

NORTHERN IRELAND LOCAL GOVERNMENT OFFICERS' PENSION FUND



Hymans Robertson

COSTINGS OF PROPOSED 2008 SCHEME DESIGNS

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18 September 2006

Executive Summary

This report is addressed to Northern Ireland Local Government Officers' Superannuation Committee as administering authority to the Northern Ireland Local Government Officers' Pension Fund ("the Fund").

This report sets out indicative employer contribution rates / savings for the Fund under each of the options proposed in the DCLG's consultation on the new scheme from 2008. (Our understanding is that the DCLG's consultation document will form the basis of the Department of the Environment's consultation on the future of the LGPS in Northern Ireland.) We also comment on the possible effect on members and on some of the other key aspects of the consultation, as we see it.

The principal conclusions are as follows:

- An analysis of the distribution of membership and accrued liabilities illustrates that the employer spend is not evenly distributed (for example 36% of members are full-time men who account for 60% of the liabilities).
- There is also a wide spread of pay growth experience (based on 2001 and 2004 valuation data).
- There is thus evidence that not all of the membership is served equally well by the current scheme and that a one size fits all approach may not suit all the scheme members.
- There are five core options put forward by the DCLG: two final salary options (A and B); two career average (CARE) options (C1 and C2), and a hybrid option D, where the default option is CARE but employees can choose to retain a final salary option.
- All the options provide a 3 x pay death in service lump sum and partners' pensions. The costings all anticipate savings from the introduction of two tier ill-health benefits as well as from commutation and the removal of the Rule of 85. These savings may be more or less than expected, depending on experience.
- Options B, C and D recycle half of the anticipated savings from commutation and the removal of the Rule of 85. Option A does not include any recycling and hence is a lower cost option.
- At the last formal valuation carried out as at 31 March 2004 the average employers' cost of future service benefits (i.e. ignoring any past service deficit) was 13.1% of pay. On the same assumptions and data the anticipated savings for the Fund as a whole for each option proposed by the DCLG would be as follows:
 1. Option A (existing scheme with removal of Rule of 85) - 2.8% of pay
 2. Option B (FS, 1/60ths pension, cash by commutation) – 1.6% of pay
 3. Option C1 (CARE with RPI, 1/54ths pension) - 1.8% of pay



4. Option C2 (CARE with RPI plus 1.5%, 1/60ths pension) - 1.9% of pay

- Allowing for improvements in life expectancy to C2030 increases the employer contribution rate by approximately 0.8% of pay for each option.
- Allowing for changes in financial assumptions since March 2004, in particular lower real gilt yields, increases the employer contribution rate by around 2.0% of pay.
- Thus, even if the new scheme were confirmed in Regulations in time for the 2007 valuation, there is no guarantee of lower employer contributions.
- Option D is a CARE scheme (either C1 or C2) with the option for members to elect final salary (probably option B) for an additional employee contribution, proposed at 3% of pay.
- Our analysis indicate that real pay increases of 4% p.a. or more would be required for the extra 3% of pay contributions under option D to be worthwhile for members with 10 years or less total membership. The required real pay increase drops to 2-3% p.a. for membership of 20 years or more.
- The career average options are likely to favour members with lower than average future pay growth, (principally part-time members and those in manual employment). Conversely, career employees with better than average pay growth are likely to be better off with a final scheme.
- Changes in interest rates, longevity, pay growth and membership will affect the cost of a defined benefit scheme regardless of the design. As all the options are defined benefit options.
- None of the options proposed materially reduces the potential variability of employer contributions to the scheme. This could be achieved by sharing risk between employers and employees or by adopting a lower cost option with greater freedom for employers.
- Within the appendices, we highlight the consequential increase in dependants' pensions (due to the higher accrual rates under B and C) and comment on how the options fare against the DCLG's objective of equality – proofing.
- This report focuses on employer contributions under the options and the effect on members. There are other considerations for administering authorities and employers which are not considered, including the level of employee contributions, tiered contributions, flexible retirement and the transition to the new scheme. We would be delighted to provide further advice on these areas if required.

Prepared by:



Alison Murray FFA
For and on behalf of Hymans Robertson LLP
18 September 2006



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Northern Ireland Local Government Officers' Pension Fund: 2008 Scheme Design Costings

1. Introduction

- 1.1 We have pleasure in presenting this report to NILGOSC ("the Committee") as the Administering Authority to the Northern Ireland Local Government Officers' Pension Fund ("the Fund").
- 1.2 The Fund is part of the Local Government Pension Scheme ("LGPS"), which is a multi-employer defined benefit ("final salary") scheme.
- 1.3 The Department for Communities and Local Government ("DCLG") is currently carrying out a review of the LGPS in England and Wales as part of the Government's broader review of public service pension schemes. Discussions have been taking place on a tripartite basis, with the DCLG, Union and employer representatives forming the Tripartite Committee. A consultation document on the options being considered by the Tripartite Committee was issued on 30 June 2006¹.
- 1.4 The consultation document sets out a number of options and provides indicative costings based on work carried out by the Government Actuary's Department. No firm recommendations are put forward in the consultation document. Further, the costings are not intended to represent employer contributions to the scheme and funds were encouraged to seek advice from their actuaries on the cost implications for their own circumstances.
- 1.5 There is a much wider spectrum of options for delivering pension benefits than is put forward for consultation by the DCLG. The options considered are limited by the policy commitment that the scheme should have a defined benefit design, which provides a degree of certainty for employees on the level of expected benefits². The Government is for the first time considering a scheme based on career average earnings rather than final pay.
- 1.6 Our understanding is that the Department of the Environment is aiming to maintain parity with the LGPS in England and Wales and has confirmed that the DCLG's consultation document will form the basis of the consultation on the future of the LGPS in Northern Ireland.

The Changing Environment

- 1.7 The LGPS was established for full-time, "officer" (i.e. white collar) employees. The complexion of membership has changed over time and the speed of change has accelerated as the criteria for joining have been relaxed. Hymans Robertson's investigations into the demographics of the LGPS in England and Wales revealed that there are now many more women, part-timers, shorter service members, and members with lower pay in the LGPS than when the scheme was first designed.
- 1.8 Regulatory changes include means-tested state retirement benefits (which potentially reduce the value of LGPS membership for the lower paid), reductions in qualifying periods for preserved pensions and the introduction of civil partnerships which allow same-sex partners to receive a survivor's pension (but not common law spouses or other financial dependants).
- 1.9 It would seem to us to be appropriate to review the design of retirement benefit schemes to ensure that they retain their appeal to today's workforce and the environment in which they operate and, in light of this, we are supportive of the DCLG's review.

¹ "Where Next"? – Options for a new look Local Government Pension Scheme in England and Wales"

² A defined benefit scheme need not be a final salary scheme.



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Government Objectives

1.10 The Government's objectives include:

- promoting **personal responsibility**, which we believe implies giving members more choice to take their own decisions;
- **fairness** or equality-proofing;
- **simplicity**;
- **affordability**;
- ensuring **sustainability** or durability;
- being **appreciated** by employees and thus helping the employer recruit, retain and motivate its staff.

Purpose

1.11 This report does not assess the options put forward against all of the objectives set out above. Instead as requested by the Committee, it sets out the following:

- a brief analysis of the Fund membership (based on the 2004 valuation data);
- the employer share (at a whole Fund level) of the cost of future service benefits for the options put forward by the DCLG using the membership and financial assumptions as at 31 March 2004;
- an indication of the likely effect of making allowance for longer life expectancy;
- the outlook for employer contributions from 2007 based on market conditions as at 30 June 2006;
- implications for Fund members of the various options; and
- a commentary on some of the other aspects of the consultation. In particular, we have included our thoughts on equality-proofing in Appendix F of this report.

Reliances and Limitations

1.12 The report is addressed to NILGOSC, the Administering Authority of the Fund and is provided solely for the purpose of giving high level consideration to pension strategy issues. It has not been prepared for any other purpose and should not be so used. The report should not be disclosed to any third party except as required by law or regulatory obligation or with our prior written consent. We hereby give consent for this report to be provided to employers within the Fund and to the Department of the Environment on the understanding that we accept no liability to these parties for its content. We do not give consent for this report to be released to any other party. We accept no liability where the report is used or disclosed to a third party unless we have expressly accepted such liability in writing. Where release of the report is permitted, the report may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.



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- 1.13 We have not considered the impact any changes to the scheme design would have on the level of take-up of employees and nor have we considered the effect on individual employers, whose needs and membership profile could be quite different from the Fund as a whole.

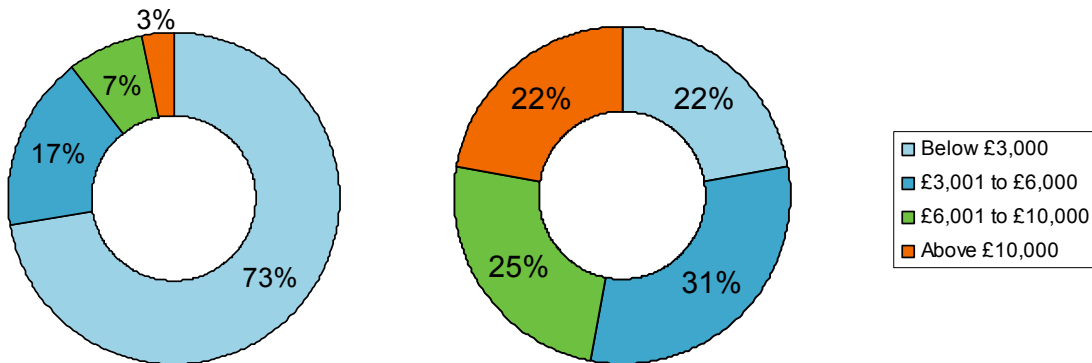


2. Analysis of Fund Membership

Distribution of Employer Spend

2.1 A crude measure of how well the scheme serves various sections of the workforce might be to consider how the accrued benefits (and hence loosely the Fund assets and employer contributions) are distributed amongst the membership. The coloured segments on the charts below show the employee membership split into bands of accrued pension. The left hand chart shows the number of members and the right hand chart the liabilities. Thus, 10% of the employee membership had an accrued pension of more that £6,000 p.a. as at 31 March 2004 (the green and orange segments). Those members accounted for almost 50% of the employee liabilities of the Fund.

Split of Total Active Membership (Grouped by Accrued Pension)

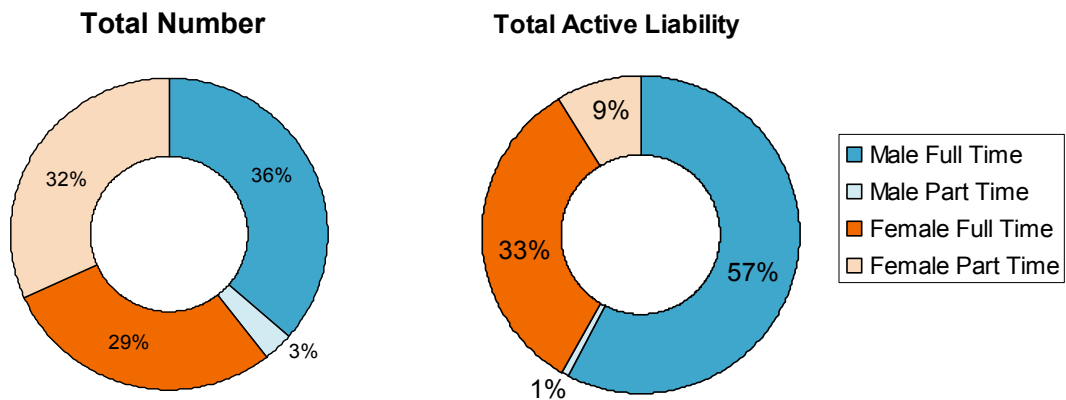
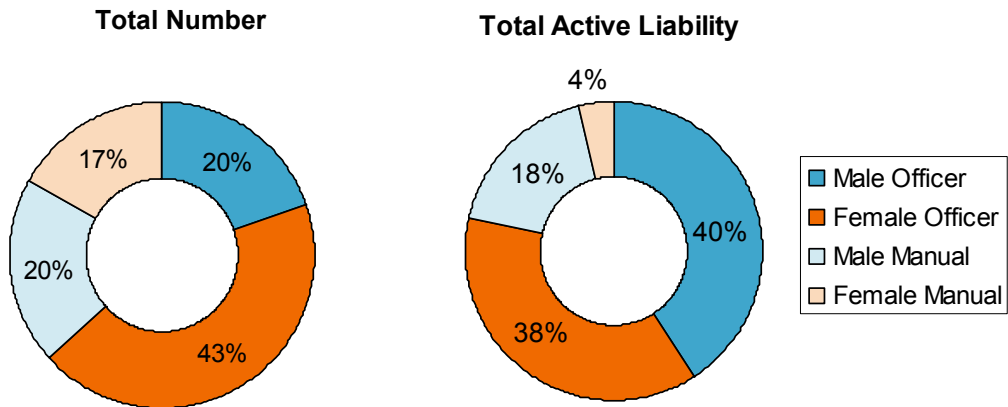


2.2 Accrued pension is affected by both salary and service. There is evidence to suggest that, to an extent, the two are related, with part-time members and those with broken career histories tending to have lower salaries. It could be argued that the statistics above are evidence that the current structure does not serve all aspects of the workforce equally well, with the “employer spend”³ heavily biased towards a relatively small proportion of the membership.

2.3 We also consider below the split of the total liabilities of the Fund between Males and Females, Officers and Manuals and part time and full time employees.

³ Where we are assuming that the distribution of the liabilities is a reasonable measure of the distribution of employer spend

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- 2.4 It can be seen that the majority of the Fund's liabilities relate to full-time, officer employees. We might expect these members to be more attracted to a final salary option, assuming that their pay growth will be in excess of RPI over their period of LGPS membership.
- 2.5 Conversely, although final part-timers account for a third of the membership, they account for less than 10% of the liability. This is a function of their lower service and lower average salaries as well as our assumptions (e.g. lower expected future pay growth and a higher likelihood of leaving before retirement with a deferred pension).

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Distribution of Pensionable Pay Increases

2.6 The current scheme provides benefits which are typically based on a member's pensionable pay⁴ over the twelve months to retirement. Thus, members whose salary increases rapidly throughout their career, or towards retirement, will tend to fare better under the current arrangement than those whose salaries do not increase as rapidly. The chart below shows the spread of annual increases in pensionable pay for members in both the 2001 and 2004 valuation of the Fund (in nominal terms) over the three years to 31 March 2004. For this purpose the pay for part-time members is based on full-time equivalent pay.



2.7 The chart shows considerable variation in pay growth. Whilst, about one-third received increases of between 3% p.a. and 5% p.a. (which broadly represents RPI to national average earnings increases), over one in five received less than RPI (assumed to be 3% p.a.) and a third received increases of more than twice RPI (at 7% p.a. or more). If this experience is typical, it suggests that a "one size fits all" approach to the LGPS may not necessarily be appropriate for the Fund's membership.

2.8 Please note that the above salary analysis may be distorted by some of the estimates we made in carrying out our data cleansing process at the 2004 valuation. Please also note that the above analysis excludes employees of the Education and Library Boards (ELBs). You may recall that the pay figures for these members at the 2004 valuation were distorted by backdated pay awards.

⁴ Pensionable pay currently includes all pay emoluments, except non-contractual overtime

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3. Summary of Options

Background

- 3.1 Draft regulations have been published which, if implemented, would abolish the Rule of 85 for existing members, for service from 1 April 2008. (The Rule of 85 will be abolished for new entrants from 1 October 2006.)
- 3.2 All the options in the consultation have a normal retirement age of 65 with no right to retire earlier under the Rule of 85. Existing staff protected by the transitional terms – broadly those aged 50 and above – would be expected to retain the value of their Rule of 85 rights on transition to any new scheme.
- 3.3 Improved death-in-service benefits, partners' pensions and a two-tier ill-health benefit are features of all of the options put forward in the consultation document.
- 3.4 In addition, all the options make allowance members being able to elect for a bigger lump sum up to the new HMRC maximum⁵, by exchanging part of their pension (known as "commutation"). The commutation terms mean that members electing additional cash will reduce the cost of the benefits.

Summary of Key Design Features

	Member's Pension	Lump Sum	Dependant's Pension	Comments
A	1/80ths Final Salary	3/80ths + commutation to new HMRC limits	1/160 th Final Salary	Existing scheme + savings on lump sum exchange rate and removal of Rule of 85 (no recycling).
B	1/60ths Final Salary	By commutation	1/120 th Final Salary	More generous than A, particularly the dependant's pension. Lump Sum – commutation at 12:1 not full value.
C1	1.85% (1/54ths) Career Ave Sal + RPI incs	By commutation	1/108 th Career Average Salary	Higher accrual – benefits 'low fliers' and those with short service. Same revaluation for employees & deferred pensioners.
C2	1.65% (1/60ths) Career Ave Sal + (RPI + 1.5%) incs	By commutation	1/120 th Career Average Salary	Similar to C1, but better link to expected salary progression (all actives credited with RPI + 1.5% p.a.). Potentially contrary to preservation laws.
D	Choice of C1, C2 or B with additional member contributions of c.3% of pay.			Career average as the default with the option to retain final salary

⁵ Broadly speaking, 25% of the value of the member's benefits.



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- 3.5 The first two options (A and B) are final salary designs, as the current scheme is, where members' benefits are based on service to and final pay at retirement. There are two career average salary designs (C1 and C2), where members' retirement benefits are based on salary in each year of service, increased ("revalued") to retirement age or earlier leaving. This is known as Career Average Revalued Earnings (or CARE). Please see Appendix A for an explanation of CARE.
- 3.6 Option D is a hybrid scheme where members have a choice. The default scheme is a career average scheme but members could opt to pay extra contributions to maintain final salary benefits. It is not clear in the consultation which of the two final salary options would be chosen (Option A or B) although we believe that the DCLG expects the final salary scheme would be in line with Option B (1/60th). As C2 is expected to be quite close to final salary (benefits increase at RPI plus 1.5% p.a.), to provide more differentiation, it would seem to us to be more sensible to make option C1 the CARE choice in this package.

CARE vs Final Salary

- 3.7 In general, a career average option with a higher headline accrual rate will be more attractive to members who are not likely to stay in local government employment for the whole of their careers and / or those who do not expect salary increases much above RPI over their LGPS membership. In section 5, we consider in detail which Fund members would be better or worse off in a CARE scheme compared to a final salary scheme.

Rule of 85 Treatment

- 3.8 All of the options incorporate the removal of the Rule of 85 and have a normal retirement age of 65. Details of how we have allowed for this in our costings are set out in Appendix B.

Dependants' Pensions

- 3.9 Options B, C1 and C2 all provide larger dependants' pensions than currently, as well as extending eligibility to include common law spouses and other financial dependants. Comparing Option A with Option B, for example, the member's pension accrual rate rises by around 6% (assuming that the maximum lump sum is taken), but the dependant's pension rises by 1/3rd. All dependants' pensions are unaffected by the amount of lump sum taken.
- 3.10 The increase in the proportion of the overall employer contribution rate which will be used to provide dependants' pensions under each option is set out in Appendix E.



4. Future Service Contributions for Options A to C

Summary of our Observations

- Option A is expected to be the cheapest option because employers would benefit from all of the expected savings from commutation and the removal of the Rule of 85; this option does not re-cycle any of the savings back to members via benefit improvements.
- Options B, C1 and C2 have similar expected employer costs at the aggregate level, with option B (1/60ths final salary) expected to be the most expensive option. However, if average real pay growth is around 1.5% p.a. or less, then option B could be cheaper than the career average options.
- Despite the removal of the Rule of 85 and taking advance credit for future commutation savings, we would not expect employer contributions in the 2007 valuation to be lower than their levels in 2004.
- Using the 2004 valuation assumptions, the expected employer contribution rate for options B, C1 and C2 are around 11.5% of pay, rising to 14.3% of pay for each option if longer life expectancy and lower gilt yields are taken into account. Option A leads to employer contributions of around 10.3% of pay (12.8% of pay including allowance for longer life expectancy and lower gilt yields).

- 4.1 This section summarises the effect of each option on future service contributions at a whole Fund level. We would encourage the Fund to consider the differences in the costs of each of the schemes, rather than just the absolute numbers. It should be noted that none of the contribution rates allow for the past service deficit recovery contributions.
- 4.2 All of the proposed options anticipate savings from the introduction of a two-tier ill-health retirement benefit and from the removal of the Rule of 85 for existing members (other than those who are protected). The costs of the new options are also reduced by taking credit for retirees commuting part of their pension to lump sum on terms which are less costly to the scheme than the cost of paying the pension. Our calculations are based on GAD's assumptions for commutation. We will be seeking information from funds on experience from April 2006 to inform our assumptions for commutation in the 2007 valuation.
- 4.3 Based on data provided by NILGOSC, about 70% of members who have retired since April 2006 have taken an additional lump sum over and above the scheme lump sum of 3/80ths.

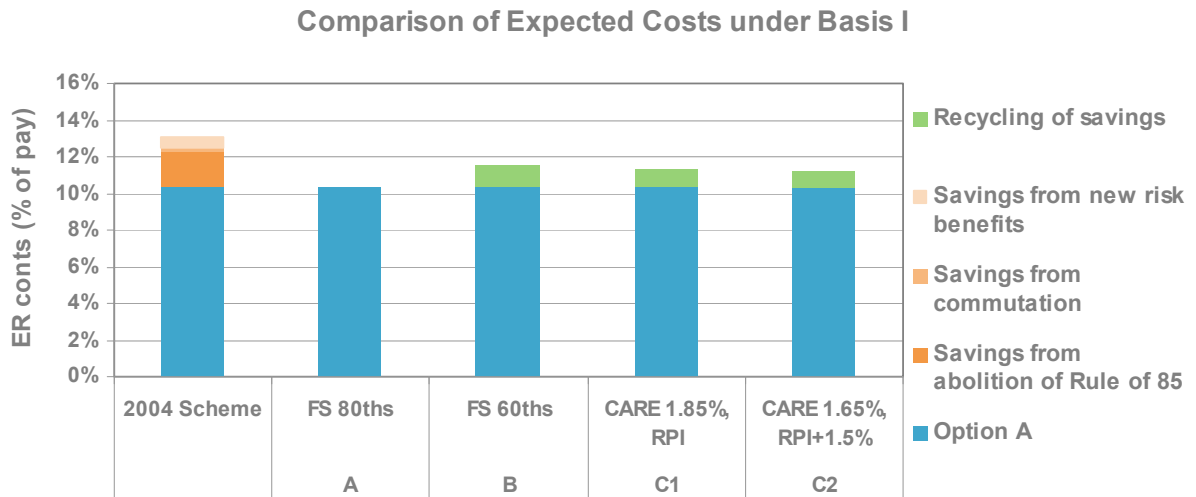
Basis I – 2004 Valuation Basis

- 4.4 The assessed cost of future service benefits in the 2004 valuation was 18.9% of pay for the Fund as a whole, including an allowance of 0.3% of pay for expenses. Average employee contributions to the Fund were just under 5.8% of pay, giving a net future service cost to the employers of 13.1% of pay, on average.



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- 4.5 The chart below compares the employers' share of the cost of future service benefits for options A, B, C1 and C2 on the basis used for the 2004 valuation, without updating for changes in investment market conditions or including an allowance for longevity improvement. The contribution rate for the scheme as it was on 31 March 2004 is also shown for comparison.



Commentary on Basis I

- 4.6 The first bar on the chart represents the employer share of future service benefits as at 31 March 2004, including an allowance for expenses. The orange shaded segments represent the anticipated contribution reductions from actual and proposed changes to the scheme. These savings may be summarised as follows:

	% of Pay
• anticipated savings from death and ill-health benefit changes ¹	0.6%
• anticipated savings from commutation (on future service)	0.2%
• 'savings' from removal of the Rule of 85 (with protections) ²	2.0%
Total Savings	2.8%

¹ This is the net effect of enhancements to death benefits – a higher lump sum death-in-service benefit and the introduction of partners' pensions (leading to a 0.2% of pay increase in employer contributions) - offset by the anticipated savings on the introduction of a two tier ill-health benefit (0.8% of pay).

² This is the anticipated saving from the removal of the Rule of 85 for all members, except those who would be age 60 by 31 March 2013, and would satisfy the Rule of 85 at that date. In practice, these transitional protections have been extended to 2016 (with tapered protection to 2020). We have assumed that the extra cost of the transitional protections, compared to the original 2013 protections in England and Wales, will be covered by the commutation savings on past service benefits.

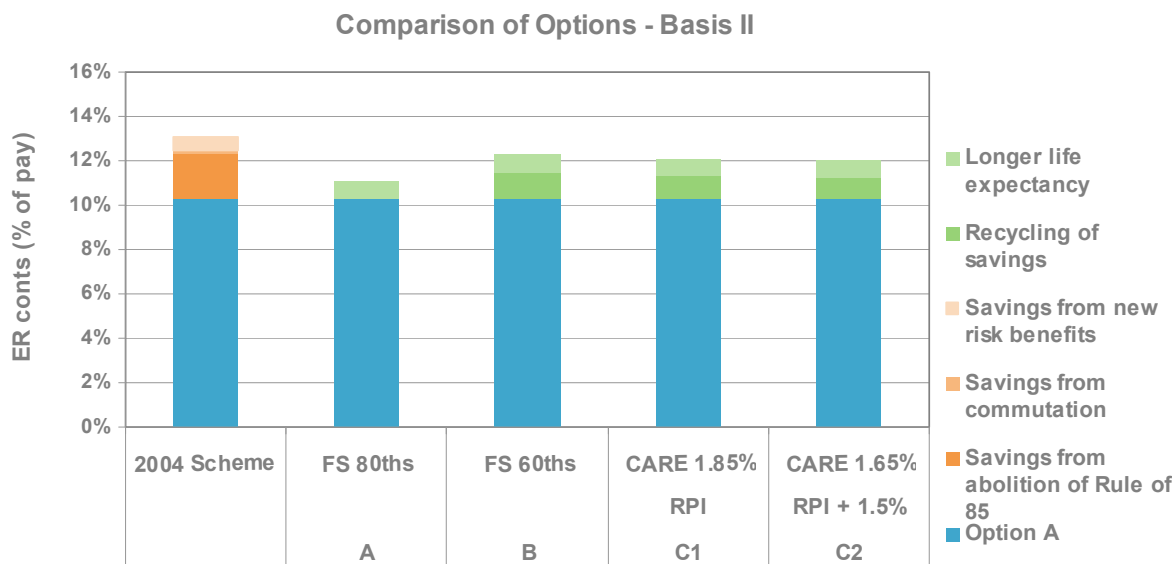


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- 4.7 The blue bars represent the expected cost of option A, which is the low cost option and does not recycle any of the future savings from the removal of the Rule of 85 or the introduction of commutation, (although it should be noted that the Tripartite Committee's agreement was that 50% of these savings would be passed back to members via benefit improvements). Thus, on a like-for-like basis, option A would have led to employer contributions for future service of 2.8% of pay lower had it been in place at the 2004 valuation (equivalent to 10.3% of pay).
- 4.8 Options B, C1 and C2 have been designed to recycle 50% of the future anticipated 'savings'. The green shaded segments on the chart above represent the difference in the cost of each option relative to option A. Thus, in essence they measure the effect of the recycling of 'savings' to members.
- 4.9 Option B is the most expensive of the options, giving an employer contribution rate of 11.5% of pay. Options C1 and C2 are cheaper, giving employer contribution rates of 11.3% and 11.2% of pay respectively.

Basis II – 2004 Valuation Basis with longevity improvement

- 4.10 At the 2004 valuation, no allowance was made for future improvements in longevity. The intention is to allow for such improvements at the 2007 valuation. If we allow for life expectancy improvements up to 2030, (which is still less than the allowance likely to be made by many private sector schemes and is less than the allowance made by GAD in its costings), employer contributions could increase by a further 0.8% of pay⁶, as the following chart shows.



⁶ This excludes the effect of building in an allowance for longevity improvement into past service, which would create a larger past service deficit and require a further increase in contributions.

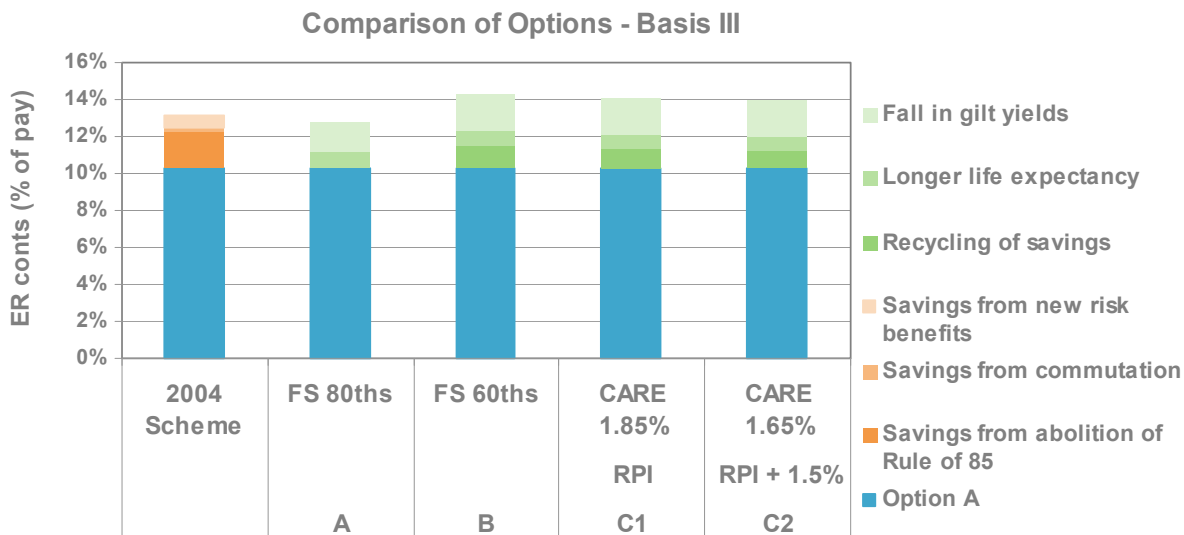
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Commentary on Basis II

- 4.11 As the chart shows, all of the options would lead to lower employer contributions (on average) than the scheme in 2004, even allowing for longer life expectancy. Contributions range from 11.1% of pay (option A) to 12.3% of pay (option B).
- 4.12 When stakeholders are considering whether the options are affordable, we suggest that the contribution rate including an allowance for additional life expectancy should be used as it is arguably more suitable in the longer-term than the 2004 basis with no adjustment for longer life expectancy. This gives a more reliable indication of the absolute level of costs that might be expected. This does not, however, allow for the effect of current investment market conditions, which, is covered in sections 4.13 to 4.18 below.

Basis III - Effect of changes in investment conditions since 2004

- 4.13 We take an investment market-related approach to valuations. This means that we assess the past service position by taking assets into account at their market value and place a value on the liabilities by reference to market indicators on the valuation date, allowing for anticipated out performance on the growth assets held by the Fund.
- 4.14 Real gilt yields have fallen since the valuation date, from 1.75% p.a. at 31 March 2004 to 1.33% p.a. as at 30 June 2006. The chart below shows the effect of this fall in gilt yields on the estimated future service contributions for each of the options. The future service contribution rate at the 2004 valuation is again shown for comparison.



Commentary on Basis III

- 4.15 The fall in real gilt yields has added about 2.0% of pay to the estimated employer contribution rate. The combination of recycled savings, longer life expectancy and the fall in gilt yields increase the employer future service contribution rate compared to that at the 2004 valuation for options B, C1 and C2. There would be only a modest reduction under option A. Thus,



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unless employee contributions are increased, if options B, C1 or C2 were confirmed in regulations in time to be taken into account in the 2007 valuations, lower employer contributions are not guaranteed.

- 4.16 The graph above may portray a bleaker picture than is necessarily the case. Employer contributions comprise contributions to meet the cost of future service plus (or minus) an adjustment if the past service position is a deficit (or surplus). Strong equity market performance since March 2004 is likely to have improved the past service position relative to that as at 31 March 2004, despite the fall in gilt yields. Thus, the total employer contribution rate may not increase by as much as implied by the chart (since required past service adjustment contributions are likely to have fallen).
- 4.17 Further, we are working on ways to deliver greater stability of employer contributions in respect of future service as part of our preparations for the 2007 valuations. Nonetheless, the figures do illustrate that employer contributions will not necessarily fall in the new scheme.
- 4.18 The consultation document does not rule out increasing employee contributions, (particularly under the final salary options). Any increase in the rate of employee contributions will of course lead to a like-for-like reduction in the required level of employer contribution to the Fund.

What if the 'savings' don't materialise?

- 4.19 The table below illustrates the effect of commutation and ill-health experience being different to that assumed by GAD in designing the options (and which we have also built into the contribution rates shown above). The savings calculated using GAD's assumptions (shown in Appendix B), are also reproduced for ease of comparison.

	% of Pay	
	Original	Revised
Anticipated savings from ill-health benefit changes	0.8%	0.5% ⁽¹⁾
Anticipated savings from commutation (on future service)	0.2%	0.1% ⁽²⁾

Notes:

- (1) this has been calculated assuming that the split of ill-health retirees between the lower and upper tiers is 50/50 rather than 85/15 as assumed by GAD.
- (2) this has been calculated assuming that 75% of members take a tax-free lump sum of 3/80ths (i.e. in line with the current scheme) and 25% elect to take the maximum tax-free lump sum, i.e. half of GAD's assumption.
- 4.20 These illustrations are only two possibilities. It is not possible to predict in advance what the savings will be, and they could of course be more than calculated using GAD's assumptions. The consultation document acknowledges the uncertainty and asks for views on whether employee contributions should increase in future if the anticipated savings do not materialise. Given that this could vary considerably between funds and between employers, it is not clear how such an adjustment could work in practice, although in theory at least it may be attractive to employers.

5. Effect on Members

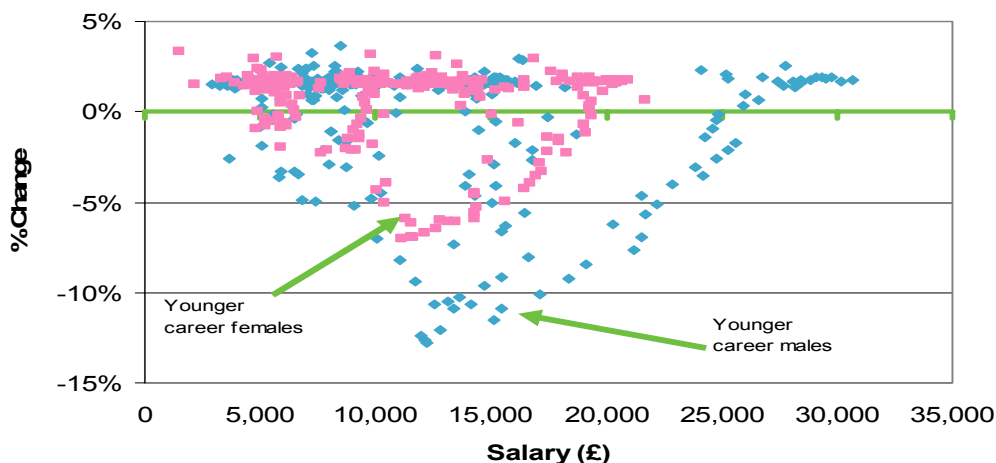
Summary of our Observations

- For a given average employer cost, career average is likely to produce higher benefits for those with lower than average future promotional pay progression, including part-time and manual workers in particular.
- Conversely, final salary is likely to produce higher benefits for those with higher than average future promotional pay progression, including younger full-time male officers in particular.

Career Average v Final Salary

- 5.1 We have compared the expected future service benefits which members in the Fund would accrue under a final salary and career average scheme.
- 5.2 For the purpose of our comparison we look at options B and C2. These options have (nearly) the same accrual rate and same increases in accrued pension before retirement if members' salaries increase in line with the 2004 valuation assumption of RPI plus 1.5%. The expected cost of providing members' benefits under these options is similar and thus these options provide a useful comparison of a final salary and CARE scheme.
- 5.3 The chart below illustrates the percentage change in the value of benefits for members' future service, based on the Fund membership as at 31 March 2004 and using the promotional salary scales used at the 2004 valuation⁷. The pink squares represent females, and the blue diamonds males. Those above the zero line are better off under the CARE scheme. Those below the line are worse off under the CARE option.

CARE (1.65%, RPI + 1.5%) v FINAL SALARY 60THS

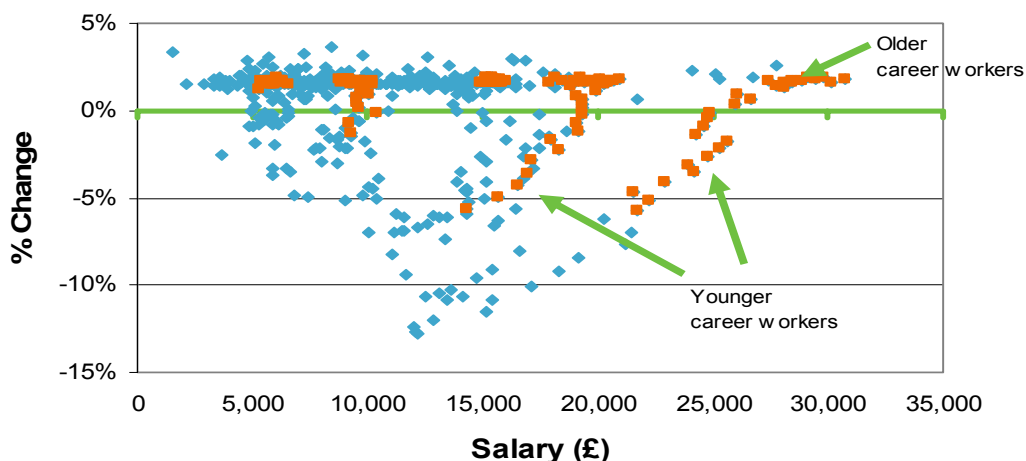


⁷ Adjusted slightly to take account of the fact that not all members will receive salary increases of RPI+ 1.5% p.a.

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- 5.4 Our experience analysis of our LGPS funds in England and Wales (on which our 2004 valuation assumptions were based), showed that part-time and manual members tend to receive little or no promotional salary increases. Promotional pay growth is most evident amongst male, full-time officers and also tends to be linked to age.
- 5.5 Thus the members who tend to do better under final salary (and hence less well under CARE) are the male full-time members who join early in their careers, and to a lesser extent, female full-time members, as marked on the above chart.
- 5.6 There are blue diamonds above the zero line at the higher salary bands; these are likely to represent the older, officer members whose promotional pay growth is largely assumed to be behind them. Thus, when looking at future service only, they would be better off under CARE if, as our valuation assumptions expect, their future pay growth is not expected to be above RPI + 1.5% p.a. The chart would look quite different for these members if their total service (i.e. including that accrued prior to March 2004) were taken into account.
- 5.7 Conversely, the members who tend to do better under career average (and hence less well under final salary) are the female part-time members. As the chart shows actual, rather than full-time equivalent salaries, the pink squares for salaries below £7,500 or so, nearly all of which are above the zero line, are likely to represent female part-timer members who will be better off under CARE. It is likely that the extent to which these members would be better off under CARE would increase if the chart showed their total service (i.e. including that accrued prior to March 2004).
- 5.8 The above chart is useful for showing the impact of moving to a CARE scheme for male and female members. It does not, however, show where the majority of scheme members lie. The following chart shows the same analysis, but with emphasis on the areas where there are larger groups of members.

CARE (1.65%, RPI + 1.5%) v FINAL SALARY 60THS



- 5.9 In the above chart, the orange areas show where the membership is most heavily weighted.
- 5.10 There is a large group of younger career workers (shown by the orange areas around the centre and to the right of the chart) who would be expected to receive pensions of up to 5%

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lower under the CARE option compared to the final salary. This is because they have a large part of their career ahead of them, with expectations of high salary growth over that time.

- 5.11 There is also a large group of individuals around the zero line at the higher salary bands; these are likely to represent the older officer members whose promotional pay growth is largely assumed to be behind them. Thus, when looking at future service only, they are likely to receive similar benefits under CARE and final salary if, as our valuation assumptions expect, their future pay growth is not expected to be above RPI + 1.5% p.a. The chart would look quite different for these members if their total service (i.e. including that accrued prior to 31 March 2004) were taken into account.
- 5.12 These patterns are averages. In all cases, there will therefore be exceptions to the patterns above for individual members.



6. Hybrid Option D - *The Best of Both Worlds?*

Summary of our Observations

- Option D provides member choice and could address the dilemma of whether to design a scheme for the majority (likely to be career average) or for the key, career workers (likely to be final salary).
- We suspect that making a choice will not be easy and many employees might opt for the CARE scheme because of its higher accrual rate (if C1) and lower member contribution rate.
- Option D could be made more simple and cheaper by making Option A the final salary choice.
- Our understanding from the DCLG is that responses to date tend to favour this option.

Summary of Option D

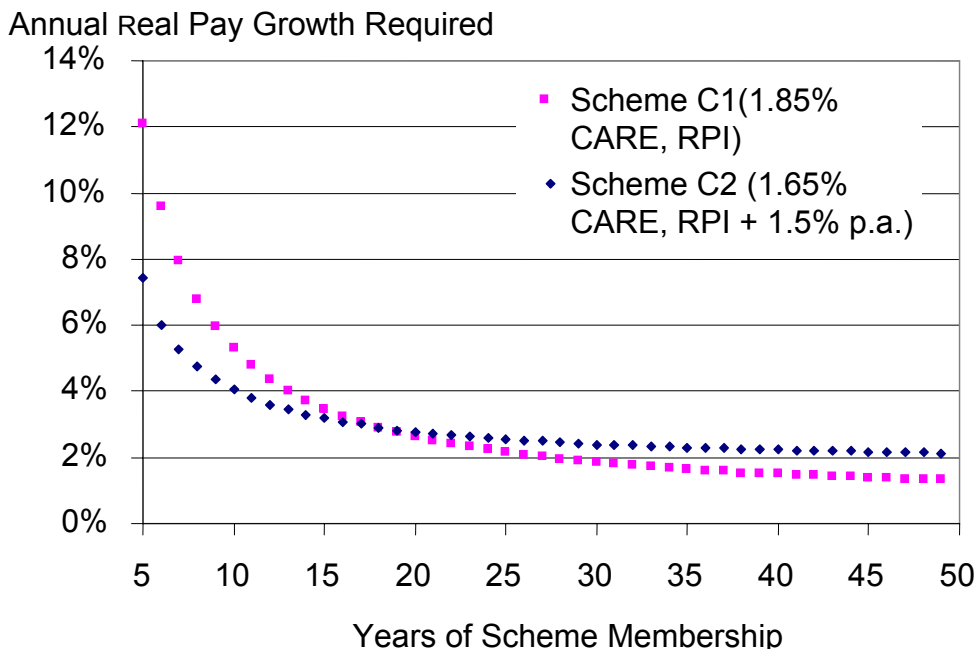
- 6.1 Under option D, the default option (and lower cost option for employees) would be CARE. Employees would be able to retain a final salary scheme but would have to pay a higher employee contribution rate. It is proposed that the extra employee contribution is 3% of pay. Thus, if members of the CARE scheme pay 6% of pay, employees opting for final salary would pay 9% of pay. Although it is not made clear in the consultation documentation, our understanding is that option D envisages a 1/60th final salary option, i.e. option B would be the final salary choice. The costings in section 3 revealed that option B was the most expensive under all bases.
- 6.2 The additional 3% of pay assumes members have a one-off choice to elect final salary (either as at 1 April 2008 or on joining, if later).
- 6.3 It is not feasible to cost option D in the same way as the other options as the membership would be expected to split into two camps, according to their own expectations of the scheme that they thought would suit them best. We would expect the majority of LGPS members to focus on the extra short term cost and to stick with CARE. The final salary option could, at least in theory, be attractive to those who expect strong future pay growth and who expect to stay in the scheme for some time.

How should members make a choice?

- 6.4 The chart below shows our estimates of the minimum level of real pay growth that would be required for a member to get the same value from the final salary scheme as from the CARE scheme, allowing for the higher employee contributions rate under final salary. This compares option B (1/60th final salary) with option C1 (1/54th CARE) and option C2 (1/60th CARE). The higher accrual rate under C1 means that minimum level of pay rises increases the shorter the period that you are in the scheme. (The chart does not show the required rates for those in the scheme for less than 5 years, which rise stratospherically.)

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What real pay growth is needed to make it worth paying 3% of pay more for Option B (1/60th Final Salary) than Option C1 or Option C2?



- 6.5 This chart implies that, for example, if a member was in the scheme for 10 years, he or she would need pay rises of at least 5% p.a. more than RPI to make it worth paying the 3% of pay extra contribution, under option C1. The required pay increase would be 4% p.a. more than RPI under option C2. If the member is in the scheme for 40 years, then the minimum pay rise in excess of RPI drops to just 1.5%p.a. under C1, equivalent to our assumption of real pay growth in the 2004 valuation. The required pay increase would be 2% p.a. more than RPI under C2.
- 6.6 This demonstrates the value of final salary schemes for those who have long service. We are not sure in practice how many members would have the confidence, conviction and foresight to opt for B in practice and many members may prefer the lower contributions required for the CARE option.
- 6.7 We understand the attraction of offering members a choice of scheme design. However, it would seem to us to be more straightforward (in terms of administration and communication to members) for the final salary option to be the current scheme (i.e. Option A). This could also permit a lower additional employee contribution rate.



7. Sustainability

How could the actual costs that emerge differ?

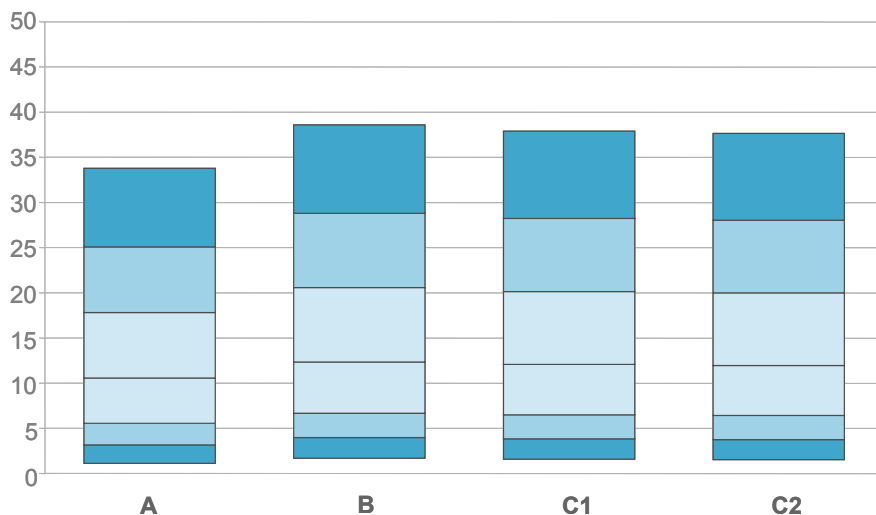
7.1 Our costings are based on a single set of assumptions. The true cost of any defined benefit structure is not known until the last benefit payment is made. We would expect variations – which would be revealed at future triennial valuations – from, for example:

- changes in interest rates;
- changes in longevity;
- the actual levels of pay growth (e.g. if actual real pay growth is lower than 1.5%pa, retaining final salary would be cheaper than moving to CARE);
- changes in membership structure (e.g. the workforce ageing).

Sensitivity to Interest Rates

7.2 The chart below illustrates the potential spread of employer future service contributions for each of the options over a ten year period assuming a typical, equity-biased investment strategy⁸ and an average (“median”) employer contribution rate broadly in line with our results for a “typical” local authority fund in England and Wales, based on membership data at the 2004 valuations.

SPREAD OF EMPLOYER CONTRIBUTIONS



⁸ We have assumed no material change in investment strategy as we think it is unlikely that many funds could afford to reduce their investment risk, due to the resulting increase on employer contributions.

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- 7.3 The height of the bars illustrates the potential variation in future service rates and would increase if other risks, such as mortality, were taken into account.
- 7.4 The lightest blue segments represents about 2/3rds of outcomes. Thus, even if we consider the low cost option, Option A, 2 in 3 outcomes would give employer future service contributions of between 6% and 18% of pay. Further, one in six outcomes would give contributions of more than 18% of pay.
- 7.5 These figures do not necessarily represent the likely outcomes for the Fund, but should be reasonably representative of the spread of future outcomes.

How could the actual costs that emerge differ?

- 7.6 The chart illustrates that delivering a stable future service contribution rate, even at a whole fund level, can be challenging. The similar height of the bars indicates that none of the options proposed materially reduce the interest rate or investment risk for employers. The reason for this is that all options are defined benefit schemes where employee contributions are assumed to be fixed and the employer pays the balance of cost.
- 7.7 There is a marginal reduction in the risk for career average options. This is because career average eliminates some of the risk of individual pay progression increasing the cost of benefits. However, even this risk reduction makes no real discernible difference to the potential spread of possible future employer contributions.

So, is it durable?

- 7.8 By their nature, none of the proposed options reduce investment-related volatility, in the sense that the true cost is unknown and employers will have to pay more if experience is worse than assumed in setting employer contributions. Conversely, employers should benefit if experience is better than expected (although the risk is slightly one-sided since the employer contribution rate cannot go below 0% of pay).
- 7.9 Our analysis indicates that options A and B have roughly the same level of volatility risk⁹ as the current scheme. Options C1 and C2 provide some risk reduction relative to the current scheme, but it is marginal. Any risk reduction associated with career average will be given away if members can elect to retain final salary benefits as envisaged by option D.
- 7.10 Ultimately it is employers and politicians (on behalf of taxpayers), who must decide what level of risk / volatility of employer contributions is affordable. Whilst funding strategy can adapt to try and deliver stability of contributions, if a reduction in the level of risk / volatility of employer contributions is deemed necessary, we would suggest that some flexibility (of either benefits or employee contributions) is introduced.

Options to improve durability

- 7.11 There are a number of options which could reduce the volatility of future employer contributions and hence make the scheme more viable. Those which could be considered within a defined benefit design include the following:

⁹ Although the absolute range is lower under option A as it is a lower cost design.



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- **cost sharing** - employee contributions could be adjusted for experience such as life expectancy or commutation, in say a 1/3 employee 2/3 employer ratio. We think that it would be difficult to justify adjusting for investment experience, although this does occur in the Railways scheme.
- **risk sharing** - some adjustment to future service benefits depending upon experience such as life expectancy or commutation. We support the concept of building in the scope to reduce future benefits if there is evidence of longevity improving.
- **employer discretions** – it seems likely that the durability of the scheme would be improved if employers had greater scope to tailor the benefits (or member contributions) to their particular needs.

Employer discretions

- 7.12 The consultation document refers to employers being able to increase benefits for individual members. This only really works if the core level of benefit is set low enough to enable the bolt-on bits to be afforded. Employers may consider that the level of option B is too high to provide scope. Using option A as the final salary choice in option D might be preferable.
- 7.13 More radical ways of giving employers more freedom would include:
- giving the employer freedom over the **definition of pensionable pay** would enable more flexible remuneration packages;
 - giving the employer freedom over the **split between employee and employer costs**;
 - **extending CARE so that the benefit is a cash sum only at retirement** (e.g. with an accrual rate of (say) 25%, rather than being expressed as an amount of pension) which employees can use in part or in full to buy a pension. This could be used to adjust the pensions payable to allow for changing circumstances, e.g. gilt yields or mortality and allow more individual choice, e.g. a lower dependants' pension or lower pension increases.
- 7.14 All of these suggestions go against the concept of maintaining a national scheme.



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8. Conclusions

- 8.1 This report does not seek to make any recommendations on the appropriate structure for the LGPS in future but is intended to assist the Fund in responding to the Department of the Environment on the future of the LGPS in Northern Ireland, should it wish to do so.
- 8.2 We have analysed the Fund membership and considered the spread of pay increases and employer spend and have assessed which groups of members may be better off or worse off under career average or final salary.
- 8.3 We have considered the possible pattern of employer contributions to the Fund under the core options, to help assist you in deciding which (if any) of the options are affordable and commented on the sustainability of the option.
- 8.4 We have considered how members might assess whether the extra contributions of 3% pay proposed under option D to retain a final salary benefit is likely to be worth it for them.
- 8.5 Some of our thoughts on other aspects of the consultation, specifically dependants' pensions and equality-proofing, are set out in appendices E and F respectively.
- 8.6 We have not considered the options for moving to the new scheme and the implications of the alternative transitional arrangements. We believe that it is more important to agree on the new structure first, before deciding how to move from the current arrangements to the new scheme. However, we would be happy to prepare a further paper setting out the options for the transition to a new scheme, if required.
- 8.7 We would be delighted to answer any questions which this paper raises.



Alison Murray FFA
For and on behalf of Hymans Robertson LLP



David Cumming FFA

18 September 2006

Appendix A - Explaining CARE

We are aware that there is unease amongst member representatives about the concept of a career average benefit, which we believe is at least in part due to a misunderstanding of the design.

In a career average (CARE) scheme, pension benefits are calculated individually for each year of service. Each year the member accrues a pension at retirement based on his or her salary in that year, which can be thought of as being like a deposit in a bank account. On top of this, previous years' benefits are increased (like interest being added). The pension scheme keeps a running total of the balance of all the benefits and this is the pension (and lump sum) which is paid out to the member on retirement. An example of how the pension builds up in a career average scheme is shown below.

Date	Transaction			Total
Year 1	Deposit	1.85% x £15,000	£278	£278
Year 2	Interest	3.0% x £278	£ 8	£286
	Deposit	1.85% x £15,600	£289	£575
Year 3	Interest	3.0% x £575	£ 17	£592
	Deposit	1.85% x £16,224	£300	£892
Etc....				
Etc...				
At Retirement: pension				£1,608

In this example, we have assumed that the accrual rate is 1.85% p.a. and that revaluation is in line with RPI (i.e. Option C1), where RPI is 3% p.a. Further, we have assumed that Mrs Brown's salary increases at 4% p.a.

Because each year's benefit stands alone and is unaffected by the actual salary experience of the member over the period to retirement, if a member gets a very high pay increase this does not affect prior years' benefits. As the distribution of pay increases tends to benefit the higher paid removing the link between high pay increases and prior year benefits reduces the value of the benefits and hence adopting a career average structure permits a higher headline accrual rate.

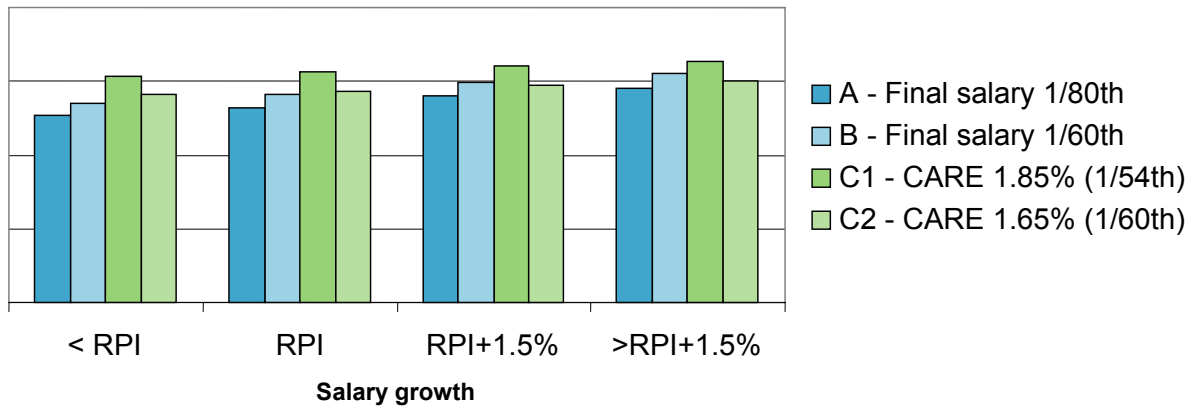
A CARE structure will also more fairly reflect a member's pay over their working lifetime (on which the member pays their own contributions).

Options B and C2 are intended to be very similar in cost terms because the increase rate under option C2 is RPI + 1.5% p.a. which is the assumption used for salary increases by GAD and by the majority of LGPS funds in setting employer contributions. The accrual rate of 1.65% is also very close to the 1/60th rate proposed for option B. However, the valuation assumptions are very much an average and there will be individuals whose salary growth is considerably more (or less) than average.

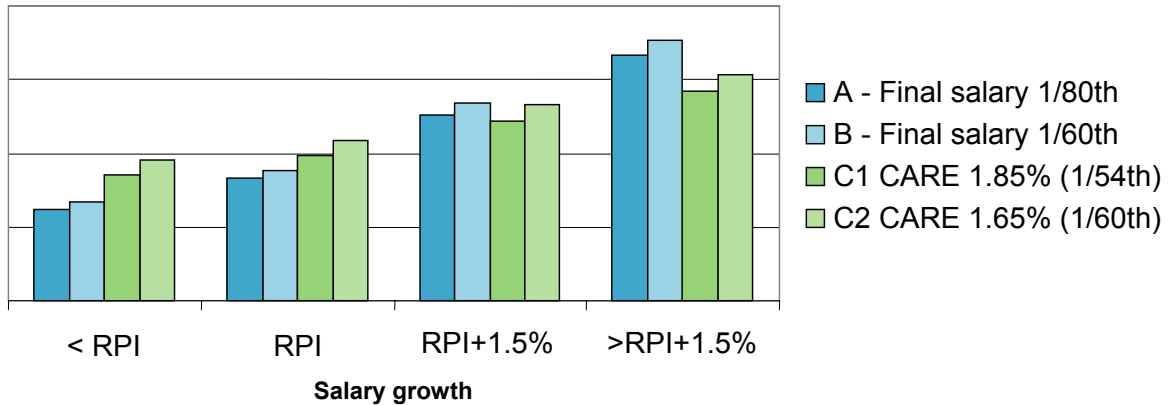
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Those whose salary growth, on average, across their whole period of membership, is less than RPI (or RPI + 1.5%) will tend to do better under options C1 or C2 than option B. Most, if not all, members will receive a lower benefit under A because this is a less valuable scheme design. The effect of the different options will also depend upon a member's length of service in the scheme. The charts below illustrate the comparative levels of pension under each option for a variety of salary increase rates for both a member with 5 years' service and one with 30 years' service.

Relative pensions at age 65 after 5 years' service
Pension at 65



Relative pensions at age 65 after 30 years' service
Pension at 65



Notes:

For the purpose of the above charts, RPI is assumed to be 3% per annum. The < RPI figures assume salary increases of 2% per annum and the >RPI + 1.5% figures assume salary increases of 5.5% per annum.

Appendix B - Methodology

Actual Contributions vs. GAD Costings

The purpose of the costings in the consultation document is to provide a consistent benchmark against which to measure the relative cost of each option. As the consultation document acknowledges, the costings will differ from the contribution rates that would actually be payable by LGPS employers should the proposed option be implemented. Some of the reasons for this include the following:

- the GAD costings are based on a 'synthetic fund' believed to be typical of a Council fund so are not necessarily appropriate for individual funds or employers.
- they are based on one set of long-term assumptions which do not necessarily reflect the funding assumptions used by funds and their actuaries;
- they explicitly differentiate between current members and future joiners (whereas actual employer contributions are based on the membership at the valuation date and make an implicit allowance for new entrants);
- they exclude expenses; and
- they ignore any past service deficits.

It seems reasonable that current and future employees should not pay to recover the deficits of past generations, so we focus on the future service costs in this report. In practice, employer contributions will be higher once additional contributions in respect of past service deficits are taken into account.

Funding Method

We make the assumption that any transfer of past service into the new scheme would have a neutral effect on contributions. This may be a bold assumption if a serious attempt at removing all the historic rights is to be made.

As in the 2004 valuation, we use the Projected Unit Method to calculate the future service cost. This measures the expected cost of the next year's accrual of benefits, expressed as a percentage of payroll. GAD's costings use two alternative methods – the Attained Age Method (AAM) and the Entry Age Method (EAM) that produce slightly different measures of expected cost.

- The AAM measures the expected cost of the in-force employees over their future working lifetime. It tends to produce higher costs than the PUM, because pension costs are typically (but not necessarily) higher for older employees.
- The EAM measures the expected cost over the working lifetime of a new entrant. It tends to produce lower costs than the PUM.



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Membership Data

We use the data on employees supplied for the 2004 actuarial valuation, which is summarised in Appendix C.

Assumptions

Our future service cost comparisons use, as a starting point, the assumptions used for the 2004 valuation. The valuation assumptions are summarised in Appendix C.

For the purpose of the comparative costings in Section 4 we have allowed for the removal of the Rule of 85, other than for protected members. For this purpose, we have allowed for the protections as they were originally agreed for England and Wales, i.e. assuming protections to 2013 for existing members who would have reached age 60 and met the Rule of 85 by that date. The principal reason for this is that the additional cost of extending the protections is assumed to be met from savings from commutation on past service. The Department of the Environment have issued draft regulations which, if implemented will apply the same protections as in England and Wales i.e. extended to 2016 (2020) for existing members and although this does not represent an extension of the protections as such (as the 2013 protections were not implemented in Northern Ireland, as that we have not considered potential cost savings from commutation on accrued service, it seems appropriate to cost the options in the same way as we have done for England and Wales.

We have made a number of other assumptions, which are detailed in Appendix D. In essence, we have adopted the same assumptions as GAD in estimating the effect of allowing for commutation and for the proposed new ill-health arrangements.

We reduced the proportion of pensioners assumed to be survived by a dependant in the 2004 valuation. The introduction of Civil Partners in late 2005 and the potential extension to common law spouses and other financial dependants in 2008 means that the assumptions would have to be raised in the 2007 valuation. The assumption would depend upon how wide the "financial dependant" test is defined – for example, would it be determined at retirement, at death or somewhere in between? For the sake of these illustrations of the costs of the new designs we have assumed that 94% of members have an eligible financial dependant at retirement (the same as GAD). We have not allowed for divorce, remarriage or for new financial dependants to be created after retirement, but have allowed for the fact that partners may die before the scheme member. Thus, the proportion assumed to give rise to a financial dependant at death is lower than at retirement age, as shown in Appendix D.



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Appendix C - Valuation Assumptions and Data Summary

Assumptions

Financial Assumptions	31/03/2004		30/06/2006	
	% p.a. Nominal	% p.a. Real	% p.a. Nominal	% p.a. Real
Discount Rate	6.3%	3.4%	6.0%	2.9%
Pay Increases	4.4%	1.5%	4.5%	1.5%
Price Inflation/ Pension Increases	2.9%	-	3.0%	-

Details of the demographic (statistical) assumptions are set out in the report on the actuarial valuation as at 31 March 2004, dated March 2005.

Membership Data

The membership data for employee members as at 31 March 2004 is summarised below.

	Number		Pensionable Pay (£000)			
	2004	2001	2004		2001	
			FTE	Actual	FTE	Actual
Full Time members						
Pre Feb 2003 Joiners:						
Male Officers	6,278	6,847	156,975	156,975	144,087	144,087
Female Officers	9,255	14,366	171,259	171,259	184,701	184,701
Male Manuals	7,305	8,535	109,767	109,754	100,083	100,083
Female Manuals	1,303	7,642	15,678	15,637	35,443	35,443
Post Feb 2003 Joiners:						
Males	1,176	-	16,960	16,960	-	-
Females	1,131	-	15,920	15,920	-	-
Full Timers Total	26,448	37,390	486,559	486,504	464,314	464,314
Part Time Members						
Pre Feb 2003 Joiners:						
Male Officers	311	-	4,916	2,561	-	-
Female Officers	5,431	-	81,260	49,934	-	-
Male Manuals	732	-	10,137	5,877	-	-
Female Manuals	5,578	-	66,444	32,645	-	-
Post Feb 2003 Joiners:						
Males	275	-	3,030	1,850	-	-
Females	1,922	-	20,575	10,294	-	-
Part Timers Total	14,249	-	186,363	103,162	-	-
Grand Total	40,697	37,390	672,921	589,666	464,314	464,314

Appendix D - Additional Assumptions for Scheme Design Costings

Summarised below are the additional assumptions we have adopted in relation to the proposed new scheme designs, including commutation and the two-tier ill-health provisions.

Commutation

We have adopted the same assumptions as GAD. That is, we have assumed that 50% of members will take the maximum cash permitted by HMRC and that the other 50% of members will receive (or elect under options B, C1 and C2) a lump sum benefit of 3/80ths of final salary for each year of service.

Two-Tier Ill-Health Benefits

As discussed in the consultation documentation, the proposed new scheme designs include a two-tier ill-health benefit.

As per GAD's assumptions, we have assumed that 15% of ill-health retirements would be "top-tier" i.e. members who "are likely to secure gainful or regular employment again". These members would be entitled to immediate payment of their accrued benefits with an enhancement to service of 50% of prospective service to age 65.

We have assumed the remaining 85% of ill-health retirements would be "second tier" i.e. members "who are judged to be capable of undertaking other regular employment". These members would not receive any enhancement to service but would receive immediate payment of their accrued pension.

We have assumed post retirement mortality experience for "top-tier" ill-health retirees is in line with our assumption for ill-health retirees at the 2004 valuation. For "second-tier" ill-health retirees we have assumed that post retirement mortality experience is between the allowance made for normal retirements and ill-health retirements at the 2004 valuation.

It is unclear what allowance GAD made for post retirement mortality of ill-health retirees in its costings.

Unlike GAD's costings, we have made no allowance for the review of individual ill-health cases which might lead to members moving between the "top-tier" and "second-tier".

Proportions with a Dependant

Sample proportions assumed to have a spouse or partner at death for different ages at death are shown below:

Age at Death	Assumed proportion with a partner at death, assuming retirement at age 65			
	Male Officer	Female Officer	Male Manual	Female Manual
65	94.0%	87.3%	94.0%	87.3%
70	85.7%	79.8%	88.2%	80.8%
75	70.9%	66.0%	77.7%	68.9%
80	49.6%	45.0%	61.2%	50.2%
85	26.4%	22.2%	40.0%	28.1%
90	9.2%	6.5%	19.4%	10.2%
95	1.7%	0.9%	5.9%	1.9%

Appendix E – Dependants' Benefits

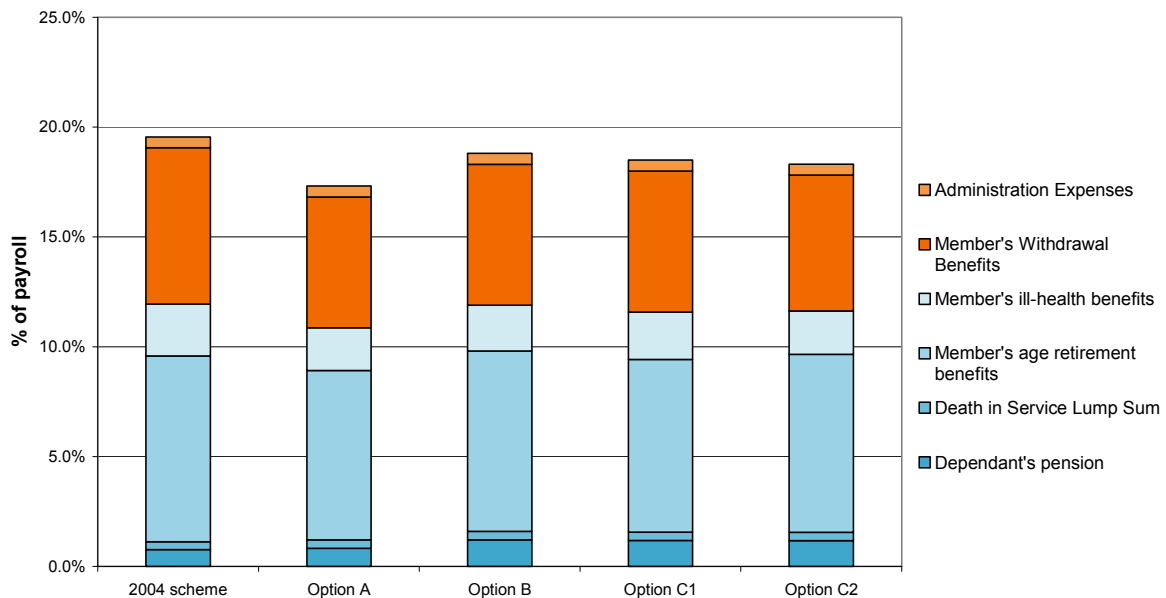
All of the proposed core options incorporate improved dependants' benefits:

- a lump sum death-in-service benefit of 3 times pay;
- much larger dependants' pensions (33% higher in options B and C2, 50% higher in option C1) compared to the current scheme¹⁰;
- extending eligibility for dependants' pensions to include financial dependants, and not just same-sex couples who have entered into a Civil Partnership; and
- a re-targeted two tier ill health benefit (where members who are not able to follow their LGPS occupation will receive an unreduced pension but with no enhancement, with those who are unable to work at all receiving an enhancement equal to 50% of their future service).

The chart below provides a breakdown of the future service cost of each of the options between each of the main types of benefit. (The chart is based on 1.5% real salary growth, with longevity improvements.)

Comparing the dark blue segments at the bottom of each bar shows that the introduction of larger dependants' pensions costs around 0.4% of pay.

Split of total contribution rate (2004 Basis, with longevity improvements)



¹⁰ Based on accrual rates with no allowances for differences in final pay and career average pay.

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We are not aware that there has been a conscious decision to increase dependants' pension as well as to extend them to unmarried partners. We do not have details of how many members are single or whose partner (or spouse) is financially independent, however, it would seem to us that a review of the effect of the options on dependants' pensions would be useful.

We consider some alternatives below:

- keep the level of dependant's pension where it is today (i.e. 1/160ths), but give members the option to buy a larger dependant's pension perhaps by paying extra contributions; or
- increase the level of lump sum payable to those who die shortly after retirement from the current "guarantee" of 5 years' pension – the new HMRC rules allow schemes to pay a large lump sum on death before age 75¹¹. This benefit would be payable to the estates of all members (exempt from inheritance tax) and would therefore also provide a benefit for single members. We estimate that guaranteeing pensions up to age 75, rather than for 5 years, would add around 0.2% of pay to the scheme cost (i.e. around half the cost of the higher dependant's pension).

¹¹ It is permissible to provide a lump sum of up to the lifetime limit (£1.5m) less the value of other benefits provided.



Appendix F - Equality Proofing

Summary of our Observations

- Many of the characteristics of CARE appear suited to the Government's equality-proofing agenda. Redistributing expenditure in this way could however cause upward pay pressure amongst higher earners/career employees.
- Lower employee contributions for the lower paid sounds fair but it looks difficult to reach a consensus on where to set them. Employers might argue that they are subsidising central Government by reducing its social security bill.

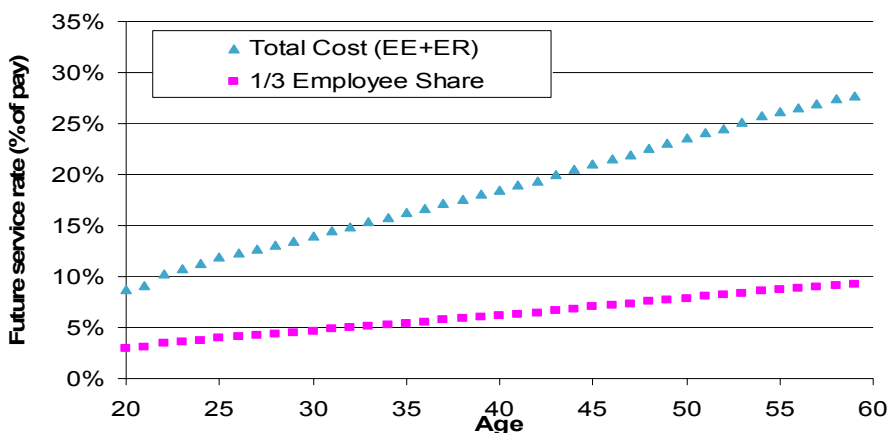
One of the key objectives is to "equality proof" the new scheme. This could mean a variety of things.

The ultimate value of the benefits derived from membership of a defined benefit pension scheme can vary considerably from member to member and differences can arise from a series of factors, including:

- between men and women,
- between full-timers and part-timers; and
- by age.

We have considered the total scheme costs (employee plus employer) expressed as a percentage of pay, which removes the effect of different pay levels. We did not observe any material difference in expected cost between men and women, or between part-timers and full-timers. However, all the options show a similar pattern of rising costs with age. The steepness is much the same for all the options too. The chart below, for example compares the costs for options B using the 2004 valuation financial assumptions updated for market conditions.

**Expected Cost of Option B
Split By Age**



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Commentary on Equality Issues

The table below summarises the key issues and comments on the extent to which the designs on offer would help to reduce differences in outcome for different types of members.

Possible sources of variation	Issue	How do the options stack up?	Are there any alternatives?
Pensioner longevity	How long pensions are in payment is potentially the biggest variable. Although the overall trend is for increased life expectancy and for fewer pre-retirement deaths, we would still expect considerable variation.	None of the options address this.	Guaranteeing pensions to age 75 ¹² , (rather than just 5 years), could provide more equality.
Gender	Women – on average – live longer. They are more likely to work part-time and typically experience lower pay growth.	The higher accrual of C1 (or the higher revaluation of C2) would tend to provide bigger benefits to women.	None that we can think of which would not be sex discriminatory.
Marital status	The current scheme provides a survivor's pension to widows, widowers and civil partners, but not 'common law' spouses or other financial dependants.	Providing pensions for financial dependants (e.g. common law spouses) reduces variation in one way, but increasing the amount of the dependant's pension introduces greater inequality for members without financial dependants.	Retain a 1/160 th accrual rate for dependants' pensions, at the same time as widening eligibility for financial dependants.
Pay progression	Not only do final salary schemes produce larger pensions for those with higher pay, but the cost of pensions as a % of pay is higher for those with more rapid pay growth over their careers.	CARE should help to reduce variation in the absolute amounts of pension, but when expressed as a % of pay on retirement, there may be more variation. Introducing CARE may cause upward pay pressure amongst high fliers who will need to save more themselves to produce the same level of retirement income.	Amend the definition of pensionable pay to allow employers to give non-pensionable pay awards or bonuses.

¹² As is permitted under the new HMRC limits.

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Possible sources of variation	Issue	How do the options stack up?	Are there any alternatives?
Career employee or short-term contractor	<p>The length of membership has a similar effect on the relative value of CARE and final salary schemes as pay progression.</p> <p>Final salary schemes can be very attractive for employees who already have considerable service, particularly if they get good pay rises.</p> <p>This may be regarded as a strong motivator/staff retention tool or a barrier to healthy labour mobility depending on your point of view.</p>	<p>The final salary options (A or B) reward career employees. Option D is a compromise which could be argued as being fairer to high fliers and those who do not expect to receive high pay growth.</p>	
Age of Employee	<p>Final salary scheme is less valuable for younger members (more valuable/expensive for older employees).</p>	<p>Adopting CARE does not appear to reduce the value gap between younger employees and older employees.</p>	<p>This could be addressed by member contributions that increased with age.</p> <p>We believe that this is permitted under the new age discrimination regulations and indeed here would be designed to reduce age discrimination.</p> <p>It could be more attractive than tiering contributions by salary level.</p>
Low paid employees	<p>Some may put off joining by the 6% contribution rate.</p> <p>Means-tested social security benefits mean that the lower paid may gain no net benefit from joining the LGPS.</p>	<p>Tiered contributions (in conjunction with career average C1) could go some way to achieving this.</p>	<p>Reducing the employee contribution rate on the first tranche of earnings should reduce opting out amongst lower paid, but will increase employer costs and may be regarded as a central tiered contributions government subsidy.</p>

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Addressing Gaps in Pension Saving

The breaks in women's pension histories from caring for children and the introduction of pension sharing on divorce (which typically depletes men's retirement savings), means that there is a need for accelerated build up of saving for members in their 50s and 60s.

Funds may wish to alert members to the increased attractiveness of paying Additional Voluntary contributions since April 2006, which creates substantially more scope to save more for pensions in the second half of an employee's working lifetime.

Tiered Employee Contribution Rates

The consultation floats the concept of lower contributions for the lower paid which may reduce opting out amongst these employees and may be justified because of the structure of the state's income tax and social security arrangements:

- Tax relief on employees' pension contributions is provided at the member's marginal tax rate, giving relief of 0%, 10%, 22% or 40% depending on income levels; and
- lower paid members derive no benefit from membership given the means-tested state pension benefits.

The DCLG appears to have moved away from its previous proposal to introduce employee contributions which if adjusted for income tax relief would give the same net contribution from all members. This would have raised contribution rates to 10% of pay for 40% tax-payers.

The consultation discusses different rates on different tranches of pay, but without going as far as nil on the first tranche of pay. There are a variety of options with cut-offs at various pay levels. Options which we have explored with some funds include the following:

- i) Nil Contributions on the first £5,000 (equivalent to the zero tax bracket)
- ii) Adjusting Contribution Rates of lower and higher rate tax payers to make them equivalent to the post tax relief rate of 22% tax payers.
- iii) Adopting age-dependent contributions, where members' contributions would rise with age

We would be delighted to explore these options in more detail if requested.



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