**Appendix 'C'**

**Commutation**

The LGPS regulations allow the commutation of 'small pension pots' under various pieces of overriding legislation\*. The new Freedom and Choice in Pensions legislation provides further flexibility in respect of commuting small pensions, the most notable being that some members of the Scheme can commute small pension pots from age 55 (previously age 60).

The LGPS regulations set out that the Fund may make the following payments:

1. A commutation payment (where the value of LGPS-only small pension pots must not exceed a lump sum payment of £10,000)
2. A trivial commutation lump sum (where the total actuarial value of all LGPS and non LGPS small pension pots does not exceed £30,000)
3. A trivial commutation lump sum death benefit (where the value of all LGPS death benefits does not exceed a lump sum payment of £30,000)

*\*The LGPS regulations set out that the above terms are defined, in the case of (2) and (3), within the Finance Act 2004 and, in the case of (1), within the Registered Pension Schemes (Authorised Payments) Regulations 2009.*

The principle of commutation relates to converting a 'small' pension entitlement into a one-off cash lump sum payment to be made by the Fund, effectively discharging any further liability.

**'Small' Pension Pots**

The commutation framework described above applies to 'small' pension pots only. Generally speaking, a 'small' pension pot's capital value is £30,000 or less. For the sake of clarity, and as a useful benchmark, the value of a person's pension 'pot' is approximately 20 times the value of the pension they have accrued; so for example a £30,000 pension pot would provide an annual pension of £1,500.

**Difference Between 'Commutation' and 'Conversion' of Pension**

**All** scheme members have the option to convert some of their pension entitlement into a lump sum, whereas **some** members have the option to commute. The following text from the YPS website explains conversion:

"You can take a tax-free lump sumby giving up some of your annual pension. You can take up to 25% of the capital value of your LGPS benefits as a lump sum5. For every £1 of annual pension that you give up you will receive a £12 lump sum. In the same way, giving up £100 of your annual pension would give you £1,200 lump sum, and so on."

This principle applies to any value of pension pot and differs from commutation, which applies only to 'small' pots – the reason for the differentiation is linked to the taxation treatment of pensions.

Small pension pots have a different conversion factor as opposed to the 12:1 factor described above; as there are no tax implications, the conversion factors are different; for example a 60 year old male's small pension entitlement would be commuted by a factor of 18.28 (e.g. £1,000 pension would commute to a lump sum of £18,280), a female of the same age would see a factor of 19.23 (£1,000 pension commutes to £19,230).

The difference in lump sum dependent on gender helps illustrate the philosophy supporting commutation: the factors are set by the Government Actuary's Department (GAD) such that, all things being equal, there should be no financial gain or loss to either pensioner or fund, upon commutation.

**Financial Impact of Commutation within the Lancashire Fund**

Whilst the GAD factors are calculated on the basis of equity, the fact that they are fixed means that local differences in fund performance and longevity can mean that, on a technical level, a small gain or loss to individuals or the fund could occur upon commutation.

The conclusion of the Fund's actuary is that in the current environment it is broadly beneficial to the calculation of the Fund's liabilities to commute pensions. However, this benefit is the difference between the theoretical value of paying benefits over an estimated lifetime when compared to an actual sum paid over to an individual, and it is impossible to prospectively estimate whether an individual will receive a greater level of benefit from commuting or continuing to receive a pension. The key issue is that the choice lies with the scheme member, who will need to consider the options available to them in the context of their own financial position.

**Fund Perspective**

The most significant benefits to the Fund from any significant increase in the level of commutation would be in the area of reduced administrative costs, and an increased level of certainty within future valuations given the crystalisation of more liabilities at an earlier point.

**Demographics of Commutation**

An equality analysis is set out at Annex 1.

Average annual pensions paid by LCPF are:

Female £2.9k per annum

Male £6.7k per annum

Given that on average female pensions are lower, this would infer that proportionately more females than males would be able to take advantage of the option to commute. However, as indicated the actuarial factors provide a higher value of lump sum to women (reflecting differential life expectancy) and it is a matter of individual choice whether or not to commute.

**Current Policy and Practice**

The Fund's current policy is to commute small pensions where they meet the relevant criteria. However, in practice commutation has been both age limited and inflexible and consequently current practice, as opposed to the actual policy, has been to include reference to commutation within the normal retirement process but not to offer commutation in isolation. The information required to satisfy the trivial commutation lump sum criteria shown at 2. above is particularly difficult to obtain and assess.

**Potential Change**

In the light of the intention to increase flexibility provided by the new freedom and choice in pensions legislation, it would appear to be appropriate now to reinforce the Fund policy to commute small pensions where the relevant criteria are met. It should be noted that it would not be possible to 'impose' commutation 'reinforce' in this context would mean that commutation would become the 'standard offer' and that, operationally, prospective pensioners would be given clearer information on their choices in pre-retirement paperwork, e.g. "You have the option of receiving a lump sum of £x or an annual pension of £y". However, all options would be explained at retirement and ultimately, pensioners would make an informed choice which suited their circumstances.

In reinforcing commutation as the Fund's standard offer where the relevant criteria are met, there is no doubt that this would result in a reduction in administrative effort in terms of processing a commutation as opposed to processing an actual retirement, and including the additional ongoing effort involved in maintaining pensioner payroll records. In addition it is clear that discharging any future liability would also be beneficial to the Fund. Day to day processing of commutation payments as business as usual should not result in any significant cashflow issues.

Current practice has resulted in a significant number (around 10,000) of pensioners and deferred pensioners with very small pension entitlements that could potentially be commuted. The Fund Actuary has been asked to consider the potential impact on both the Fund's cashflow and liabilities, of carrying out an exercise to commute these pensions. Clearly the cost of undertaking such an exercise would need to be weighed against the benefits of potentially discharging the ongoing liability in full but nonetheless the affected pensioners and deferred pensioners could be offered the option to commute in line with future practice.

It is also possible to commute pensions payable to a Child dependent. Children's pensions can be paid up to age 23 so long as the child is in higher education. Assumptions would need to be made in calculating a commuted children's pension as to how long they will be in higher education, but again it would be beneficial to the Fund to commute where possible, and would again be in line with national policy intentions.

**Recommendation**

That a policy be approved and adopted where:

* Commutation is the Fund's standard offer when a member retires or leaves the Scheme, where the pension value satisfies the £10k commutation criteria described at 1. above
* All other retirement/leaver cases are offered the option to commute where possible i.e. where they satisfy the criteria described at 2. and 3. above.
* Child dependant pensions will be commuted where possible.
* Where a child is aged 16 or over and still in full time education, the commutation will be based on an assumption that the pension would be paid until the age of 23.
* In respect of certain protected members, it may be possible to pay an ill-health commutation, and the policy would continue to be that this provision be applied where possible.

In addition, following consideration of advice from the Fund Actuary, a one-off exercise will be undertaken with a view to commuting current pension and deferred pensions where they satisfy the criteria described at 1. above.