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Briefing note

McCloud consultations – 17 July 2020

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- The Local Government Pension Scheme in England and Wales now has a much clearer picture of the benefit changes arising from the McCloud ruling;
- There is much which LGPS administration teams should be doing now, not least in terms of project planning, without waiting for the consultation conclusion;
- Funding impacts will be relatively small at whole fund level …
- … but some employers (eg academies, leisure centres) may see a bigger impact
- Auditors may wish to see these proposals reflected in revised accounting reports?
- The position in Scotland is still uncertain.

Yesterday the Westminster government released the long-awaited consultation on applying the remedy to address the age discrimination inherent within the transitionary protections that were adopted by the public service schemes in 2014 and 2015.

In this Briefing Note we discuss the contents and the potential impact of the proposed remedy. We will be formally responding to the consultation and will share a copy of this well ahead of the deadline of 8 October, to allow you to build our comments in to your own response if you wish.

Two Consultations and an announcement

Two consultations have been issued; one from HM Treasury sets out the remedy for the unfunded public sector schemes, while MHCLG's consultation deals solely with the LGPS. It is the latter consultation with which we concern ourselves here.

Note that the HMT unfundeds consultation relates to most British public service schemes (Northern Ireland will be covered separately), however the MHCLG one covers England & Wales only: there will be separate consultations on the LGPS in Scotland and Northern Ireland.

Yesterday's flurry of activity also included an announcement that the McCloud remedies will be wrapped into the cost control mechanism process for all public service schemes, which has now been un-paused. In essence this means that further benefit changes will possibly be needed over and above these McCloud amendments in England & Wales: we know the Scottish LGPS situation means that material benefit improvements are likely in any event, and we await further detail on those.

Next steps for English & Welsh LGPS funds

The proposed remedy will require a significant amount of administration and communication. Our analysis shows that around 1.2 million LGPS members, equivalent to roughly a quarter of all members, may be affected.

We suggest that funds should now:

- Analyse their membership to identify those affected
- Set up a dedicated McCloud project to agree workstreams and plan what resource is needed
- Respond to the consultation (closing date 8 October), bearing in mind the possible involvement of your Committee and/or Local Pension Board.

Administration aside, the remedy will lead to increased costs for employers, and will feed into pension accounting disclosures. We have analysed a sample LGPS fund and found that the proposed remedy may add around 0.5% to total liabilities. In general, the contribution rate impact is likely to be small, but may be more significant for employers with younger membership profiles, such as academies or leisure centres. There is also the potential for March 2020 accounting reports to require revision. See later in this note for fuller details on funding and accounting implications.

Overview of proposed English & Welsh LGPS remedy

In summary, the remedy extends the ‘transitional protections’ underpin (that was promised to active members in 2012 who were within 10 years of normal retirement age) to all other active members, regardless of age. The underpin gives the member the better of CARE or final salary benefits for the eligible period of service.

In general terms, the key features of the underpin are:

- Eligibility is restricted to members who were active in the LGPS on 31 March 2012 and have accrued benefits since 1 April 2014;
- The underpin period applies between 1 April 2014 and 31 March 2022, but ceases when the member leaves active membership or dies in service;
- The final salary for comparison purposes applies at the point that the member leaves active status or reaches age 65.

However, the devil is in the detail! For example, it is possible for members with accrued CARE benefits that are higher than their accrued final salary benefits during the eligible period to still benefit from the underpin. This is because the two tranches of benefits can have different normal pension ages. If those members take early retirement, the impact of actuarial reductions may lead to their final salary benefit being higher.

We have given more details below, with paragraph numbers in the consultation document added in brackets for your ease of reference.

Who is in scope?

As expected, the consultation extends the existing LGPS underpin to all members who were active on 31 March 2012 and who went on to have membership of the CARE scheme, without a break in service of 5 years or more (para 41).

The idea is that the underpin will apply on service from 1 April 2014 to the earlier of 31 March 2022 or the member’s date of leaving (para 64).

The changes will be retrospective and will apply to anyone who has left, retired or died and who didn’t meet the old underpin criteria but meets the new one. In some cases, this will mean retrospectively recalculating benefits for pensioners, and paying arrears and interest.

How will it work?

Members who meet the criteria will have an "underpin date" and an "underpin crystallisation date" (para 61). The underpin test will be applied:

(i) On an indicative basis (without actually changing the member's benefits) at "the underpin date", being the date at which the member dies, leaves or reaches their 2008 Scheme NPA, whichever is earlier.

(ii) On a finalised basis at the "underpin crystallisation date", which is when the member actually takes their benefits.

The test will be based on the member's final salary at leaving/retirement, thus preserving the final salary link beyond 2022 as long as they are accruing benefits (para 66).

Where a member retires from active service (whether on an early, normal or ill-health basis) the underpin date and underpin crystallisation date will be the same. The underpin test will be applied and if the underpin kicks in the member will receive an underpin addition (paras 73-77).

However, in late retirement cases the underpin date will occur before the underpin crystallisation date. For example, if a member retires at age 67 (their underpin crystallisation date) the underpin is not recalculated based on their final pay at 67. Instead the underpin that was calculated at NPA (their underpin date) is revalued by the cost of living and is used in the calculation. In this way salary growth after NPA will not be taken account of for underpin purposes (para 74).

A similar situation would occur when a member leaves with a deferred benefit (the underpin date) and then draws their benefits at some later date (the underpin crystallisation date) (para 71).

What else has changed?

MHCLG have also taken the opportunity to address a few anomalies that existed with the old underpin. Which means some cases where previously the underpin didn't apply will qualify for the new underpin.

Early leavers (para 42)

The existing protection only applied if a member left with immediate entitlement to benefits, which will be much less likely to be the case with the extended membership coverage. Therefore, the proposals extend eligibility to those leaving with deferred benefits.

Death in service and Survivors benefits (paras 58 & 59)

An underpin calculation will now be required for death in service and survivor benefits, which was not previously the case.

Breaks in service and aggregation (paras 44-54)

As currently worded the regulations suggest that a member who;

a) was active in the LGPS on 31 March 2012, but left before 1 April 2014

b) became subsequently active in the 2014 Scheme in a separate employment without a disqualifying break in service, and

c) where the two records were not aggregated,

would still qualify for the underpin in both periods of service. This was never really the intention and administratively it is difficult to know how the second employer could apply the underpin since they would not hold the member's earlier LGPS record.

To address this, the new regulations will require that a member must meet the underpin criteria in a single LGPS record. This means that the above member would need to aggregate both periods of membership in order to apply for underpin protection. If the service was not aggregated the member would lose their underpin protection.

Under normal circumstances, such members will have missed the opportunity to aggregate such service, since an election must normally be made within 12 months of joining a new employer. To address this there will be a 12-month window for such members to make an election to aggregate.

Reductions and uplifts (para 57)

Currently the underpin assessment is carried out before the application of early retirement reductions (and late retirement uplifts). Given that final salary service and CARE service have different Normal Retirement Ages, and so different early retirement reductions (and late retirement uplifts), this can give a misleading impression of which benefit is better for the member.

The proposal is that at the underpin crystallisation date the new underpin will be applied after reductions or uplifts have been allowed for. This might mean that some members who have already had the old underpin applied will have to be assessed against the new underpin.

Other matters

Individual transfers (paras 88-97)

The proposals differ between “Club” and “Non-Club” situations:

- Club transfer in or out of LGPS: member is given the choice of whether to buy final salary or CARE benefits in the receiving scheme;
- Non-Club transfer out: member’s figures based on likely situation given calculations as at “underpin date”;
- Non-Club transfer-in: member’s benefits in the LGPS are purchased without entitlement to underpin.

Annual Allowance (paras 105-110)

The consultation confirms that where the application of the new underpin causes a member’s actual benefits to exceed the annual allowance, or where they already exceeded it, to exceed it by more, then an annual allowance charge may be payable. The annual allowance assessment only applies at the underpin crystallisation date as it is only at that point at which the member’s benefits would actually be increased. Where the underpin date falls before the underpin crystallisation date, an assessment made at the underpin date would not trigger an annual allowance charge.

Annual benefit statements (paras 103-104)

LGPS funds will be expected to carry out a notional underpin test for each qualifying member as part of the annual benefit statement process. This will be for information only and the ABS should state that the underpin figures are provisional, and may change.

Impact on funding and employer costs

At **whole fund level**, we don’t expect the McCloud remedy to have a significant cost impact. Based on typical LGPS funding assumptions, we estimate that total liabilities might increase by around 0.2% (or by 0.6% of active liabilities), equivalent to around £0.5bn across the whole of the English & Welsh LGPS.

This estimate is significantly less than the £2.5bn quoted in the LGPS consultation. This will be due to a combination of factors, with the pay growth assumption being a crucial one. The Government estimate uses CPI +2.2% pa which is significantly higher than that used by a typical LGPS fund (which might only be around CPI + 0.7% pa).

At whole fund level, our estimates translate to a rise in typical primary contribution rates of 0.2% of pay until 2022, and a small change to secondary contribution rates of only 0.1% of pay. SAB asked funds and actuaries to allow for McCloud costs at the 2019 valuation in England and Wales when setting funding strategies. This allowance would have taken different local forms e.g. some funds may have based contribution rates on slightly more prudent measures (e.g. higher required likelihood of full funding), whilst others might have added on an explicit ‘McCloud margin’ to the contributions themselves. We expect that most funds will not revisit employer contribution rates until we reach the next valuation in 2022, unless no allowance was made for McCloud at 2019 or if funds have concerns over rates for particular employers (see comments below).

The **Scottish 2020 LGPS valuations** are currently underway. As per guidance from SPPA, we intend to explicitly build the proposed McCloud remedy directly into our liability calculations. Contribution rates will therefore automatically allow for McCloud costs.

Whilst at whole scheme level the impact is small, **it may be material at individual employer level**. This is where the LGPS differs from the other public sector schemes - everything is funded at employer level and contributions can and do vary materially from one employer to the next for various reasons.

The variation in McCloud underpin impact arises due to differing membership profiles, and particularly age. Younger members will have a longer period of salary increases compared to older members (especially once promotional increases are considered, which tend to be higher at younger ages). There is therefore a higher likelihood that the underpin 'bites' for younger members.

Our modelling suggests that some employers may see their total liabilities increase by as much as 5-10% (which may equate to at least a 1% of pay contribution rate increase), whilst other employers will see no impact at all. There is also the potential for one-off significant increases which may result in an impact greater than noted above, for example, an employer with only one member who is awarded a significant pay increase.

It is worth noting that introduction of the underpin to all eligible members, and the fact that the link to final salary will be retained up until the member retires, means that another source of volatility and uncertainty is introduced into the funding of LGPS benefits. We may see employer's funding positions and contribution rates changing by larger amounts between valuations because of this factor.

Impact on pension accounting disclosures

Allowance has already been made for McCloud in most employers' FRS102 or IAS19 reports via a past service cost. This allowance, based on analysis by the Government Actuary's Department (GAD), assumed that everyone active in the scheme was eligible for the protections. However, the proposed McCloud remedy now limits eligibility to only members who were active at 31 March 2012. This will reduce the size of the allowance, and reduce the balance sheet liabilities, for a typical employer by more than half of the previously reported McCloud allowance.

Auditors may require this reduction to be reflected in the reports that have prepared for the March 2020 accounting year end. This will result in additional work and extended timescales for employers to revise their accounts (and incur additional costs for the preparation of revised reports).

Looking beyond 2020, these proposals mean ongoing volatility of the cost of benefits due to the underpin potentially 'biting' (or not) year-on-year. This therefore may be something auditors will want to be considered in the preparation of reports going forward and which would introduce higher reporting costs on an ongoing basis.

Interaction with cost control mechanism

(This is the process of revisiting the benefit structure (including member contributions) from time to time, introduced a few years ago at the same time as the current Scheme).

There were previous question marks over the inclusion of McCloud costs in the mechanism. The calculations at 2016 had been 'paused' due to this uncertainty but will now be brought to a conclusion as the Government has confirmed that the cost of the remedy will be fully reflected in the mechanism.

We will wait to see the outcome of the 2016 valuation. The inclusion of McCloud in the cost envelope will reduce, or possibly even wipe out completely, the proposed package of benefit improvements that had been due to take effect from 1 April 2019 in the LGPS in England and Wales.

The impact on the Scottish LGPS is less clear. Unlike England and Wales, there is no secondary Scheme Advisory Board cost control mechanism running alongside the 'main' HMT mechanism and acting as a 'brake' against a breach of the latter mechanism. It is possible that, even after allowing for the McCloud remedy, the 2% of pay 'trigger' that is built into the HMT mechanism (and leads to changes to members' benefits and/or contributions) could still be breached.