



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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**Government Actuary's Department**

# Investigation into Police and Firefighters' Pension Scheme commutation factors

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Government Actuary's Department

# Investigation into Police and Firefighters' Pension Scheme commutation factors

Report by the Comptroller and Auditor General

Ordered by the House of Commons  
to be printed on 30 January 2017

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National Audit Act 1983 for presentation to the House of  
Commons in accordance with Section 9 of the Act

Sir Amyas Morse KCB  
Comptroller and Auditor General  
National Audit Office

27 January 2017

Our investigation covers the compensation paid by government to those that retired from the Police and Firefighters' Pension Schemes between 2001 and 2006 without receiving their full pension entitlement.

These payments were made following the Pensions Ombudsman's finding of maladministration in the Government Actuary's Department's handling of the administration of the factors that were used to convert annual pension entitlements to lump sum payments.

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## Investigations

We conduct investigations to establish the underlying facts in circumstances where concerns have been raised with us, or in response to intelligence that we have gathered through our wider work.

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# Contents

**What this investigation is about** 4

**Summary** 6

**Part One**

Background 10

**Part Two**

Key events and their implications 16

**Part Three**

The government's response 27

**Part Four**

The governance arrangements 30

**Appendix One**

Timeline 32

**Appendix Two**

Methodology 34

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This report can be found on the National Audit Office website at [www.nao.org.uk](http://www.nao.org.uk)

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## What this investigation is about

**1** In May 2015, the government recognised a liability of £711 million relating to the underpayment of lump sums received by an estimated 34,000 individuals who retired from the Police and Firefighters' Pension Schemes between 2001 and 2006. This equated to an average payment of £21,000 per pensioner, between 5% and 36% of the value of the pension lump sums they received initially. This liability arose because of the collective failure by government to understand its statutory obligations for the administration of the schemes; and to recognise that the formula that was used to convert annual pension payments to lump sums should have been updated between 2001 and 2006. This failure was judged by the Pensions Ombudsman to amount to maladministration in 2015, between 9 and 14 years after the affected individuals retired. Following the Ombudsman's judgment, the majority of individuals received compensating payments by 31 March 2016, but some complex cases did not get resolved until the 2016-17 financial year.

**2** Public sector occupational pension schemes cover staff working in central government (for example in the civil service and NHS), local authorities and arm's-length bodies including public corporations. The largest schemes in central government, including the Police and Firefighters' Pension Schemes that are the focus of this report, are unfunded. Unfunded schemes operate on a pay-as-you-go basis, whereby contributions from current employees and employers are used to pay current pensioners their pensions. The Police and Firefighters' Schemes include provisions for commutation. This is the process by which an individual sacrifices a portion of their future pension payments, in exchange for an 'actuarially equivalent' lump sum.<sup>1</sup>

**3** In May 2015, the Pensions Ombudsman upheld a test case on the appropriateness of the 2001 to 2006 commutation provisions against the Government Actuary's Department (GAD). In its judgment on the test case, the Ombudsman found maladministration in relation to GAD's role in the calculation of commutation factors for the Firefighters' Pension Scheme. The Ombudsman's ruling also indicated that its conclusion on the test case should set the terms for a broader settlement of similar cases across the Firefighters' and Police Pension Schemes.

<sup>1</sup> The majority of these commutation payments are tax free, however, they may incur a tax charge dependent on the individual's circumstances.

4 This investigation describes the chain of events, set out in Appendix One, which led up to the Pensions Ombudsman's decision. In particular we identify the role of government and its advisers from the failure to understand the statutory responsibilities for updating commutation factors between 2001 and 2006; through the initial commutation payments; the legal challenges that the government faced and instigated; and resolution of the claims in 2015-16 and into 2016-17. We set out the reasons for the time taken to resolve the position throughout the process; and identify those actions that are relevant to broader consideration of similar cases in the future. The investigation does not examine the evidence in support of the test case or the judgment reached by the Ombudsman.<sup>2</sup>

5 Part One of the report sets out the roles and responsibilities in relation to the management of the Police and Firefighters' Pension Schemes. Part Two sets out the key events in the lead-up to the Ombudsman's decision and the implications for the individuals concerned. Part Three sets out the government's response to the claims made; and Part Four describes the governance processes that were in place at the time and their relevance to the case.

2 These are set out in the Ombudsman's judgement which can be found at: [www.pensions-ombudsman.org.uk/wp-content/uploads/PO-1327.pdf](http://www.pensions-ombudsman.org.uk/wp-content/uploads/PO-1327.pdf)

# Summary

## Key findings

- 1 The government failed to provide appropriately valued pension lump sums for an estimated 34,000 police and firefighters.** Following complaints by pensioners, the government was aware in 2006 that the commutation factors used to calculate police and firefighters' pension lump sums did not reflect the life expectancy of pensioners or the underlying trends across pension schemes for payments made before 2006 (paragraphs 2.29 and 2.34).
- 2 The Pensions Ombudsman (the Ombudsman) upheld the pensioners' complaints in 2015.** The majority of pensioners received corrective payments, including interest to compensate for the time that elapsed, within 10 months of the Ombudsman's ruling. However, this meant that some individuals had retired for over 15 years before they received their full pension entitlement (paragraph 2.29).
- 3 The total value of payments to the affected individuals is estimated to be £711 million, an average of £21,000 per pensioner.** This equates to increases of between 5% and 36% of the lump sums the pensioners received initially (paragraph 2.34).
- 4 Government's statutory responsibilities in relation to the review of commutation factors were not sufficiently understood in the period leading up to the pensioners' complaints.** In the 2001 to 2006 period, the Government Actuary's Department (GAD); which is overseen by HM Treasury; the Home Office; and the Department for Communities and Local Government (DCLG), did not adequately consider their collective responsibilities for oversight of the factors; and whether they provided lump sums that were equivalent to the pension payments the individuals agreed to surrender (paragraphs 2.4 to 2.10).

The timeline

## Identifying the failure to update the commutation factors

- 5 The initial query about the appropriateness of the commutation factors that were applied in the 2001 to 2006 period was raised by the Office of the Deputy Prime Minister (ODPM), now known as DCLG, in 2002.** GAD was aware that the factors did not reflect the life expectancy of pensioners or the trends across similar pension schemes by April 2004. This is shown in documentation and emails that were available at the time that evidence the discussions between GAD, the ODPM and the Home Office (paragraphs 2.6 and 2.7).



**6 GAD started to commission reviews of the appropriateness of the commutation factors in 2005 and scheme members initially raised concerns regarding the appropriateness of the factors in 2006.** This started the process of establishing whether the commutation factors were significantly out of line with the life expectancy of scheme members, which affects the assumptions used to calculate pensioners' lump sums (paragraph 2.11).

**7 Following internal consideration of the concerns raised by pensioners, GAD updated the commutation factors for the Police and Firefighters' Pension Schemes in December 2006.** At this point the government was aware that the factors had not changed between the time they were last updated in 1998 and 2006 and had increased during the period (paragraph 2.11).

**8 The government decided to test its liability through the courts.** The government received legal advice from the Government Legal Department, previously known as Treasury Solicitors, which supported GAD's decision to pursue legal judgments through the High Court ruling and in the test case that was brought by Mr Milne.<sup>3</sup> Given the need for HM Treasury to ensure it is not setting undue precedent in its consideration of pension claims, there is a rationale for the government to test its liability through the courts (paragraph 3.8).

#### **Assessing the appropriateness of the commutation factors**

**9 In 2009, the High Court was asked to judge whether the Home Office was able to delay the implementation of the revised factors, produced by GAD in 2006, to the Police Pension Scheme until October 2007.** The High Court ruled that the Home Office did not have the discretion to delay implementation. In effect this meant that the factors were purely a matter for GAD's professional judgment. According to the GAD witness statement for the 2009 High Court judgement, up until 23 October 2007, when the Office for National Statistics published new mortality data, GAD deemed the factors to be actuarially acceptable (paragraphs 2.13 and 3.5).

**10 The High Court judgment also ruled that GAD had a statutory responsibility to ensure the factors were kept up to date.** The High Court ruled that the factors should have been updated and that GAD had a statutory responsibility to prepare the tables and update them regularly. This established the principle upon which the Ombudsman subsequently concluded that GAD should have updated the tables on behalf of the pension schemes in the 2001 to 2006 period (paragraphs 2.13 and 3.4).

<sup>3</sup> On efficiency grounds the Pensions Ombudsman ruled on a test case brought by 'Mr Milne' which was considered to be representative of the impact on all the other pensioners that commuted their pension benefits between 2001 and 2006.

### **Challenging the jurisdiction of the Ombudsman**

#### **11 The Ombudsman invited challenges to its jurisdiction in March 2010.**

GAD challenged whether it was an administrator as defined by the relevant regulations before 2005 and, therefore, whether the Ombudsman was able to conclude on its actions in this period.<sup>4</sup> The Ombudsman concluded that he did have jurisdiction over this case in July 2011 (paragraphs 2.21 and 2.22).

**12 Following the Ombudsman's conclusion, and supported by legal advice, GAD escalated its challenge to the Ombudsman's ability to rule on the case through the High Court and the Court of Appeal from September 2011 through July 2013.** This legal process restricted the Ombudsman's ability to progress his judgment on the test case. The High Court and the Court of Appeal agreed with the Ombudsman's conclusion with regard to jurisdiction. This process took 20 months to complete (paragraphs 2.22 to 2.24).

**13 GAD's legal challenge to the Ombudsman's jurisdiction was not directly related to the initial failure to update the commutation factors.** This is because this legal process did not seek judgment on whether an initial mistake had been made. The case focused on the Ombudsman's ability to exercise judgement on GAD's actions in relation to the commutation factors in the pre-2006 period. It is not clear whether the government would have been able to avoid the liability, if the legal challenge to the Ombudsman's jurisdiction was successful (paragraph 3.9).

### **The Ombudsman's ruling**

**14 The Ombudsman upheld the test case brought by Mr Milne in May 2015. The Ombudsman concluded that there was maladministration as GAD should have proactively updated the commutation factors rather than waiting to be commissioned.** The Ombudsman ruled that GAD had a professional duty to take the lead in the consideration of the assumptions that fed into the commutation factors as it had the expertise to do so. This resulted in the recognition of the £711 million liability by government in May 2015 (paragraphs 2.29 to 2.31).

### **The governance of pension schemes and GAD**

**15 During the period when this issue arose, there was a lack of independent oversight of the schemes by parties outside government or representation from scheme members.** The fire authorities and police services were responsible for the governance of the schemes up to April 2015. Pensions can be complex and individual scheme members need support and appropriate representation to ensure that they understand their arrangements and can make the right decisions regarding their retirement. The commutation factors used by actuaries to calculate lump sums in accordance with scheme rules are one such complexity and have a significant impact on the pension benefits received by members (paragraphs 1.12 and 4.2).

<sup>4</sup> GAD challenged whether the Personal and Occupational Pension Schemes (Pensions Ombudsman) Regulations 1996, applied to it during this period.

**16 Scheme members (police officers or firefighters in this case) rely on the scheme and its advisers to determine whether the commutation factors that apply to their circumstances are appropriate.** Governance arrangements need to be in place, therefore, to protect these individuals and ensure that they are not disadvantaged as a result of the administration of schemes (paragraphs 1.13 and 4.2).

**17 The revised governance arrangements for unfunded public sector pensions following the 2011 Independent Public Sector Pension Commission's review are designed to provide protection for pensioners in the event of future issues of this nature.** These include pension boards which are independent of scheme administration and have representation from scheme members in line with private sector practice (paragraph 1.14).

**18 The mechanism by which GAD was commissioned and received funding contributed to the initial failure to update the factors.** At the time of the initial failure to review the factors, GAD, the Home Office and DCLG understood that GAD needed to be commissioned to carry out a review of commutation factors. The funding structure of GAD, which required it to be commissioned by its clients before it could conduct work and charge for its services, contributed to the uncertainty regarding the requirements to review the factors. This position has been subsequently revised so that GAD can engage with departments proactively without concerns about its funding position (paragraph 4.3).

**19 GAD has reviewed its internal controls to ensure its statutory duties, such as the review of commutation factors, are clearly understood and discharged.** GAD's revised controls, together with the updated approach to governance of government pension schemes, are designed to provide a more rigorous approach to ensuring that scheme regulations are considered sufficiently in future cases of this nature (paragraph 4.4).

# Part One

## Background

### **Government pension landscape**

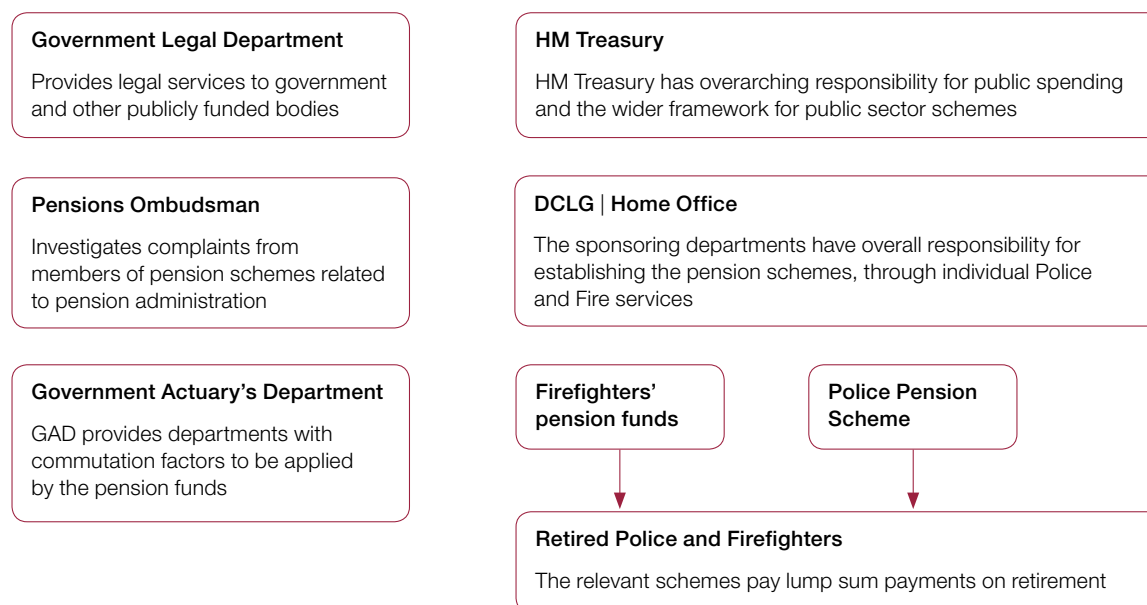
**1.1** The government manages a broad pension landscape covering a wide range of schemes across numerous public sector bodies. Our recent report, *Evaluating the government balance sheet: pensions*,<sup>5</sup> considers the various pension commitments on the government balance sheet, which constitute a liability to government of £1,493 billion. The administration of these schemes is difficult, due to the range of governance structures and benefit regimes that are in place. The government needs to balance fairness and consistency in its treatment of pensioners, with the need to ensure that it is not setting undue precedent when managing challenges to the administration of the schemes. The financial implications of inconsistent administration of the various schemes under government control can be significant in reach and scale.

**1.2** Most of the schemes in central government are unfunded pension schemes, including those considered in this report. Unfunded schemes operate on a pay-as-you-go basis, whereby today's contributions from current employees and employers are used to pay today's pensions. HM Treasury (the Treasury) ultimately covers any shortfall between the pensions paid and the contributions received and would also retain any surplus. By comparison, most of the schemes outside central government are funded pension schemes. Funded schemes operate by investing pension contributions from employers and employees to build up assets in a pension fund that are then used to pay pensions as they fall due.

**1.3** The roles of the various parties in pension scheme governance are set out and summarised in **Figure 1**.

**Figure 1**

Government bodies and their roles within the public sector pensions landscape



Source: National Audit Office analysis

## The Government Actuary's Department

**1.4** The Government Actuary's Department (GAD) is responsible for providing actuarial advice to public sector bodies and is overseen by the Treasury. GAD is a non-ministerial department and its funding is based upon fees charged to clients. GAD performs a wide range of services to government including the provision of actuarial support and analysis and many of these responsibilities are laid down within legislation. This also includes a role as valuer of public sector pension liabilities.

## The Treasury

**1.5** The Treasury does not have a formal role in respect to pension administration, such as the setting and implementation of commutation factors. The Treasury does, though, have overarching responsibilities for public spending and the wider framework for public sector schemes. It was responsible for setting out, through the Public Service Pensions Act 2013, the governance arrangements required for public sector pension schemes. As a coordinating body, the Treasury meets regularly with the major schemes to discuss any significant areas of cross-government significance and has an important role in the resolution of legal claims and decision-making on other types of contentious public spending.

## **Pensions Ombudsman**

**1.6** The Pensions Ombudsman (the Ombudsman) is independent and operates to resolve complaints in relation to pension administration. The Ombudsman can make legally binding rulings in relation to these complaints. The Ombudsman's underlying legal framework is set out in the Pension Schemes Act 1993. This created powers to deal with complaints of maladministration and disputes of fact or law in relation to personal and occupational pension schemes. Subsequently, various regulations under the act have been put in place that consider the powers and procedures in place at the Ombudsman in greater detail. For example, section 146 of the act and the Personal and Occupational Pension Schemes (Pensions Ombudsman) Regulations 1996 set out the Ombudsman's jurisdiction over what it can and cannot investigate.

## **Government Legal Department**

**1.7** The Government Legal Department (GLD) (previously known as Treasury Solicitor's Department) is a non-ministerial government department providing legal services to central government departments and other public sector entities. It has various responsibilities which includes advising ministers on matters of law and also provides support to public bodies requiring legal representation. Throughout the process regarding commutation factors, representatives of GLD provided services to both GAD and the Treasury.

## **Home Office and the Department for Communities and Local Government**

**1.8** The Home Office is responsible for overall management of the pension arrangements in relation to the Police and Firefighters' Pension Schemes. Prior to the transfer of ministerial responsibility in January 2016, the Department for Communities and Local Government (DCLG)<sup>6</sup> held responsibility for fire pensions. While separate funds are set up and managed at a local level, the Home Office are (or were in DCLG's case) ultimately responsible for the pension arrangements.

## **Police and Firefighters' Pension Schemes**

**1.9** Funding and administrative arrangements for the Firefighters' Scheme differ between various parts of the UK, but the underlying schemes are governed by the same statutory instrument, The Firemen's Pension Scheme Order 1992. Similar provisions for the Police are set out in The Police Pensions Regulations 1987.

<sup>6</sup> Responsibility for the fire pension schemes was also previously held by the Office of the Deputy Prime Minister.

**1.10** Both the Police and Firefighters' Pension Schemes are unfunded and include provisions that allow individuals to commute a portion of the pension, based on the relevant commutation factor. This clause notes that commutation is based on actuarial equivalence and that this should be based on tables prepared by the Government Actuary's Department (GAD). Historically these have varied depending on the impact of the underlying variables, most notably mortality and discount rates (see Part Two for further details).

**1.11** Since the formation of the schemes, police and firefighters have been able to commute a portion of their pension for a lump sum. Based on established trends in life expectancy throughout the late 1990s and 2000s and given the requirement for actuarial equivalence, it is clear that during this period, the commutation factors applied to individuals in these schemes would be expected to increase.

### **Governance of government pension schemes**

**1.12** Pension schemes in the private sector are required to appoint trustees who act in the interest of those with scheme membership. The main function of the trustees is to act in the interests of the beneficiaries, for example by making sure benefits are paid accurately and when due. Following the government's response to the Independent Public Service Pension Commission's report in 2011, see paragraph 1.13, revised public sector pension scheme governance arrangements aimed to replicate this model. However, prior to this report and during the period in question the governance of public sector pension schemes, including the Police and Firefighters' Pension Schemes, did not include significant representation from scheme members.

### **Independent Public Service Pension Commission**

**1.13** In March 2011, the Independent Public Service Pension Commission published a report that covered a broad array of considerations regarding the governance of public sector pension schemes and made recommendations for improvement.<sup>7</sup> The report indicated that at the time "there is not always a clear separation of duties between those responsible for the governance of public service pension schemes and those delivering the benefits to the members". In particular, the report noted that members of the scheme were not formally represented in the governance arrangements and that there can be a lack of clarity over responsibilities.

<sup>7</sup> *Independent Public Service Pension Commission: Final report*, 10 March 2011. Available at: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/207720/hutton\\_final\\_100311.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207720/hutton_final_100311.pdf)

**1.14** The report recommended that more independent oversight and stronger governance was required. In particular, ensuring representatives of the workforce have a role in the governance of the scheme, in line with practice in the private sector. This was covered by a recommendation to develop pension boards, with member nominees. The report also recommended that a framework should be established to ensure independent oversight over the governance and transparency of schemes. An overview of the proposed governance arrangements, can be found in **Figure 2**. The government accepted the Commission's recommendations in full.

**1.15** Following this report, the Public Service Pensions Act 2013 was enacted, aiming to address the issues raised. This created a statutory requirement for the creation of pension boards to assist each scheme manager. These boards operate independently (and include a requirement for representation for scheme member) to ensure there is a clearer separation of those providing oversight of schemes from those who fund and administer them. The 2013 act also included an expanded oversight role for the regulator. This gives it comparable powers to those it currently holds over trust based schemes in the private sector.

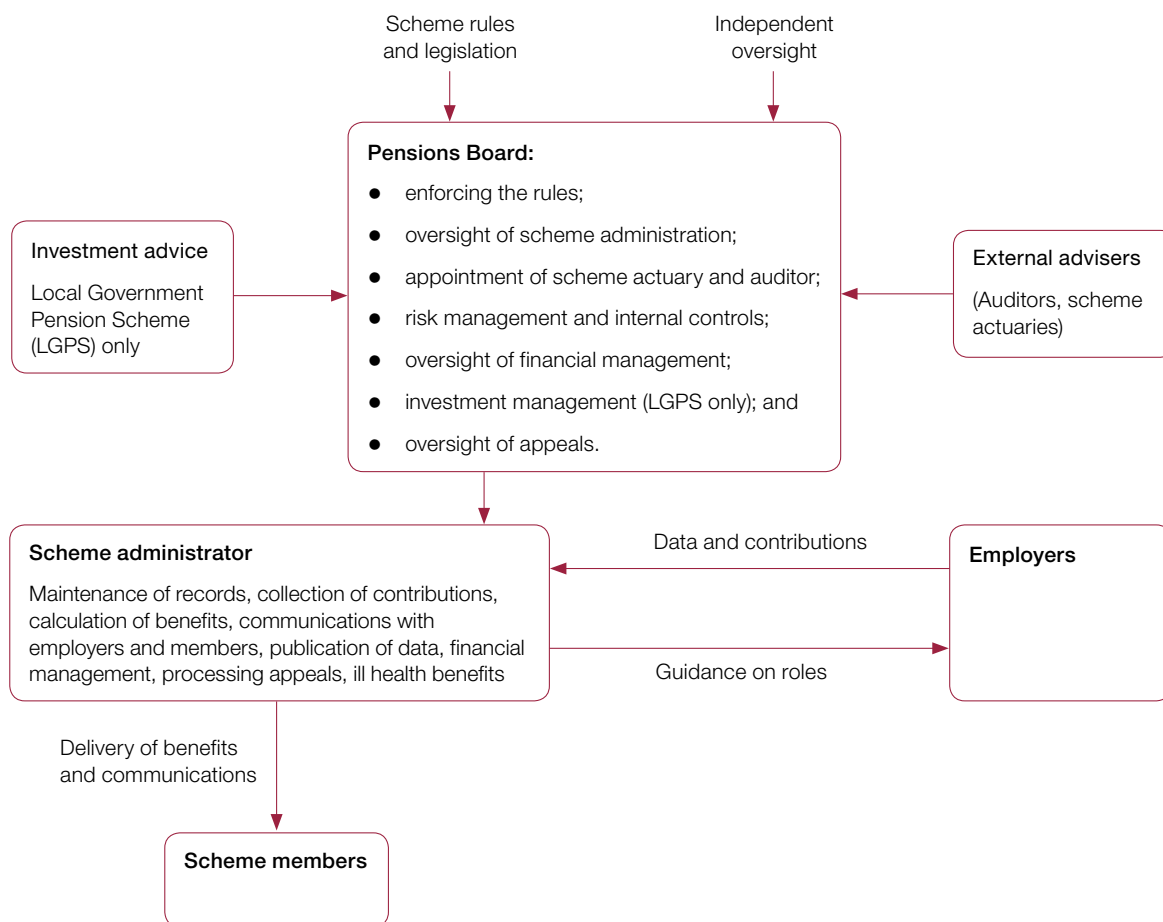
**1.16** The government introduced revised public service pension scheme governance arrangements in April 2015. These aimed to strengthen and formalise member representation in schemes to provide clear separation of responsibility for policy and administrative functions. Pension boards have similar responsibilities to trustee boards to help ensure compliance with scheme provisions and wider legislation.

**1.17** It is difficult to assess how effective these new arrangements will be until issues of a similar nature to the case considered in this report arise. However, it is a positive step that there is a statutory requirement for independent oversight and representation of employees on pension boards. Separate arrangements for a scheme advisory board and local pension boards have been established and are operating for both the police and firefighter pension schemes, however for this investigation we have not assessed their effectiveness. If the governance processes operate as per the legislation, and the boards have the necessary skills, this should lead to a more balanced representation of the needs of members, the scheme sponsor and government.



**Figure 2**  
Proposed governance arrangements for scheme administration

**Box 6D: Proposed governance arrangements for scheme administration**



Source: Independent Public Service Pension Commission report (2011)

# Part Two

## Key events and their implications

### Commutation factors

**2.1** Individuals in the Police and Firefighters' pension schemes are entitled to sacrifice a portion of their future pension payments in exchange for a lump sum on retirement.<sup>8</sup> A commutation factor is used to calculate the size of the lump sum payment. This factor is multiplied by the value of the annual pension payments that are sacrificed in order to calculate the lump sum. Factors vary between schemes and can either be fixed or determined based on the 'actuarial equivalent' level of annual pension being sacrificed, as was the case for the Police and Firefighters' Pension Schemes considered in this report.

**2.2** A commutation factor based on 'actuarial equivalence' aims to produce a lump sum whose value is equivalent to the current value of estimated future payments being sacrificed, as illustrated in **Figure 3**. The factors are determined based upon the population of the whole pension scheme, rather than tailored to individuals.

**2.3** The general principle for actuarial equivalent factors is that they correlate to the number of years an individual would be expected to drawdown the pension. They, therefore, increase to provide a greater lump sum if the relevant population is anticipated to live longer.

### The gap in the commutation factor review between 2001 and 2006

**2.4** Historically, GAD has prepared commutation factors proactively for the Police and Firefighters' Pension Schemes. Reviews took place in 1982, 1986, 1994 and 1998. A new funding arrangement was introduced in 1989 which created a requirement for clients to commission and pay for GAD's input, including reviewing commutation factors, rather than GAD receiving funding centrally. Following this change GAD operated on the basis that responsibility for ordering the review of the commutation tables and publishing the tables lay with the relevant government department.

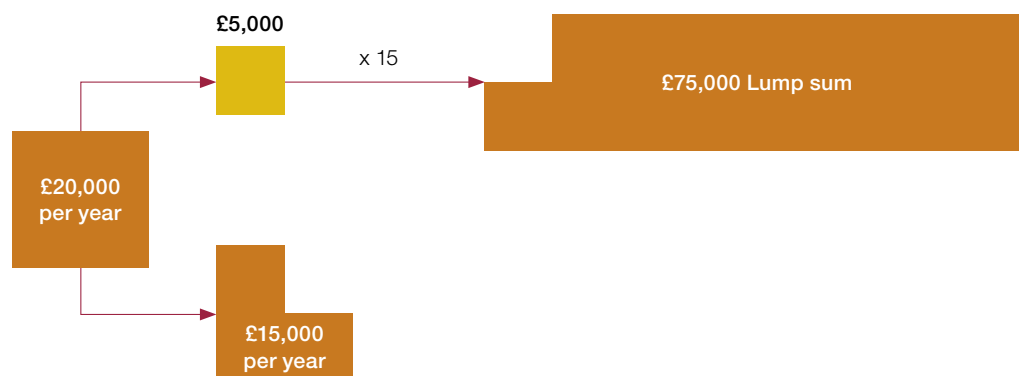
<sup>8</sup> For both the police and firefighter pension schemes, any member who has attained age 55 or maximum pensionable service can commute up to a maximum of one quarter of their full annual pension for a lump sum payment at retirement. All other members are entitled to commute a proportion of their pension that provides up to a maximum lump sum payment of 2.25 times their full annual pension.

**Figure 3**

## Operation of commutation factors

**Commutation factor – Example<sup>1</sup>**

Mr Smith has a pension which will pay him an annuity of £20,000 per year. The commutation factor relevant to him has been calculated as 15. He wishes to sacrifice £5,000 per year and take this instead as a lump sum. He will therefore receive  $(15 \times £5,000) = £75,000$  as a lump sum, with annuity remaining of £15,000 per year.

**Note**

<sup>1</sup> Actual values will be affected by discount rates applied to reflect that the current value of payments are worth more than the same payments in the future.

Source: National Audit Office analysis

**2.5** In July 1998, GAD reviewed the commutation factors applicable to the Firefighters' Pension Scheme. This review recommended that the commutation factors be reviewed three years later. However, this scheduled review did not happen and these factors were applied to lump sum payments up to 22 August 2006 for the Firefighters' Scheme.

**2.6** In November 2002, the Office of the Deputy Prime Minister (then responsible for the Firefighters' Scheme) enquired about the value of benefits being provided by the scheme. GAD's response noted that the life expectancy of firefighters in retirement, used to calculate the commutation factors, had been set at the same level for many years. GAD also noted that other public sector schemes were reflecting increased longevity in their assumptions and that, in the absence of firefighter-specific data, the public sector scheme assumptions would probably be used for the Firefighters' Scheme. This suggests that GAD had reasonable knowledge that the commutation factors did not reflect those in use across other public sector schemes.

**2.7** In April 2004, in response to a formal request from the Office of the Deputy Prime Minister to review actuarial assumptions, GAD noted that improvements in life expectancy had exceeded all previous expectations and commented that the commutation factors would probably be found to be too low. Further internal emails substantiate this point, as highlighted within the Ombudsman's determination. However, at this stage an explicit statement that the factors no longer bore actuarial equivalence was not made. It was also noted in internal emails that, even if the factors were found to be accurate, GAD was still concerned that they had not been reviewed frequently enough.

**2.8** During this period, GAD provided assistance in relation to the implementation of the new Police Pension Scheme. In November 2005, GAD commented in an email to the Home Office (HO) that many of the extant factors were out of date and that they would have difficulty recommending that they be used for the new scheme. The similarity in nature between the Police and Firefighters' Schemes means decisions on one scheme have significant relevance to the other.

**2.9** Life expectancy on retirement increased significantly throughout the late 90s and 2000s. This has a commensurate impact on commutation factors, if the impact has not been factored into the assumptions, as individuals are sacrificing pension payments over a predicted longer period, resulting in increases to the lump sum payments. GAD was aware of these trends through its actuarial role across the government's pension schemes.

**2.10** It is clear, therefore, that GAD was aware of the mortality trends which affect commutation factors. This was a broadly known trend and even had GAD not known the exact effect, they would have been aware that it was likely to materially affect commutation payments in the Police and Firefighters' Pension Schemes. In addition, GAD had historically prepared commutation factors for these relevant schemes and the fact that it was no longer producing them should have been raised with the pension schemes to consider whether this was appropriate. Even if GAD was correct in its reading that it did not have a statutory duty to prepare the tables, it had a duty to ensure the departments were fully aware that the commutation factors did not reflect the underlying trends.

## The Cox judgment: initial challenge by pensioners of the commutation factors that were applied to calculate their lump sums

**2.11** Throughout late 2005, further consideration was given to updating the commutation factors. In early 2006, Scheme members questioned why the commutation factors had not been updated. Correspondence between the Home Office and GAD also discussed a potential review of the factors, with the Home Office commenting that it was awaiting further work to be completed, but would then commission GAD. On 11 May 2006, GAD advised HO that the commutation factors were now out of date. The commutation factors for both schemes were reviewed in 2006 and GAD provided a new table of factors to the Home Office and DCLG on 1 December 2006. The Home Office applied the new factors to the Police Pension Scheme on the 13 May 2008, with effect from 1 October 2007.

**2.12** On 22nd October 2008, permission was granted for a judicial review against the Home Secretary by the Police Federation of England and Wales. The government's legal case, which was presented by GAD and the Home Office on the government's behalf, considered whether or not the Home Office had the right to postpone the implementation of the commutation factors from 1 December 2006 to 1 October 2007.

**2.13** The subsequent High Court judgment in March 2009, known as the 'Cox judgment', found that it was not for the Home Office to decide the date at which the factors applied, once they had been prepared by GAD. Additionally, the High Court determined that GAD had a statutory responsibility to prepare commutation tables and to update them on an appropriate basis; to ensure that the lump sums being paid were consistent with the actuarial equivalent value. In resolution, the 2006 factors were backdated to 1 December 2006 and applied to lump sum payments made after this date. The Cox judgment did not consider whether the commutation factors should have been backdated prior to GAD providing them.

**2.14** It was later noted by the Ombudsman that while this case related specifically to the Police Pension Scheme, it clearly has an impact on the Firefighters' Scheme. The regulations in place are broadly similar in terms of the benefit and commutation provisions. Therefore, the Police Federation case can be used as a precedent for the Firefighters' Pension Scheme.

## Mr Milne: Challenge of the failure to update the commutation factors between 2001 and 2006

**2.15** Following the Cox judgment, a number of complaints were raised with the Ombudsman in relation to the failure to update the commutation factors between 2001 and 2006. For efficiency purposes, instead of ruling on each case individually, the Ombudsman selected Mr Milne as a test case on which a determination could be made. The test case would be used as a guide for other cases, which could then be resolved without further intervention by the Ombudsman.<sup>9</sup>

**2.16** Mr Milne brought his complaint to the Ombudsman in 2010. Mr Milne had previously commuted the maximum amount allowable on his pension on retirement from the Firefighters' Scheme in November 2005. The commutation factor applied was in use since 1998. Mr Milne commuted a lump sum of £111,038. In exchange, his pension entitlement reduced from £29,610 to £22,207. This equates to a commutation factor of 15.

**2.17** Mr Milne argued that, as per the 2009 High Court Cox judgment, GAD had a statutory duty to provide the relevant Department (at this point DCLG) with commutation factors which reflected the actuarial equivalence of the sacrificed payments. As it was clear that the factors would have increased due to trends in life expectancy, Mr Milne argued that GAD was responsible for maladministration by not doing so. He argued that the lack of a service level agreement or administrative arrangement between the Department and GAD meant that periodic reviews of commutation factors were not ensured. In the absence of these, Mr Milne concluded that GAD should have taken the initiative.

**2.18** Various supporting points are outlined in Mr Milne's position. He noted that GAD had previously identified 2001 as a time where a review would be appropriate, but did not follow its own advice. Additionally, GAD and DCLG both had knowledge that the commutation factors were highly likely to be out of date and that they were slow to initiate a review. Had updated commutation tables been provided Mr Milne noted he would have received a higher lump sum payment. Further details of Mr Milne's complaint and GAD's position can be found within the Ombudsman's determination.<sup>10</sup>

<sup>9</sup> Separate schemes are in place concerning England, Northern Ireland, Scotland and Wales. We, and the Ombudsman, have considered this issue in its entirety.

<sup>10</sup> [www.pensions-ombudsman.org.uk/wp-content/uploads/PO-1327.pdf](http://www.pensions-ombudsman.org.uk/wp-content/uploads/PO-1327.pdf)

**2.19** GAD, however, argued that:

- the regulations confer no explicit obligation for it to review the commutation factors;
- it had operated on the basis, in conjunction with the relevant departments, that responsibility for commissioning a review of the factors rested with the departments;
- advice and services were to be provided by GAD only when it was commissioned; and
- it is not necessarily maladministration if a body takes the wrong view of the law.

**2.20** The Ombudsman subsequently concluded that GAD's role was central to the administration of the scheme. The relevant administrators of the scheme could not conduct their responsibilities in a correct manner, unless GAD had discharged its functions appropriately.

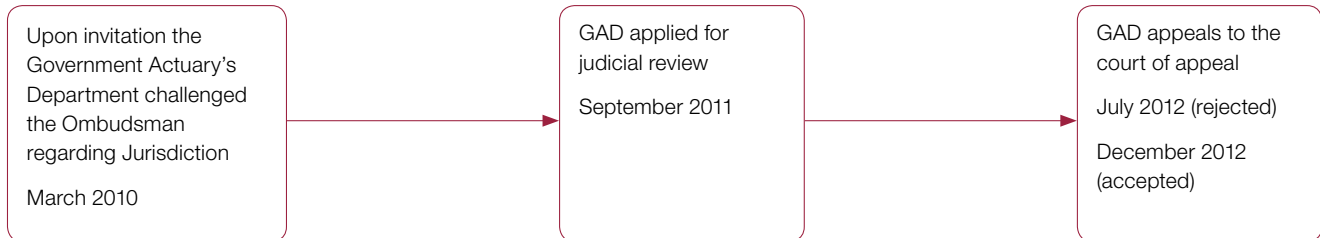
Jurisdictional challenge: GAD's challenge of whether the Ombudsman had the jurisdiction to rule in relation to this case

**2.21** Before the Ombudsman considered Mr Milne's case, GAD, on behalf of government, challenged the jurisdictional basis for the ruling in March 2010, as summarised in **Figure 4** overleaf. GAD argued that, prior to 2005, it did not accept it was an administrator for the purposes of the Personal and Occupational Pension Schemes (Pensions Ombudsman) Regulations 1996. This was conducted at the invitation of the Ombudsman, who invited submissions in relation to jurisdiction before progressing the case. If this challenge was successful it would have meant the Ombudsman would have only had the ability to consider the need to review commutation factors from 5 April 2005. Those retiring before this point would not have been covered.

**2.22** Having issued a preliminary decision on jurisdictional issues in December 2010, the Ombudsman dismissed GAD's argument and determined that it did have jurisdiction in July 2011. GAD applied for a judicial review in September 2011, which was granted in January 2012. The decision of the Ombudsman was upheld by the High Court in June 2012.

**Figure 4**

## Challenges to the Ombudsman's jurisdiction



Source: National Audit Office analysis

**2.23** GAD made a third challenge by filing a subsequent appeal in July 2012. This application to the Court of Appeal was initially rejected. However, GAD reapplied to the Court of Appeal in December 2012 and this was accepted for consideration. This was based on legal advice provided by the Government Legal Department.

**2.24** The Court of Appeal ruled in July 2013, that GAD was an administrator and fell under the jurisdiction of the Pensions Ombudsman throughout the period. It was noted that the role of GAD could not be described as incidental but was a central part of the scheme. Additionally, it noted the requirement for GAD to be proactive in relation to its role:

“It cannot wait to be asked to advise about updating actuarial tables. It is obliged to decide whether the tables need updating and to update them as necessary”.

**2.25** At this point, legal advice provided by the Government Legal Department did not recommend pursuing the case further to the Supreme Court. At this point GAD abandoned the legal challenge concerning jurisdiction.

### Pensions Ombudsman's decision

**2.26** Once the situation regarding jurisdiction was resolved, the Ombudsman was able to consider the substantive points in the Milne test case from July 2013 onwards. The Ombudsman issued a first preliminary decision on the substantive points in July 2014 and a second preliminary decision in March 2015. On 13 May 2015, the Ombudsman published his final determination.

**2.27** The Ombudsman noted that the High Court's decision in the Cox judgment had established the precedent that GAD had a statutory duty to ensure the commutation rates it provided were reviewed periodically as appropriate. It also noted that until the 1990s, GAD revised the commutation factors proactively, implying that GAD did have an awareness of its responsibilities under the relevant statutory frameworks.



**2.28** The Ombudsman upheld Mr Milne's complaint. The decision concluded that there was maladministration as GAD should have provided the tables in advance, rather than wait for them to be requested by the relevant government bodies. GAD owed a duty of care to update the tables and Mr Milne suffered a loss as a result of this oversight. GAD noted that Strathclyde Fire and Rescue Service had no choice but to apply the extant 1998 factors. In regards to this point, the Ombudsman ruled that the onus was clearly on GAD, as the professional actuary, to take the lead on ensuring the appropriateness of assumptions and factors, as the relevant bodies applying the factors do not have the same level of expertise. The relevant bodies were therefore only following the regulations that were in place at the time.

**2.29** The Ombudsman concluded that GAD failed to review the commutation factors between 1998 and 2006, which led to smaller lump sum pension payments. The Ombudsman noted that GAD had the opportunity to review the factors in 2000-01 and also between 2002 and 2004, but did not do so. The decision did not conclude on what the commutation factors should have been, or specifically when they should have been recalculated, but rather outlined that GAD should recalculate these based on the evidence available at the time.

**2.30** The Ombudsman ordered that a payment be made to Mr Milne. The remedy sought to put Mr Milne back in the position he would have been had the updated commutation factors been used. This was, therefore, based on the commutation factors that would have been in place if they had been reviewed in December 2004, plus interest and any associated tax liability. This has subsequently been determined to be £26,000.

**2.31** The Ombudsman was clear that the ruling referred only to Mr Milne's case, but noted that he expected the government to take forward and resolve other similar cases in line with this ruling. This was on the assumption that should similar cases be brought to the Ombudsman, the same decision would arise and this would be highly inefficient. Therefore, the Ombudsman urged government to consider this issue as a whole. Government accepted this approach and has taken the matter forward as suggested by the Ombudsman, resulting in the recognition of the £711 million liability in 2015.

## Implications of the failure to update the commutation factors

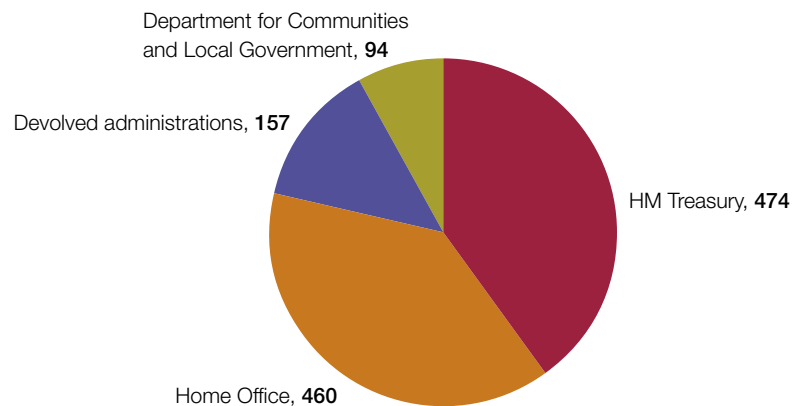
**2.32** The most significant implication of this determination is that the commutation factors applied to payments between 2001 and 2006 were not appropriately updated. This led to individuals receiving a smaller lump sum payment than they should have been entitled to. In response to the ruling, the government accepted liability for the increased commutation payments and GAD prepared tables to show the factors that should have been calculated at 1 December 2001 and 1 December 2004. They also provided estimated cost breakdowns which totalled £711 million to pensioners and £474 million internal to government, as summarised in **Figure 5** and set out below. These tables were provided to the relevant government bodies who recognised provisions within their 2014-15 accounts.<sup>11</sup>

**2.33** For those individuals who retired between 1 December 2001 and the effective dates in 2006, government compensated them to put them in the position they would have been in had the commutation factors been updated as per GAD's statutory obligation.<sup>12</sup>

### Figure 5

#### Provisions

Provisions in respect of compensation payments required for those previously underpaid commutation (and the associated tax) (£m)



Source: Government Actuary's Department estimate of liability and 2014-15 Departmental accounts

<sup>11</sup> As indicated in figure 5, a proportion of payments relevant to devolved assemblies were not recognised in the accounts of central government bodies.

<sup>12</sup> As noted above, separate schemes operate in different areas of the UK and resolution of claims will differ depending on the area. The main principles and approaches are however consistent across the affected schemes.

## Underpayment

**2.34** GAD estimated that 34,000 individuals were underpaid by material amounts between 2001 and 2006. The total cost of this underpayment was estimated as £711 million. The underpayment including interest was between 5% and 36% of each individual's original lump sum. Taking an average, this corresponds to each individual being underpaid by almost £21,000. As payments were made from 1 April 2015, individuals have therefore been retired for at least 9 years and up to 15 years before receiving their full pension entitlement. Both the level of payments and the period of time that elapsed before they were made are significant in the context of an individual's retirement.

## Retirement decisions

**2.35** In December 2005, the predecessor department to the DCLG, the Office of the Deputy Prime Minister wrote to GAD and noted that the commutation factors in place at the time were a disincentive for those who wanted to remain in service longer. Although this relates to the reduction in the value of commutation factors as retirement age increases, this shows that the amount of commutation an individual would receive on retirement may affect decisions made over retirement timing and the desirability of commuting. It is difficult to evidence this point in retrospect, however, the time taken to update the commutation factors may have had an impact on individuals' retirement choices.

**2.36** In addition, individuals may not have selected a lump sum once they were provided with the amount of future pension payments they would have had to sacrifice. The Home Office witness statement for the Cox judgment notes that the application of factors had an impact on retention rates

## Tax position

**2.37** A provision of £474 million was also included within the 2014-15 Treasury financial statements. This was to recognise the additional tax liabilities created by the additional lump sum payments, which the Treasury agreed it would cover to ensure recipients did not have a tax liability arising due to the applicable rules on the payment of lump sums. This provision has a net zero impact on the exchequer as it is a cash payment made by the Treasury to HMRC.

### **Current Position and resolution**

**2.38** As noted, the government has accepted the Ombudsman's ruling and confirmed redress would be paid to those affected. GAD prepared commutation factors based on a reconstruction of the factors that would have been applied had they been prepared in 2001 and 2004. GAD has also issued guidance to assist scheme managers in determining the redress owed to affected individuals.

**2.39** As payments are the responsibility of the different fire and police pension schemes, it is difficult to track the completion of payments, however, the Treasury is content that the significant majority of payments had been made. For example, as at 31 March 2016, there were £89.4 million payments made to the affected firefighters with around £1.5 million remaining to be paid in 2016-17. There is no corresponding data available for the police pensions due to the range of different schemes that are operated at a local level.

# Part Three

## The government's response

### Communication with departments

**3.1** The Ombudsman's decision sets out a detailed consideration of the commutation factors in the 2000s and the extent that GAD communicated with the relevant departments. The correspondence shows that the relevant parties were well aware of the issues and potential challenges, however at no point was a clear and decisive position established. This reflects the level of uncertainty regarding the responsibilities for ensuring the commutation factors were updated.

**3.2** The scheme factors were reviewed and prepared by GAD in 2006. However, our review of documentation shows that GAD was aware that the commutation factors for the Police and Firefighters' Schemes did not reflect the underlying trends for life expectancy, which impacts commutation factors, across government pension schemes. Various pieces of correspondence highlight that the increase in life expectancy was likely to impact commutation factors in this period. At the point GAD became aware that mortality rates had materially increased, it did not seek clarification over its statutory responsibilities or provide clear advice to the Home Office and DCLG that the commutation factors breached the principle of actuarial equivalence. It is not clear from our review of documentation why GAD did not do so.

**3.3** Our review of internal and cross-government communication on this issue indicates that GAD did inform the departments that the commutation factors were likely to require updating. However, GAD's communications were not clear or explicit enough to ensure the departments were aware of the impact of the failure to update the factors. As the Home Office commented in an email from late 2007: "The context in which we received their recommendation was that we did not need to make an immediate change but that time was running out". This email, and other similar documents, did not set out clearly that the commutation factors were likely to be out of date or insufficient.

## **Initial High Court ruling – the Cox judgment**

**3.4** The Cox judgment in 2009 ultimately concluded that the assessment of actuarial equivalence lies with GAD, as they are the department with the required professional and technical knowledge. This position is also developed by the Ombudsman who noted that even if GAD's view of its obligations was correct, it should have supplied advice to the Department regarding the need for a review.

**3.5** According to the GAD witness statement for the Cox case, up until 23 October 2007, when the Office for National Statistics published new mortality data, it deemed the factors to be actuarially acceptable. At this point, however, GAD's case was based around the timing of the implementation of revised factors. The High Court sought clarity on whether there was a need to introduce the revised factors from the time revised factors were prepared in December 2006, rather than in October 2007, when they were applied by the pension schemes initially. This demonstrates that the legal position adopted by the government was based on the timing of implementation rather than whether the factors appropriately reflected underlying life expectancy.

## **Legal Challenge to the Ombudsman's jurisdiction**

**3.6** Once the issue of the Ombudsman's jurisdiction was raised by GAD, at the Ombudsman's request, the subsequent legal challenge of the Ombudsman's conclusions on jurisdiction further extended the resolution of the test case. The Ombudsman's 2015 ruling implies that the legal position was determined retrospectively out of the need to minimise cost, rather than on a thorough belief in the position. The Ombudsman notes:

“It (GAD) had already acted as if there was no obligation to review the factors and was aware of the potential for additional cost to the scheme and police authorities. It was bound to argue its own case, given there was room for such argument. But had it considered its obligations when they arose, rather than having to support its behaviour after the event, it might well have identified the correct position.”

**3.7** The Ombudsman's determination, therefore, indicates that the government focused on developing a defensive position.

**3.8** Our review of documentation shows that GAD followed legal advice throughout the process of considering its legal challenge to the Ombudsman's jurisdiction. The Ombudsman invited all parties to consider jurisdiction in advance of a decision being made on maladministration. Once the Ombudsman reached his own conclusion regarding jurisdiction, GAD then considered the legal avenues available. At each stage of the process, they were advised by the Government Legal Department to have a reasonable chance of success.

**3.9** The wider point however, is the counterfactual position in the event that the legal challenge of the Ombudsman's jurisdiction was successful. It is clear that, in substance, the government had collectively failed to take account of increases in life expectancy for the Police and Firefighters' Schemes; and apply appropriate and actuarially equivalent commutation factors. The jurisdictional challenge was not related to this point, but related to whether the Ombudsman had jurisdiction over GAD in the period the determination would cover.

**3.10** Though we have not been able to identify any documentation that considers the government's position on the likely outcome despite the legal position, we would have expected that broader considerations around the likely end result would have been given more precedence as this issue escalated through the legal process. This is particularly the case as the High Court initially refused permission to appeal in October 2012, with permission being granted in February 2013 after GAD's December 2012 reapplication.

**3.11** The jurisdictional challenge took 20 months, pushing back the resolution of this case for pensioners further. Continuing to pursue the technical legal defences on jurisdiction did not advance the main point in this case, which was the failure by government to update the commutation factors and ensure actuarial equivalence in the commutation of benefits.

# Part Four

## The governance arrangements

### Pension scheme governance

**4.1** The governance and administration of the pension schemes in place at the time, as set out in Part One, contributed to this case. Our review has shown that departments were aware that any change to the commutation factors would lead to an increase in lump sums and therefore higher costs.

**4.2** At the time, the relevant departments had oversight of the relevant pension benefits and, though initial cost increases were born by individual fire authorities and police forces, were ultimately responsible for funding the police and fire sectors,<sup>13</sup> increasing the risk of a conflict of interest. This is a key issue that the revised governance of pension schemes seeks to resolve. *The Independent Public Sector Pensions Commission's 2011 report*,<sup>14</sup> set out in Part One, shows that the departments both funded the schemes and made the decision over commutation factors, which constituted a lack of independent governance. Additionally, the report comments that external scrutiny would build trust both for the taxpayers and members of the scheme. If the governance arrangements the government introduced following the Commission's report had been in place in 2006 when the issue with commutation factors was first raised, pensioners would have had stronger representation in the overall management structure. This would have increased the likelihood that the factors would have been updated in the first place and provided a forum for ensuring that, once identified, the error was resolved quickly.

<sup>13</sup> Costs relating to the payment of pensions for retired firefighters and police were paid by each of the employing fire and rescue authorities and police forces from their operational accounts. Any increase in expenditure on commutation retirement lump sum payments during this period would therefore have fallen to them, however, they are ultimately funded by the sponsoring departments.

<sup>14</sup> *Independent Public Service Pensions Commission: Final Report*, 10 March 2011. Available at: [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/207720/hutton\\_final\\_100311.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207720/hutton_final_100311.pdf)



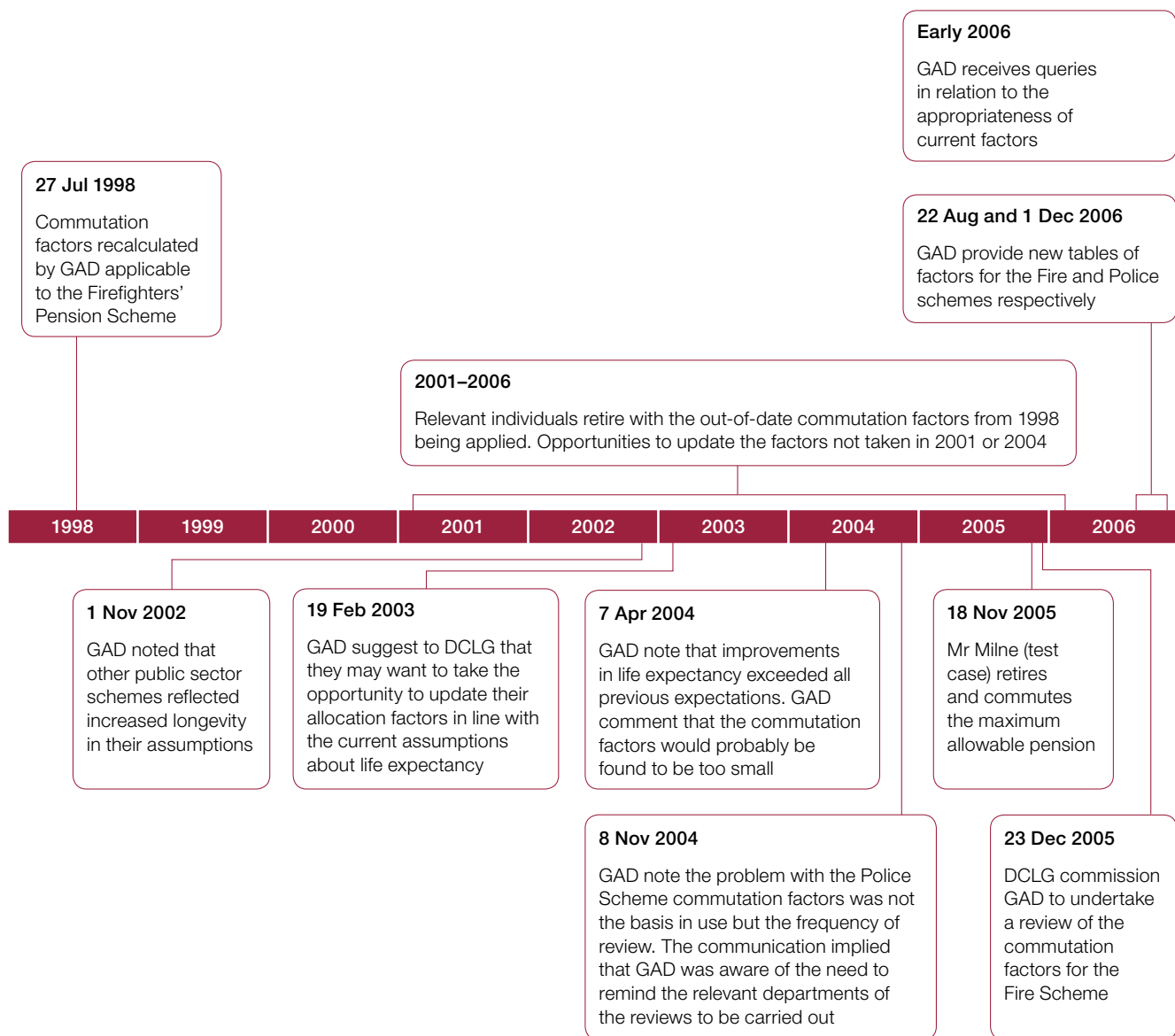
## **GAD's governance and oversight**

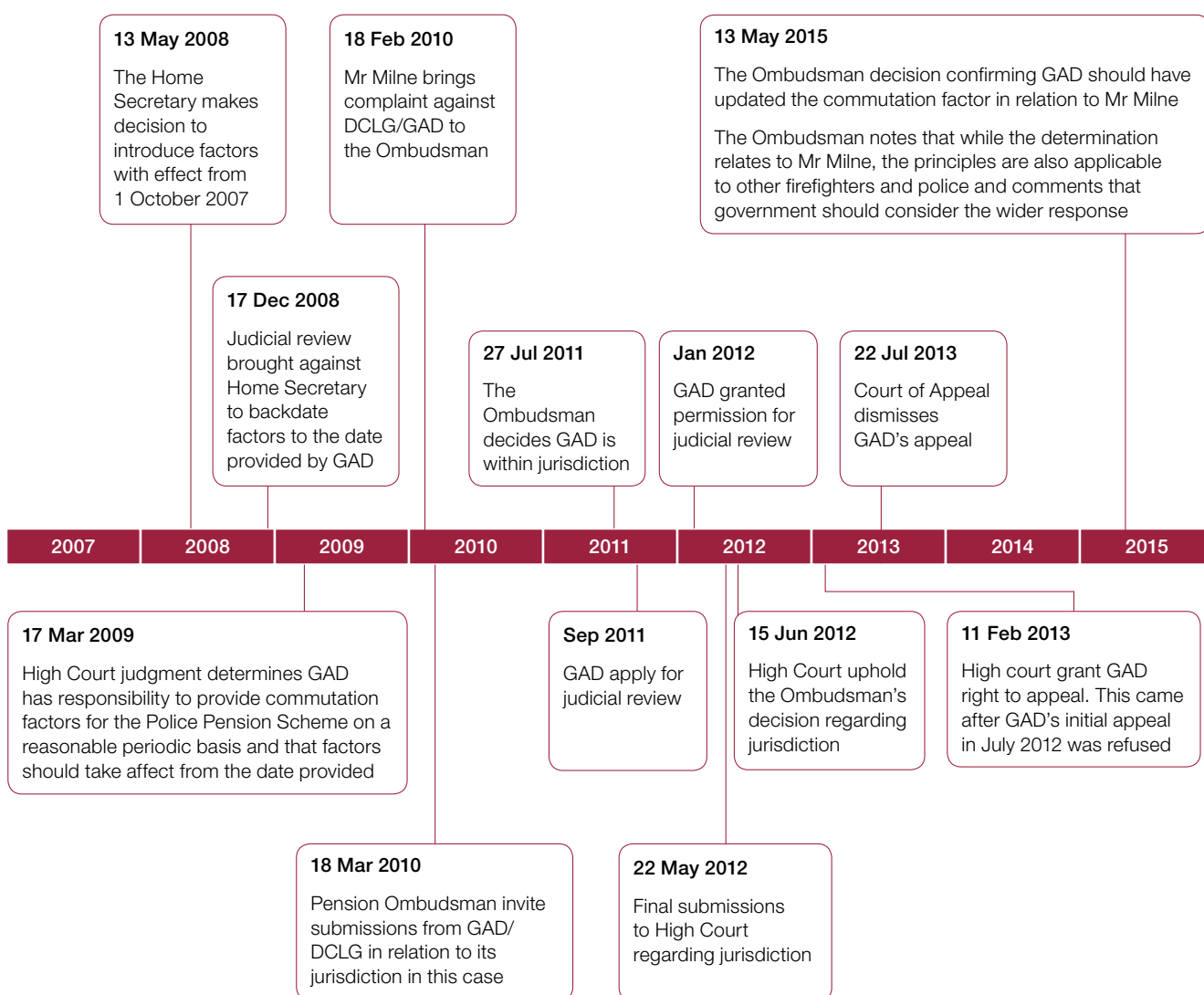
**4.3** A further factor in this issue was GAD's funding structure. The need for GAD to receive commissions prior to carrying out work on the commutation factors caused tensions in the process. This led to the position whereby GAD had knowledge, or at least a reasonable expectation, that the commutation factors were out of date; but that it needed to be commissioned by the relevant schemes to carry out the work and charge for it. The Ombudsman indicates that this was a primary cause of the issue, as GAD took this change in the funding mechanism to mean that it no longer had to supply commutation factors proactively. This was also eluded to in the witness statement provided by GAD as part of the Cox judgment, which states that GAD was generally not able to conduct work until it was commissioned to do so.

**4.4** GAD has implemented revised policies to ensure that, following the Cox and Ombudsman's judgments, its responsibilities for reviewing commutation factors are clear and that revised factors are implemented immediately following their production. GAD has strengthened its internal controls to monitor when factor reviews are due. It has established a central database of statutory references and a technical committee which includes a standing item on its agenda to consider the status of factor reviews across GAD. These changes are designed to ensure that, in the event of a review being required, GAD will engage with departments in advance. These mechanisms should ensure that GAD is more aware of its role in relation to commutation factors and ensure that similar cases such as this should not occur in the future.

# Appendix One

## Timeline





# Appendix Two

## Methodology

### **Our investigative approach**

#### Scope

**1** We conducted an investigation that a significant number of individuals had been materially underpaid in their lump sum pension payments. In particular we focused on the timing of the issue and how GAD responded at each stage. We also considered how the various governance and administration arrangements impacted the issue.

#### Methods

- 2** In examining these issues, we drew on a variety of evidence sources:
- We interviewed key individuals from GAD and the Pension Ombudsman to understand the situation as it unfolded.
  - We reviewed key internal and cross-government communication.
  - We assessed formal submissions provided as part of the legal process.
  - We considered related reports and information concerning the arrangements around pension governance and administration.

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