Minster Court
22-30 York Road
Maidenhead
Berkshire
SL6 1SF
Tel: 0845 602 7237
Email: info@berkshirerepensions.org.uk

LGS44(1211)