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Circular 06.2010

To: Pensions Contacts  
All Employing Authorities

22 April 2010

Dear Colleagues

**Additional costs for Employers due to events giving rise to strains on the Fund or on cessation of admission agreements**

*This circular has been sent to the Pension Contacts in each Employing Authority. Please distribute it to the appropriate staff within your organisation.*

**1. Purpose of this Circular**

This circular is issued to highlight to employing authorities some of the events which may cause a strain on the Fund and the costs which are payable as a result. I have also outlined the potential costs on the cessation of an admission agreement and the impact of closing the Scheme to new members. In each illustration I have tried to explain the strains and costs in the simplest form but it should be noted that the calculations are often complex and the actuary will take a wide range of factors into account.

**2. What is a strain?**

A strain occurs when an event causes a member's benefits to increase above the funded level. In the Fund strain can arise because of the following events:

- Early retirement
- Augmentation – award of additional membership
- Award of additional pension
- Ill-health retirement
- Transfers
- Re-joining the Scheme

- Miscellaneous events – e.g. increasing whole-time hours for posts, making non-pensionable emoluments pensionable

The above list is not exhaustive and a strain is usually met by a cost to the employer. Employer costs also arise on terminations of admission agreements.

### 3. Early Retirement<sup>1</sup>

If an employer allows an employee to retire early on redundancy, business efficiency, flexible retirement or early retirement with employer consent an actuarial cost to the employer may arise. This is because the funding of the Scheme assumes that the member's benefits will be paid from his/her normal retirement date. The strains on early retirement are managed in one of two ways; either by paying reduced benefits to the member for the duration of his/her pension or by paying out unreduced benefits to the member and charging a capital cost to the employer for the funding shortfall. The Scheme regulations and guidance from the Association of Consulting Actuaries and the Government Actuary's Department (GAD) specify the following strain treatments:

- 3.1 Redundancy** – unreduced benefits are payable to the member and a capital cost is charged to the employer. However, if the member meets the 85 year rule at the date of leaving and is age 60 or over there is *no* capital cost to the employer. If the member meets the 85 year rule and is under age 60 there *may* be a capital cost to the employer. If the member does not qualify for the 85 year rule and is leaving before age 65 there *is* a capital cost. This capital cost is calculated on an individual basis.
- 3.2 Business efficiency** – unreduced benefits are payable to the member and a capital cost is charged to the employer. However, if the member meets the 85 year rule at date of leaving and is age 60 or over there is *no* capital cost to the employer. If the member meets the 85 year rule and is under age 60 there *may* be a capital cost to the employer. If the member does not qualify for the 85 year rule and is leaving before age 65 there *is* a capital cost. This capital cost is calculated on an individual basis.
- 3.3 Flexible retirement** – reduced benefits are payable to the member (if 85 year rule not met) and usually a capital cost is charged to the employer (if the member retires before his/her normal retirement date or is younger than age 60). The employer may choose to waive the member's reductions on compassionate grounds if its policy permits. This capital cost is calculated on an individual basis.
- 3.4 Voluntary early retirement** – reduced benefits are payable to the member (if the 85 year rule is not met) and usually a capital cost to the employer (if the member retires before his/her normal retirement date or is younger than age 60). The

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<sup>1</sup> The Local Government Pension Scheme (Administration) Regulations (Northern Ireland) 2009 – Regulation 36

employer may choose to waive the member's reductions on compassionate grounds if its policy permits. This capital cost is calculated on an individual basis.

*The 85 year rule* allows members who retire early to take their pension benefits without actuarial reductions if the member's age (in whole years) and membership adds up to 85. This rule was abolished on 1 October 2006 and anyone joining the Scheme after 30 September 2006 will have a normal retirement date of age 65 and no 85 year rule protections. Some members have tapered 85 year rule protections.

*Normal Retirement Date* is age 65. Members with 85 year rule protections may have an earlier retirement date.

#### **4. Augmentation (award of additional membership)<sup>2</sup>**

In the event of augmentation there is an immediate augmentation cost charged to the employer. This is because there has been no prior funding for this additional benefit. The cost of augmentation depends on the number of years being awarded, when it is occurring (e.g. at date of leaving or during employment) and the underlying actuarial assumptions. The underlying actuarial assumptions are investment returns, mortality, salary growth and pension increases. An award of augmentation at date of leaving is more expensive than an award of augmentation during active membership. It should be noted that the true cost of augmentation is not known until payments to the member and surviving dependants cease.

#### **5. Award of additional pension**

If an employer chooses to award additional pension to a member, either during or on leaving membership, there is an immediate actuarial charge to the employer. The maximum amount of additional pension which may be awarded by an employer is £5,000 per year. The cost of this additional pension is calculated according to tables provided by GAD and it is payable by a lump sum.

#### **6. Ill-health Retirement<sup>3</sup>**

Strains can occur on ill-health retirement for the following reasons:

- The accrued benefits are paid early and unreduced (early retirement strain).
- The level of augmentation depends on the tier awarded (augmentation cost).

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<sup>2</sup> The Local Government Pension Scheme (Administration) Regulations (Northern Ireland) 2009 – Regulation 35

<sup>3</sup> The Local Government Pension Scheme (Administration) Regulations (Northern Ireland) 2009 – Regulation 36

- The strain depends on the ill-health allowance which the actuary set at the previous valuation for that employer (funding reserve).

NILGOSC is intending to monitor the actual costs of ill-health retirement by employer during the next twelve months. This is to enable us to see whether the cumulative cost of ill-health retirement by employer exceeds the employer's allowance which was set at the valuation. We will let you know the outcome of this monitoring in April 2011.

## **7. Transfers**

Strains may occur on transfers-in to the Scheme as the service credit may cost more than the transfer value received. For this reason the Committee restricts transfers-in to the first twelve months of employment.

Strains may also occur on transfers-out from the Scheme as the transfer value paid may be more than the funding reserve. If there is a transfer-out of several members from one employer e.g. an outsourcing arrangement, the Committee may consider a one-off bulk transfer with actuarial terms specified by the Scheme's actuary.

## **8. Member re-joining the Scheme**

When an employee rejoins the Scheme and aggregates his/her previous benefits with his/her new membership, there may be a rejoining strain. A strain occurs when the new pensionable pay is higher than the leaving pensionable pay plus pension increases. The funding reserve for that employee is lower than what is immediately required on aggregation. This strain is assessed at the actuarial valuation and is reflected in the employers' contribution rate.

## **9. Miscellaneous events<sup>4</sup>**

Over the last few years some employing authorities have incurred individual actuarial charges for the following reasons:

### **9.1 Increasing whole-time hours for posts** – several employers have had individual actuarial calculations and strain charges when they have increased the whole-time equivalent hours for part of their workforce. For example, an increase in the whole-time hours from 35 hours per week to 37 hours per week will generally increase the pensionable pay used to calculate benefits. This causes a strain on the fund as pension benefits are always calculated on the whole-time equivalent pay. In these

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<sup>4</sup> The Local Government Pension Scheme (Administration) Regulations (Northern Ireland) 2009 – Regulation 33

cases the whole-time pay is increased without a corresponding decrease in accrued membership and consequently a funding shortfall arises.

**9.2 Making non-pensionable emoluments pensionable** – recently two employers made what were previously non-pensionable emoluments pensionable. In one case the previously non-pensionable overtime element was incorporated into increased whole-time hours. The other case involved non-pensionable allowances being made pensionable. In both of these cases the effect was an increased pensionable pay and a funding shortfall with substantial actuarial costs to meet the funding shortfall.

**9.3 Please contact NILGOSC before implementing any increases in whole-time hours or altering the emoluments which constitute pensionable pay as you may incur substantial actuarial costs.**

## **10 Employers Leaving the Fund<sup>5</sup>**

If an employer's admission agreement terminates NILGOSC will, in accordance with the Scheme's regulations, instruct the actuary to carry out a valuation of that employer's liabilities. This is known as a cessation valuation. The employer is responsible for all pension liabilities in respect of its active, deferred and pensioner members.

The basis used for this type of valuation is more prudent than that used on the ongoing actuarial valuation (i.e. the triennial valuation) and the leaving employer, or its guarantor, in the event of a deficit will be required to pay additional contributions to the fund as a termination payment. Conversely any surplus is paid as a lump sum to the leaving employer.

If, instead, the employer has a successor body and it agrees to subsume the assets and liabilities of the leaving employer there may be a transfer of any funding deficit on closure to the successor body in place of a termination payment being required from the leaving employer itself. The successor body then becomes responsible for all the pension liabilities.

If the employer becomes insolvent and it, or its guarantor, is unable to meet any deficit, additional contributions will be required from each remaining employer in the fund, in proportion to its liabilities. This means that the majority of the deficit will fall on the large employers.

Employers are reminded that they should notify NILGOSC immediately when they are aware of any changes in legal status, ownership, membership, employer funding or

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<sup>5</sup> The Local Government Pension Scheme (Administration) Regulations (Northern Ireland) 2009 – Regulation 33

bulk employee transfers (either in or out) which may impact on the terms of their admission to the LGPS (NI).

## **11 Closing the fund to new employees**

A few employers have queried the impact of closing the membership of the Scheme to new employees. This is seen as a less radical move than leaving the Scheme altogether which, as mentioned under 9 above, would trigger a termination valuation and a termination payment.

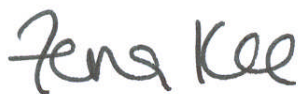
Closure to new members is generally considered as a cost-saving measure and it is important that employers are aware of all the cost implications. The employer contribution rate is likely to increase for two reasons; the average age of the active members is increasing and therefore the cost of future accrual increases and there is usually a shorter period to recover contributions over. The shorter recovery period is because the future working lifetime of the active members may be less than the deficit recovery period.

At the point the last active member either leaves or retires a cessation valuation is carried out and a termination payment is due. This termination payment can be substantial as the Fund needs to hold sufficient reserves to pay the future benefits of the employer's pensioners and deferred members.

In summary, closing the fund to new employees could lead to long-term savings but in the short-term it is likely there would be increased costs.

I realise this is a very high level summary of strain and costs so please do not hesitate to contact me if you have any queries regarding this letter.

Yours sincerely



Zena Kee

Pensions Manager