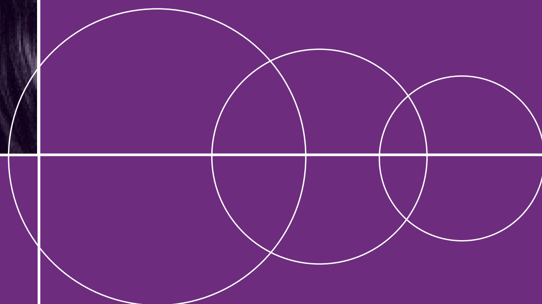
ACCOUNTS COMMISSION

PERFORMANCE AUDIT

Early retirement

A note for council managers



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PREPARED BY AUDIT SCOTLAND

The Accounts Commission

The Accounts Commission is a statutory, independent body, which through the audit process, assists local authorities in Scotland to achieve the highest standards of financial stewardship and the economic, efficient and effective use of their resources. The Commission has five main responsibilities:

- securing the external audit
- following up issues of concern identified through the audit, to ensure satisfactory resolutions
- reviewing the management arrangements which audited bodies have in place to achieve value for money
- carrying out national value for money studies to improve economy, efficiency and effectiveness in local government
- issuing an annual direction to local authorities which sets out the range of performance information which they are required to publish.

The Commission secures the audit of 32 councils and 34 joint boards (including police and fire services). Local authorities spend over £9 billion of public funds a year.

Audit Scotland

Audit Scotland is a statutory body set up in April 2000, under the Public Finance and Accountability (Scotland) Act 2000. It provides services to both the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Executive and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Early retirement - a note for council managers

Background

This is a guidance note for council managers with responsibility for making decisions about the retirement of employees from the Local Government Pension Scheme (LGPS). The content is also relevant to the management of early retirement amongst teachers, whose pension scheme is run separately.

Early retirement is an important management tool. It can help in managing staffing levels by facilitating the departure of employees by one of four routes. Early retirement due to efficiency or redundancy is at the discretion of the employer. An employee may need to retire early due to ill-health if s/he is medically unfit to work. An employee aged 50+ may apply for early payment of retirement benefits. If their age plus pensionable service total 85 years or more, under the 'Rule of 85', the pension payable is not reduced[1].

In December 1997, the Accounts Commission for Scotland published *'Bye now, pay later?'*, a report on councils' management of early retirement from the LGPS. The Commission found that early retirement was widespread and costly, and that there was considerable scope for tightening up management practice. The report can be found in full on the Internet at www.audit-scotland.gov.uk then by searching for 'early retirement' under 'Publications'.

The role of managers

Managers have an important role to play in the responsible use of early retirement by council departments. The endorsement of an early retirement proposal can be costly, impacting on the council's revenue budget and the pension fund, sometimes for decades into the future. The decisions managers make should take account of:

- **their council's policy on early retirement** – which should cover the relevant regulations[2], the balance between the council's interests and those of its employees, and the balance between the council's interests and the long-term security of the pension fund

- **the full financial implications of the proposed early retirement.**

Managers should ensure that they are aware of, and follow, their council's early retirement policy. This note deals with the second bullet point – the need to ensure that the full financial implications are considered. It emphasises the importance of counting the potential costs, highlights where the various cost elements fall to, looks at potential savings, then underpins the importance of considering alternatives to early retirement in good time.

Count the cost

The financing of the pension fund assumes that the employer and the employee both normally make contributions to the fund until the employee's normal retirement age. So if an employee retires early, contributions already made to the fund are typically insufficient to cover the full gross cost of a pension. This shortfall is often larger where there is an automatic award of added years by the pension fund in the case of an ill-health early retirement, or a discretionary award of added years benefits by the employer in other circumstances.

How do the extra costs arise? When calculating the cost of an early retirement, actuaries take account of higher than expected costs and lower than expected income. Higher costs arise because:

- the fund pays out the accrued benefits pension and lump sum early, and pays the pension for a longer period
- the employer pays for the costs of any added years pension and lump sum benefits arising from its award of added years, until the death of the retiree and the ending of any claim the retiree's dependants have on the pension fund[3]
- the employer makes a one-off redundancy payment in a case of redundancy early retirement.

Actuaries also take account of the fund's lower than expected income due to lost income from contributions that the employer and employee would otherwise have made, and lost income from investment returns that would have accrued had benefits not been paid out, and contributions not ceased. Exhibit 1 illustrates where the costs fall for the four types of early retirement.

Exhibit 1: How the costs of early retirement are met

Depending on the type of early retirement, some of the extra costs are met from the pension fund and some directly from the council's revenue budget.

Benefit to the employee	Type of early retirement/how the cost is met			
	Ill health	Redundancy	Efficiency	Rule of 85
Redundancy payment	–	Revenue account	–	–
Lump sum: added years	Pension fund	Revenue account	Revenue account	–
Lump sum: accrued benefits	Pension fund	Pension fund	Pension fund	Pension fund
Pension: added years	Pension fund	Revenue account	Revenue account	–
Pension: accrued benefits	Pension fund	Pension fund	Pension fund	Pension fund

Source: *'Bye now, pay later?'*, Accounts Commission

Shortfalls in pension fund resources eventually need to be replenished by the employer, who also pays directly for the costs arising from redundancy payments and the award of added years pension enhancements.

When advising on funding arrangements, actuaries generally make provision only for ill-health early retirements on the basis that redundancy, efficiency and 'Rule of 85' early retirements are difficult to forecast safely.

In cases of redundancy early retirements, outlays now can be balanced by savings later on. These savings relate to the salary and other employment costs of the post which disappears.

There may be very small savings which arise for other types of early retirement. For instance, these might occur from recruitment of a replacement staff member at a lower point on the post's salary scale .

Exhibit 2 summarises the capitalised costs for five early retirement scenarios[4]. Costs have been worked out using the actuarial model applied by Hymans Robertson, the firm of consulting actuaries that advises most Scottish local authority LGPS administering authorities. Savings are included for the redundancy scenario.

Consider the alternatives

Since early retirement can be so costly, it is important to evaluate all viable alternatives in the light of the respective interests of the council and its employees. For example, is it possible to redeploy relevant staff to other posts for which they may be suited, either with their existing skills and experience or with supplementary training? Alternatively, could savings be made by restricting the use of non-compulsory overtime or by delaying the filling of vacant posts?

Where an employee is confronted with ill-health early retirement, the Disability Discrimination Act 1995 requires that the employer takes reasonable steps (eg altering duties, modifying premises) which would allow the person to continue working.

Consider the pros and cons

Before approving an early retirement, a manager should weigh-up the costs and benefits to the council (as well as to the service and department) against the benefits to the employee, and the ongoing financial effects should be taken into account in corporate financial planning and budgeting. This means not only catering for the costs to the employer, but also acknowledging the impact on the pension fund. Corporate finance and personnel staff can help to ensure that all the pros and cons are considered before a decision is reached.

Exhibit 2: Examples of the additional costs and savings arising from early retirement

For efficiency and redundancy early retirements, the costs are significant and fall to both the council and the pension fund. In an ill-health retirement, all the costs fall to the pension fund. When an employee aged 50+ meets the 'Rule of 85' criterion for early retirement, the pension fund still pays the costs arising from the early payment of accrued benefits. In the scenarios below, only the redundancy case generates a saving to the employer.

Example case	Cost/saving	£
Efficiency early retirement		
Married male aged 52 years	Capitalised cost – to pension fund	23,023
■ Service = 25 years	Capitalised cost – to employer	17,364
■ Salary = £14,000	Capitalised cost – total	40,387
■ Awarded five years at the council's discretion	Capitalised saving – to employer [5]	–
	Net capitalised cost	40,387
	Net capitalised cost (rounded)	**40,400**
Married male aged 52 years	Capitalised cost – to pension fund	32,891
■ Service = 25 years	Capitalised cost – to employer	24,806
■ Salary = £20,000	Capitalised cost – total	57,697
■ Awarded five added years at the council's discretion	Capitalised saving – to employer [6]	–
	Net capitalised cost	57,697
	Net capitalised cost (rounded)	**57,700**
Redundancy early retirement		
Single female aged 53 years	Capitalised cost – to pension fund	40,103
■ Service = 15 years	Capitalised cost – to employer [7]	34,143
■ Salary = £35,000	Capitalised cost – total	74,246
■ Awarded four added years at the council's discretion	Capitalised saving – to employer	291,550
	Net capitalised saving	217,304
	Net capitalised saving (rounded)	**217,300**
Voluntary retirement under the 'Rule of 85'		
Single male aged 58 years	Capitalised cost – to pension fund	6,546
■ Service = 28 years	Capitalised cost – to employer	–
■ Age plus service = 86	Capitalised cost – total	6,546
■ Salary = £14,000	Capitalised saving – to employer	–
■ No added years awarded	Net capitalised cost	6,546
	Net capitalised cost (rounded)	**6,500**
Ill-health early retirement		
Single female aged 52 years	Capitalised cost – to pension fund	57,436
■ Service = 20 years	Capitalised cost – to employer	–
■ Salary = £20,000	Capitalised cost – total	57,436
■ Automatically awarded six-and-two-third years, under the Local Government Pension Scheme	Capitalised saving – to employer	–
	Net capitalised cost	57,436
	Net capitalised cost (rounded)	**57,400**

Source: Audit Scotland and Hymans Robertson

Contacts

If you need any further information or assistance in connection with early retirement, please contact your personnel or finance section, in the first instance.

If you would like more information on the Accounts Commission, Audit Scotland or the background to this note, please contact:
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Notes

[1] Between the ages of 50 and 60 staff need their employer's approval to retire; beyond 60 they do not. Where age and pensionable service total less than 85, there is a reduction in both pension and retirement grant.

[2] In particular, the Local Government Pension Scheme (Scotland) Regulations 1998, (UK SI 1998/366, as amended by Scottish SI 2000/199) and the Local Government (Discretionary Payments and Injury Benefits) (Scotland) Regulations 1998 (UK SI 1998/192, as amended by Scottish SI 2000/77).

[3] Except for an ill-health retirement, when the pension fund pays for added years' costs.

[4] All the scenarios assume that the employee has worked full-time. A capitalised net cost is the single sum that is equivalent to rolling-up all related anticipated income and expenditure streams into one amount, taking the future value of money into account.

[5] Some savings may be possible in certain situations – eg where a knock-on vacancy is deleted and its costs saved. Where this is the case, these should be included in the analysis.

[6] Some savings may be possible in certain situations – eg where a knock-on vacancy is deleted and its costs saved. Where this is the case, these should be included in the analysis.

[7] In the redundancy early retirement, the capitalised cost to the employer includes a redundancy payment of £14,135, equating to 21 week's pay.

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