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pay, pensions and  
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Dear Lynda,

### **Draft proposals re third tier ill health provisions**

I am pleased to provide comments on the proposals for a third tier of ill health retirement benefits as set out in the Department's letter of 21 November 2007.

### **Background**

The Benefits Regulations for the new scheme, as **currently** written, contain a two tier ill health retirement benefit package under which, if a member's employment is terminated because of permanent ill health and the member has at least two years membership, the pension payable is to be based on the person's accrued membership plus:

#### **Tier 1**

- 100% of prospective membership between leaving and age 65 where the member has no reasonable prospect of being able to obtain gainful employment before age 65, or

#### **Tier 2**

- 25% of prospective membership between leaving and age 65 where the member is unlikely to be able to obtain gainful employment within a reasonable period of time but is likely to be able to obtain gainful employment before age 65

with gainful employment being defined as "paid employment for not less than 30 hours per week for a period of not less than 12 months".

There is to be an underpin for certain existing older members (aged 45 or over on 31<sup>st</sup> March 2008) so that they receive no less than they would have done under the current Scheme rules (i.e. under the LGPS Regulations 1997).

At the time the Benefits Regulations were issued it was proposed that there should be a third tier covering members whose employment is terminated on the grounds of permanent ill health but who are likely to be capable of obtaining gainful employment within a reasonable period of time. Under the third tier, employers would be provided with powers to pay a reviewable benefit from their revenue account (not from the Pension Fund) which could not continue if the person obtained alternative employment.

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Managing Director Jan Parkinson

Discussions between CLG, employer representatives and the national unions since the initial proposals for a third tier were issued failed to reach a consensus on how the third tier should work and who it should cover and, as a result, the CLG have come forward with the proposals set out in the consultation paper dated 21 November 2007.

## **Comments on proposals**

As you will know, the proposals set out in the consultation paper have been discussed at the Technical Group, the Officer Advisory Group and the Local Government Pensions Committee. The following represents the outcome of discussions in those forums and our response is prepared based on an decremental approach setting out our preferred approach first, followed by our next fall back position, and so on.

## **Preferred approach**

The first point that we would wish to make is that we would far rather there were only a two tier ill health system, rather than three tiers.

In our response of 12<sup>th</sup> October 2006 to the two tier ill health proposals in *Where next? – Options for a new-look LGPS in England and Wales* we said:

*We understand that the rationale for wishing to move to a two tier ill-health retirement pension arrangement is that it could be better focussed and targeted compared to the present "one size fits all" ill health retirement arrangements which may, in some cases, be putting unfair pressure on medical advisers and local government employers and managers who are asked to make life long decisions at a single point in time.*

*71% of employer responses supported a move to a two tier ill health system.*

### ***The top-tier***

*The consultation paper indicates that the top tier would apply to those permanently unable to undertake any gainful or regular employment and would provide a benefit based on actual membership plus 50% of notional membership between the date of leaving and age 65. Of those respondents who expressed a view, 76% agreed that this would be the appropriate level of enhancement at the top tier.*

### ***The second tier***

*85% of respondents supported the view expressed in the consultation document that there should be no enhancement under the second tier for those incapable of performing the duties of their own job but who are capable of undertaking other "regular employment".*

*The consultation paper suggests that the second tier could be broken down into a set of sub-tiers, each offering a different level of benefit (to reflect that across employees falling within the second tier there would be a wide range of incapacities and prospective job opportunities). Our view is that the scheme should be kept as simple as possible and that more than two tiers should be avoided. This view is supported by 96% of respondents.*

*A drawback of having multiple tiers is that it could lead to numerous appeals from members seeking to be placed into a higher tier in order to increase the amount of enhancement they are awarded, thereby increasing the administrative and appeal burden. Having only two tiers might make matters clearer as there would be an obvious difference between those tiers i.e. to get into the top tier the member would have to be very seriously incapacitated and permanently unable to undertake any gainful or regular employment.*

### ***Review of ill health awards***

*The consultation paper discusses the possibility of reviewing ill health pensions and adjusting them in the light of changes in a person's circumstances.*

*62% of respondents do not support a review mechanism for the top-tier and 63% do not support a review mechanism for the second tier.*

*Whilst these are not large majorities we would argue that, for the sake of consistency of application and ease of administration, a burdensome review arrangement should be avoided, particularly as it is anticipated that the majority of ill health retirees would fall into the second tier (no enhancement of benefits). If this line is followed it will mean that once a level of benefit had been awarded, it will remain in payment for life.*

So, our starting position is that, based on the responses we received from employers, we do not wish to have a complex three tier system and would, if possible, prefer it if there was only a two tier system. It is felt that a three tier system would potentially:

- i) add to the administrative burden
- ii) increase the number of appeals
- iii) make it more difficult for medical practitioners to decide which tier an employee should be placed in, particularly in borderline cases or where, in cases which could fall into tier 3, it is not certain how long treatment will last and whether or not it will be effective, and
- iv) if the third was to be from the Pension Fund, as per the CLG proposal, it could lead to authorities having to chase people for overpayment of benefit if they had failed, inadvertently or otherwise, to inform the authority that they had obtained gainful employment.

Additionally, having three tiers could potentially increase costs. We understand that the overall assumption in the CLG proposals is that 35% of ill health retirees would fall into tier 3 and the average length of time a benefit payable from the Pension Fund would be paid under tier 3 would be 14 months. If the eventual experience shows that a lesser proportion of retirees fall into tier 3 and more into tier 2, the cost to local government will increase. It is clearly difficult to cost the provisions with any accuracy at present as we do not yet have any experience as to the proportions and absolute numbers of cases that will fall into each category. However, if more cases than predicted fall into tier 2 and less into tier 3, there will be an additional cost to local government, which is of concern. We acknowledge, however, that any additional cost would potentially feed through into the cost sharing mechanism for the new scheme (assuming, of course, that ill health costs form part of the cost sharing mechanism).

We appreciate that to move from a three tier system to a two tier system, whilst at the same time remaining within the cost envelope, would necessitate either:

- i) a reduction in the levels of enhancement at tiers 1 and 2 from 100% and 25% respectively, to something lower<sup>1</sup> if all those meeting the permanent ill health criteria were to be provided with a benefit under tiers 1 and 2 (a position we appreciate the unions are unlikely to be in favour of), or
- ii) a retention of the current tiers 1 and 2 with anyone not falling into tiers 1 or 2 receiving no immediate benefit from the Pension Fund and no termination payment from the employer (other than any pay in lieu of notice that is due). The difficulty with this scenario is that employees who, under the current pension scheme arrangements, would get an immediate enhanced pension (because they are certified as being permanently incapable of their current job) would get no benefit if they did not fall into tiers 1 or 2 (apart from any protection arrangements for existing active members at 31 March 2008). Again, this is a position we appreciate the unions would be unlikely to accept, particularly as the provision of a third tier is seen as part of the overall ill health package. However, the LGPS is a pension scheme and, as such, should be used to provide a pension to those who have retired, not be used to provide short-term benefits for those who are deemed to be capable of undertaking gainful employment within a reasonable period of time. If there is no third tier, there would be a 0.1% saving which would potentially then be available for some other scheme improvement.

One other point we would wish to make is that, for small employers, a tier 1 benefit with 100% enhancement paid to a relatively young employee will be extremely costly (and could, for example, put a small charity out of business). It may be that a method of pooling ill health costs needs to be considered

### **First fallback position**

If our preferred approach is not acceptable, and there has to be a third tier of ill health benefits, we would prefer the benefit to sit outside the Pension Scheme and be in the form of a one off termination payment.

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<sup>1</sup> As originally proposed in *Where next? – Options for a new-look LGPS in England and Wales*

Under this scenario, those judged by an independent qualified occupational health practitioner as being permanently incapable of their job but capable of other gainful employment within a reasonable period of time after leaving would not receive an immediate pension from the Pension Scheme. Instead they would be entitled to a deferred benefit in the Pension Scheme but the Compensation Regulations would be amended to either:

- i) give the employer the discretion to award a one off termination payment (in the same way as employers have discretion to award a termination payment on redundancy or efficiency terminations up to a maximum of 104 weeks pay) or,
- ii) provide for a mandatory one off termination payment (set at a level that would mean the overall cost stays within the budgeted 0.1% of payroll cost which we understand equates to the capitalised value of approximately 14 months of unenhanced pension). This could, for example, be based on the same concept as used for the calculation of a statutory redundancy payment.

<b>Pros</b>	<b>Cons</b>
The payment would be a one off payment	Payment would be made from an employer's Revenue Account, not from the Pension Fund and so the cost would have to be met by the employer in the year of leaving (rather than spread over a number of years if paid via the Pension Fund).
If cost is met from the employer's Revenue Account it is arguable that this might act as an incentive to employers to further improve the management of health issues in the workplace	
Once paid, there would be no need for a subsequent review but the person could subsequently have deferred LGPS benefits brought into payment early if their health worsens. If the person believes that they have been placed into tier 3 incorrectly and should have been placed in tier 2 (or even tier 1) they would appeal under IDR and, if successful, would receive tier 2 (or even tier 1) benefits with arrears but any termination payment already received would have to be paid back to the ex-employer.	
If the payment was discretionary, the cost could be controlled by employers	Employers would need to draw up and maintain a policy on the exercise of their discretion. There is very little time before April 2008 in which to draw up a policy on the exercise of a discretion. Could potentially cost more than 0.1% if employers do not adequately control payments. The national unions are opposed to a system under which payment is discretionary.
If the payment was mandatory, all employees falling into tier 3 would receive a payment, which might be seen to be fairer than if the benefit were discretionary. The level of payment would need to be such as to remain within the 0.1% cost envelope. There would be no need for employers to produce and maintain a policy. The Compensation Regulations could be amended in time for April 2008	Lack of discretion for employers.
The member could aggregate membership in respect of the deferred pension with any future membership if he / she were subsequently to rejoin the LGPS in a future employment and thereby gain the benefit of any relative increase in pay (which would not be possible under the third tier proposed in the consultation paper)	

All employees falling into tier 3, not just those in the Pension Scheme, could be awarded a termination payment. This would protect the employer from age or sex discrimination claims (as many non-pensionable employees are younger employees or part-time female employees).*	Not consistent with tiers 1 and 2, as these only cover those in the Pension Scheme. Many employers have up to a quarter or even a third of staff not in the Scheme.
Not a disincentive to return to gainful employment (whereas the CLG 3 <sup>rd</sup> tier proposals could be seen as a disincentive to return to work as soon as reasonably possible)	

\*Note: If a lump sum termination payment is made to all employees falling into tier 3, not just those in the Pension Scheme, it would, we believe, be necessary to also make such a payment to those non-pensionable employees who would have fallen into tiers 1 or 2 if they had been pensionable, so as to protect the employer from potential age or sex discrimination claims (as many non-pensionable employees are younger employees or part-time female employees).

### Least preferred approach

Our least preferred approach is the one set out in the consultation paper under which:

- those adjudged by an independent qualified occupational health practitioner to be permanently incapable of their job but capable of other gainful employment within a reasonable period of time after leaving would receive a benefit payable from the Pension Fund (not from the Revenue Account)
- the benefit would be payment of their accrued pension benefits, with no enhancement
- the pension would subsequently be suspended if the person obtained gainful employment
- the membership in respect of the suspended pension could not be aggregated with any future membership if the person were subsequently to rejoin the LGPS in a future employment

Our concerns around this approach relate to the potential costs and the administrative practicalities of the proposed approach.

If the third tier is to reside in the Pension Scheme:

- the definition of "a reasonable period of time", which would determine whether or not a person falls into tier 2 (immediate benefits with 25% enhancement) or tier 3 (immediate short term benefits with no enhancement), should be longer than the twelve months suggested in the consultation paper and be set at something more like three years for two reasons. Firstly, this would give time for a person to obtain treatment and for relevant treatments to run their course. Secondly, a low period of only twelve months would, we expect, result in significantly more people falling into the more costly tier 2 than if the period was set at, say, a more reasonable period of three years. Only those not likely to be capable of obtaining gainful employment within the longer, say three year, period would be placed into tier 2 (or even tier 1). Those whom the independent qualified occupational health practitioner considered would be capable of gainful employment within three years would fall into tier 3

For those falling within tier 3:

- a) the regulations could provide that the independent qualified occupational health practitioner should be asked to give an opinion on when the person would be likely within that three year period to be capable of obtaining gainful employment. If the opinion given is that the person would be capable of gainful employment within, say, fifteen months the pension would be stopped within fifteen months if the person obtained gainful employment within that period<sup>2</sup> or stopped at month fifteen unless at that time the person asked the employer to re-refer their case to the medical adviser, claiming that they were still not capable of gainful employment. If the adviser disagreed, the pension would stop or, if the adviser agreed with the ex-employee, the pension would continue in payment but with a further review to determine when payment should cease although, subject to (c), the payment could not continue in payment beyond, say, three years, or

- b) using a simpler approach (and one that would be easier for the medical advisers), the regulations could provide that the pension would be stopped within three years if the person obtained gainful employment within that period<sup>2</sup> or if, following a request from the ex employer for a further assessment, the medical adviser<sup>3</sup> confirms that the person is capable of undertaking gainful employment. If neither of these circumstances occurred, the pension would, subject to (c), stop at the end of, say, three years
- c) whichever approach was specified in the regulations, (a) or (b), if the pension had not been stopped within, say, three years and the person claimed at the end of the period that they were still not capable of gainful employment, the case would have to be referred back to a medical adviser<sup>3</sup> by the former employer. If the medical adviser disagreed with the ex-employee, the pension would stop or, if the medical adviser agreed with the ex-employee, either
- the Scheme could provide that the person would retrospectively be placed into tier 2 with arrears of pension being payable. However, if CLG were to consider this approach, the implications under the Finance Act 2004 of making a retrospective change would need to be clarified first (and see section below on Changing Tiers for other possible consequential implications); or
  - the Scheme could provide that the person would be placed into tier 2 but not retrospectively (this would be our preference); or
  - the Scheme could provide that the person could continue to be paid the unenhanced tier 3 pension benefit
- d) the test to determine when the pension should be stopped should be based on whether the person is capable of gainful employment; not whether the person has obtained gainful employment (otherwise a person could work the system by not seeking employment, or by only obtaining employment for, say, 29.9 hours per week – which falls below the definition of gainful employment which is defined as "paid employment for not less than 30 hours per week for a period of not less than 12 months")
- e) subject to the comment in the first indent under (c), the above would meet with HMRC rules governing when a pension in payment can be suspended / stopped
- f) it would seem reasonable that if a tier 3 pension is stopped within the three year period but the person's condition subsequently worsens, the pension should be brought back into payment for the rest of the three year period and then be subject to (c) above
- g) it would also seem reasonable that if a tier 3 pension is stopped at the end of the three year period but the person's condition subsequently worsens, the unenhanced pension should then be brought back into payment permanently provided the person would at that stage meet the ill health criteria of tiers 1 or 2, in the same way that a deferred pension can be brought into payment (unenhanced) if a deferred beneficiary subsequently meets the ill health criteria for tiers 1 or 2
- h) if, under paragraph (c), a person is retrospectively put into tier 2 (or even tier 1) and by then the former employer has ceased to exist (e.g. an admitted body has gone into liquidation) or the former employer was a contractor who has since lost the contract, it will be necessary to determine who should meet the retrospective cost<sup>4</sup>

Pros of benefit being from Pension Fund	Cons
The payment would be made from the Pension Fund and the employer would not have to make a one off payment out of the Revenue Account	Not a one off payment and hence there would be a need for potential reviews within or at the end of, say, a three year period.
Employers would not need to draw up and maintain a policy.	The payment would not be discretionary so less control for employers in relation to cost.
	Big administrative overhead for employers and administering authorities. Sickness management procedures could have been ongoing for many months, even years, and sick pay could have

<sup>2</sup> A potential problem with stopping a pension if a person obtains gainful employment would be that if the person did not inform the authority of the gainful employment (but this was subsequently discovered) or informed the authority late, there would have been an overpayment. There would be inevitable difficulties in recovering the overpayment with possible tax implications for the administering authority under HMRC write off rules for unrecovered payments in excess of £250.

<sup>3</sup> Unlike in an IDR case, the employer should not be debarred from referring the case to the same independent medical practitioner who made the initial determination. It is felt that the original medical practitioner will already know the case and may be best placed to make the further determination.

<sup>4</sup> Mechanisms already exist whereby, depending on the circumstances, costs are either spread across all remaining participating employers, or met by the authority that let the relevant contract, or met by a bond or indemnity, or by a guarantor, etc. We assume this would be the case for retrospective changes in ill health benefits.

	been paid for 12 months prior to leaving; so to add a reviewable benefit payable for up to another 3 years would represent a considerable additional administrative overhead
	Additional workload for a limited pool of medical advisers.
Only those in Pension Scheme could be awarded a benefit, thereby ensuring consistency of approach with tiers 1 and 2.	No benefit for those not in the Pension Fund
Regulations could be made and laid in time for April 2008.	

## Changing tiers

It is suggested in paragraph (c) above that a person in tier 3 could subsequently be moved into tier 2. This potentially generates other consequential questions i.e.

- should a person in tier 2 be moved into tier 1 if their condition worsens?
- should a person in tiers 1 or 2 be moved into a lower tier if their condition improves?
- should the change in benefit from tier 2 to tier 1 or vice versa be made retrospective?

This would move towards a truly reviewable benefit with all the administrative overheads and costs this would entail together with the possibility of yet more appeals and, if made retrospectively, major problems in the recovery of overpayments. Thus, on balance, other than in the limited circumstances set out in paragraph (c) above we could not support changes in tiers.

## Reduction of period to qualify for an ill health pension

The consultation paper suggests that the qualifying period to be eligible for an ill health benefit under all three tiers (tiers 1, 2 and 3) should be reduced from two years membership to three months membership.

For the sake of consistency, it would make sense for the period to be reduced to three months. However, this then begs the question "Should a person with three months or more but less than two years membership be entitled to an enhanced pension under tiers 1 and 2, or only immediate payment of an unenhanced pension?"

One could argue that for ease of administration and to ensure less complicated rules, such people should be entitled to enhanced benefits in the same way as anyone else falling into tiers 1 or 2. Conversely, given that between a quarter and a third of the workforce are not in the Pension Scheme, any of those who are likely to leave, or have their employment terminated, on the grounds of permanent ill health would clearly want to get into the Scheme, achieve three months membership, and then leave with a benefit based on their three months membership plus 25% (tier 2) or 100% (tier 1) of their prospective membership to age 65 – a very good deal for anyone astute enough to take it up. In such a case there would clearly be a cost to the employer (although how many cases there would be is, of course, hard to tell). Nevertheless, there is the clear cost danger for employers that non-scheme members will opt in just prior to ill health retirement to get the benefit of a significantly increased pension after as little as three months membership. Keeping the period to be entitled to an enhanced ill health pension at two years would overcome this potential problem, although we do recognise that after as little as one days membership the scheme will, on death in service, provide a death grant of three times pay plus a spouse's, civil partner's, nominated co-habiting partner's and children's pensions based on accrued membership with 100% enhancement. However, the number of potential ill health retirements significantly outweighs the number of deaths in service.

Having considered the pros and cons, we are of the view that the period to be eligible for a benefit should be reduced to 3 months but the period to be entitled to an enhanced pension under tiers 1 and 2 should be kept at 2 years. Those with 3 months or more (or under 3 months but who have had a transfer in) but less than 2 years membership should receive an unenhanced pension if falling into tiers 1 or 2.

## General comment

As a general comment we would make a plea for an early decision and quick promulgation of the relevant statutory instrument and the Statutory Guidance which is to accompany the ill health provisions. The current uncertainty and lack of regulations and guidance is causing difficulties for employers.

employees and medical advisers as employees are already being referred to medical advisers with a prospective termination date that falls after 31 March 2008.

## **Comments on regulations 20 and 31 of the Benefits Regulations 2007**

### Regulation 20

There is no provision corresponding to that in the 1997 Regulations which prevents a member who is already in receipt of an enhanced ill health pension from again receiving an enhanced pension should they subsequently be retired on ill health grounds for a second (or further) time. Is this the policy intention?

Any member satisfying the provisions of regulation 20(1) is to be "paid benefits under this regulation". This apparently suggests that those who satisfy regulation 20(1) but do not meet the requirements of regulations 20(2) or (3) are to be paid benefits under this regulation. This will only be true if tier 3 benefits are payable from the Fund.

At the end of regulation 20(1) it would have been helpful if the words "in relation to that employment" were added (to cater for multiple employment scenarios).

Regulation 20(1)(b) says the person has a "reduced likelihood of obtaining gainful employment" but regulation 20(3) applies to a person who "is likely ... to obtain gainful employment". It is difficult to see how the wording in each regulation can rationally and comfortably sit together.

Regulation 20 throughout talks about "obtaining gainful employment" but we believe it should be amended to refer to "being able to undertake gainful employment because of his ill health" in order to relate the prospects of gaining other work to the person's state of health rather than to the state of the local job market.

We believe that regulation 20(5), which provides the underpin for existing Scheme members, would be better placed in the Transitional Provisions Regulations and, crucially, should make it clear that the protection only covers those who are an "active member" on 31<sup>st</sup> March 2008 and who were 45 or over on that date.

The underpin in regulation 20(5) should cover cases falling into regulation 20(3)(a) as well as (3)(b).

We are not clear as to the intentions behind the wording of regulation 20(5). Is the protection meant to be a protected level of enhancement or a protected level of benefit? The former produces a higher benefit than under the 1997 Regulations as the IHE would be given at the rate of 1/60<sup>th</sup> rather than 1/80<sup>th</sup> plus a 3/80<sup>ths</sup> lump sum.

Regulation 20(5) refers to the period that would have been added under regulation 28 of the 1997 Regulations. However, regulation 28 did not "add" membership – it simply referred to an enhanced (total) membership period.

Regulation 20 uses the words "permanently incapable", "reasonable prospect", "reasonable period" and "within a reasonable time of leaving". These need to be defined in the regulations or the statutory guidance that is to accompany the regulations.

Regulation 20(6) refers to the medical adviser having to be "qualified in occupational health medicine". However, this is not defined. This needs to be defined in the regulations or the statutory guidance that is to accompany the regulations.

### Regulation 31

There has been some debate in the past as to the meaning of the word "immediately". For example, in regulation 31(1)(a) does "immediately" mean "immediately from the date the person became permanently incapable" or "immediately from the date of election"? In order to be precise and to ensure consistent application of the regulations, the word "immediately" in regulation 31(1)(a) should be amended to "immediately from the date of election".

Regulation 31(1)(a) does not specify to whom the member has to make an election for early payment.

Regulation 31(1)(b) appears to award ill health enhancement (equal to the period from cessation of employment to age 65) to a member who successfully applies for his deferred benefits to be released early on grounds of permanent ill-health. This is clearly incorrect. It is understood the intention is that

only deferred pensioners who, at the date of application, would have met the provisions of regulations 20(2) or (3) if they had still been employed by the former employer, would be able to have their deferred pension brought into payment and then only at an unenhanced rate. An appropriate amendment to regulation 31 should be made.

The equivalent of regulation 20(6) needs to be added to regulation 31 and, as per regulation 20(6), "qualified in occupational health medicine" will need to be defined in regulation 31 or in the statutory guidance that is to accompany the regulations.

Yours sincerely

A handwritten signature in black ink that reads "TBE Edwards". The signature is written in a cursive, slightly slanted style.

Terry Edwards  
Head of Pensions