

The LGPS McCloud consultation



The Government has issued the eagerly anticipated consultations to remedy the age discrimination cases, known as McCloud and Sargeant, which came about as a result of the transitional protections adopted as part of the public service pension scheme reforms in 2014 and 2015.

This briefing note summarises the LGPS (England and Wales) consultation only and considers the impact on funding, administration, accounting and other related issues. The full consultation is [here](#). Scotland and Northern Ireland are to be dealt with separately. The consultation runs until 8 October 2020 and we will be responding to the consultation. We would be happy to share our more detailed response with you ahead of the deadline.

A quick summary

- The remedy proposes that the transitional underpin protections will extend to all members active on 31 March 2012 and who have accrued benefits since 1 April 2014 in the career average (CARE) scheme and also amends how the underpin works
- The underpin period will apply from 1 April 2014 to 31 March 2022 and ceases on reaching the 2008 Scheme normal pension age, retirement, leaving or death in service, if earlier
- Members will get the higher amount of pension accrued under either the 2014 Scheme (CARE) or that would have been accrued under the 2008 Scheme (final salary) in the underpin period while retaining the final salary link into the future (but of course it's more complicated than that!)
- From 1 April 2022, all members will accrue benefits in the 2014 Scheme and there will be no underpin applied to membership from that date
- Administration of the extension of the underpin is going to be onerous for administering authorities, requiring, for example, exercises in communications, data collection, option to amalgamate memberships and review of records back to 1 April 2014, and for many members the underpin will need to be calculated twice
- There will be an impact on funding and contributions. At whole fund level this should be relatively small, although there could be a larger impact on some (generally smaller and/or less mature) employers



BARRY MCKAY
Partner and Actuary

- We do not intend to revisit the 2019 valuation results and any employer contributions as we allowed for the cost of McCloud in the valuation process, but there may be some employers that funds will want to look at more closely
- We do not believe that accounting reports produced by us need to be revised as our approach, based on analysis by the Government Actuary's Department (GAD), closely replicates the proposed remedy
- The Government also announced the unpausing of the 2016 cost cap process, which will now take into account McCloud, but could lead to even further benefit changes

The consultation

As a reminder the current underpin was originally provided to protect members within ten years of normal retirement age when reform to the Scheme was announced. The proposed remedy is to extend this underpin to all active members as described in the summary. Other key elements are as follows.

The proposed remedy is a two-stage process with the underpin being calculated at the underpin date and recalculated and applied at the underpin crystallisation date. The underpin date is the earliest date at which the member leaves active service with an immediate or deferred pension, reaches their 2008 Scheme normal pension age (NPA), or dies. The crystallisation date is the date the member starts to receive benefits. The underpin date will be used to inform and communicate benefits to members but there will be no change in accrued benefits at this stage. This only applies at the crystallisation date.

Qualifying members will receive the higher of CARE and final salary pension in respect of the underpin period. Importantly, the final salary link has been retained and so the underpin test will be based on the member's final salary at date of leaving service or the 2008 Scheme NPA. Note that the NPAs of the 2008 Scheme and the 2014 Scheme may be different and so the underpin will also take this into account. This could mean that the benefit accrued under CARE is higher but if a member was to retire at say, age 65, and an early retirement reduction was applied to the CARE pension, then the final salary benefit may then be higher. Where a member remains in active service after their 2008 Scheme NPA, late retirement factors will be applied to the final

salary benefit prior to comparison. Where there is a gap between the two underpin calculation dates, cost of living increases will also be applied to both prior to comparison.

⋮ If the 2008 Scheme benefits are higher at the underpin crystallisation date, the additional amount will be added to the CARE annual pension.

Impact on members

This is quite complicated so a couple of examples of how the CARE and final salary benefits compare and work in practice on early, normal and late retirement are given below. The calculated accrued pension under each scheme has been revalued to the appropriate retirement age and then early or late retirement reduction or increase factors applied as appropriate. The tables consider a member aged 50 and aged 30 at 1 April 2020 respectively (so aged 52 and 32 at 1 April 2022 respectively).

For the 50-year-old member, the CARE pension is higher at each retirement age as there is not sufficient time for the higher salary growth under the 2008 Scheme (compared to CPI on CARE) to catch up with the higher accrual rate of the 2014 Scheme (49ths accrual versus 60ths accrual). However, for the 30-year-old member this result is reversed. The 2008 Scheme pension is higher at each retirement age as the higher salary growth outweighs the higher 2014 Scheme accrual rate, as there are over 30 years before the member reaches retirement. Therefore, we could be seeing the effects of McCloud for many years to come!

	Accrued pension 31 March 2022	Pension revalued to age 63	Early retirement pension at age 63	Pension revalued to age 65	"Normal" retirement pension at age 65	"Late" retirement pension at age 68
CARE pension	£5,676	$£5,676 \times 1.025^{11}$ = £7,447	$£7,447 \times 0.778$ = £5,794	$£5,676 \times 1.025^{13}$ = £7,824	$£7,824 \times 0.857$ = £6,706	$£5,676 \times 1.025^{16}$ = £8,426
Final salary pension	£4,241	$£4,241 \times 1.035^{11}$ = £6,192	$£6,192 \times 0.901$ = £5,579	$£4,241 \times 1.035^{13}$ = £6,633	£6,633	$£4,241 \times 1.035^{13} \times 1.12$ = £8,003

Based on salary of £25,000 at 1/4/2014, full time service from 1/4/2014 to 31/3/2022 and NRD of 1/4/2035
Assumes CPI of 2.5% p.a., salary growth of CPI+1%, GAD early retirement reduction factors, 2008 Scheme NPA of 65 and 2014 Scheme NPA of 68

	Accrued pension 31 March 2022	Pension revalued to age 63	Early retirement pension at age 63	Pension revalued to age 65	"Normal" retirement pension at age 65	"Late" retirement pension at age 68
CARE pension	£5,676	$£5,676 \times 1.025^{31}$ = £12,203	$£12,204 \times 0.778$ = £9,494	$£5,676 \times 1.025^{33}$ = £12,821	$£12,821 \times 0.857$ = £10,988	$£5,676 \times 1.025^{36}$ = £13,807
Final salary pension	£4,241	$£4,241 \times 1.035^{31}$ = £12,320	$£12,320 \times 0.901$ = £11,101	$£4,241 \times 1.035^{33}$ = £13,198	£13,198	$£4,241 \times 1.035^{33} \times 1.12$ = £15,924

Based on salary of £25,000 at 1/4/2014, full time service from 1/4/2014 to 31/3/2022 and NRD of 1/4/2055
Assumes CPI of 2.5% p.a., salary growth of CPI+1%, GAD early retirement reduction factors, 2008 Scheme NPA of 65 and 2014 Scheme NPA of 68

These are, of course, only two examples from a wide range of possibilities and, as ever, the results will be highly dependent on the assumptions and actual experience of each member. For example, increasing salary growth even just a small amount to CPI plus 1.25% results in a range of outcomes for the 50-year-old member – a higher benefit under the 2014 Scheme at age 63 and age 68 but a higher benefit under the 2008 Scheme at age 65. For the 30-year-old member, the 2008 Scheme will always be higher.

Reducing salary growth to CPI plus 0.5%, means that the 2014 Scheme pension is always higher for the 50 year-old while providing very similar benefits for the 30 year-old at all retirement ages. While it is complicated the consultation provides for the underpin to apply to members without the need for any action by them.

Impact on funding and contributions

More work is needed, but across the whole Scheme we estimate that the impact of the remedy might be to increase the liabilities by around 0.3% or around £0.9bn. This will depend on several factors; in particular, assumed salary growth relative to CPI and the level of withdrawals. This is significantly less than the £2.5bn estimated by GAD. This is largely because the salary growth assumption made by GAD is CPI plus 2.2% which is materially higher than our assumption for the 2019 E&W valuations which was typically CPI plus 1% p.a.

The impact of the remedy might be to increase average primary contributions by around 0.2% - 0.3% p.a. of pay and secondary contributions by around the same (with more variability at individual employer level). However, as we have already allowed for McCloud in our 2019 valuation calculations through various mechanisms, such as increased prudence in the discount rate or an explicit asset reserve, we do not intend to revisit the 2019 valuation results (but see below on variability by employer) as our certified contributions will have already anticipated these increases. Any further differences will be captured at the 2022 valuation and of course subsequent valuations, where experience differs from what has been assumed. Details of each fund's McCloud allowance can be found in their Funding Strategy Statement.

Variability by employer

Although the impact is likely to be small at whole fund level it could be significant at individual employer level. The member examples shown above illustrate how the impact on funding and cost could be very variable at member level and therefore at employer level.

For many employers in the LGPS with a mature workforce, like the councils, there is likely to be minimal impact. Although promotional increases could result in a material cost for certain members as the 2008 Scheme pension could exceed the 2014 Scheme pension as where salary increases are higher, the underpin is more likely to bite.

For employers with a young workforce (e.g. academies and leisure centres) there could be a material impact on costs – the 2008 Scheme pension for the member above is between 15% and 20% higher than the 2014 Scheme pension at retirement ages 63 and 65.

Smaller employers may also be more affected. The change in an individual member's benefits may make up a significant proportion of their current liabilities and therefore the impact on smaller employers is likely to be more volatile.

Where there has been a material change in liabilities, the LGPS Regulations allow for a valuation to be carried out between valuation dates, and the contributions in the rates and adjustment certificate to be revised. Given the examples above, you may want to consider if you have any employers that could fall into this category and request a revised valuation.

Impact on administration

We always knew that, whatever the remedy, there would be a lot for funds to do, particularly in relation to administration. It's important, given the scale of the task, that funds start to plan ahead and think what they can be doing now to get ready for implementation. While the consultation plans for the Scheme Advisory Board (SAB) to continue to produce some centralised guidance and materials to assist and provide consistency across the various funds, administration system providers have estimated that it may take up to twelve months to update their systems to be able to deal with the administrative complexities. It is clear that project planning and additional resources will be required.

Communication to employers and members is a key current area of focus.

- Qualifying members not only need to know that the underpin will be applied to them without the need for any action on their behalf, but to have their expectations managed of when their benefits will be reviewed if necessary.
- Employers need to understand the requirement to provide historic and ongoing data to enable the 2008 Scheme benefits to be calculated. The SAB implementation group have been working on materials to assist with this.

The consultation proposes that the underpin applies only to those who have amalgamated their service and, to avoid members losing out as a result, provides for a reopening of the aggregation window for twelve months for certain members. It also proposes the inclusion of underpin date results on annual benefit statements. Communications will, therefore, continue to be an area of focus.

Ensuring that the data to calculate 2008 benefits is obtained and uploaded onto records will be a huge task ahead of an exercise to review or carry out calculations for the qualifying members since 1 April 2014. With the underpin changing in its operation, this will include not only the additional members covered by the underpin, but those who were previously covered as well.

Where members have retired and their benefits have been put into payment, arrears may be payable, and in general the proposals bring a number of pension tax complications to consider and to respond on.

Looking forward, staff and employers will need to understand these requirements for some time to come as administering authorities will need to hold final pay data for around 50 years to calculate the final salary when you consider a member who joined in 2012 at age 20, could be retiring at age 68!

Given the scale of the overall task, now is a good time for administering authorities to move forward their planning processes, and to ensure that their pension committees and local pension boards are fully aware of the task ahead.

Impact on the cost cap mechanism

For the avoidance of doubt, this section is talking about the cost cap mechanism relating to the 2016 Scheme valuation carried out by GAD! This, along with the SAB cost cap, had been paused because of the uncertainty surrounding the McCloud costs and their impact on the cost cap calculations.

To recap, initial calculations carried out on behalf of the SAB indicated that the cost of the Scheme had fallen by around 0.9% of pay, due to lower life expectancy at 2016 relative to the assumptions adopted for the 2014 Scheme costings.

Several benefit improvements had been proposed including removal of the Tier 3 ill-health retirement benefit, possible employee contribution reductions at the lower pay bands and a minimum death in service grant.

The Government has now confirmed that the cost of the McCloud remedy will be included in the cost cap calculations and so will impact on any benefit improvements that were previously anticipated. The process is that the SAB carry out their calculations first and suggest changes to HMT. HMT then carry out slightly different calculations and make the required changes to the Regulations to allow for any required benefit changes. We understand that the intention is to have the cost cap calculations concluded by the start of 2021 with any changes applying retrospectively with effect from 1 April 2019 in England and Wales. Although it's possible that the cost of McCloud will mean that there are no other benefit improvements required.

At the same time, the 2020 Scheme valuation in E&W will proceed alongside a review of the cost cap mechanism, with the review taking place before the results of the valuation are finalised.

Impact on accounting disclosures

The SAB, with consent of the Ministry of Housing, Communities and Local Government (MHCLG), commissioned GAD to report on the possible impact of the McCloud judgement on LGPS liabilities, and in particular, those liabilities to be included in local authorities' accounts as at 31 March 2019. This followed an April 2019 CIPFA briefing note which said that local authorities should consider the materiality of the impact. This analysis was to be carried out on a "worst-case" basis, (i.e. what potential remedy would incur the highest increase in costs/liabilities).

We used the analysis provided by GAD to estimate the possible impact of the McCloud remedy. However, as pension fund accounting is a best estimate, we adjusted GAD's analysis to allow for the estimated cost in respect of members that were active as at 31 March 2012 (in line with that proposed in the Government's consultation) and to reflect the employer's salary increase assumption. This adjustment is an estimate of the potential impact on the employer's defined benefit obligations.

An allowance has already been made for McCloud for all employers, unless an employer has specifically requested no allowance to be made. Fortunately for our funds, our approach replicates the proposed remedy.

So although auditors are being more pedantic in their review, we believe our estimate remains appropriate and avoids the need to revisit accounting reports, saving our funds and their employers the hassle and cost of revisiting reports.

Next steps

There are a number of areas which funds can now be getting on with and others where funds can start to plan for the volume of work that will be required for this project. At Barnett Waddingham we can help funds at each step of the way to prepare for and to deal with the various issues as efficiently as possible.

As noted above, exercises in communications, data collection, the option to amalgamate memberships and a review of records back to 1 April 2014 will be among the work required.

In addition, consider any employers that may be impacted materially as a result of their membership profile and request an updated valuation and contribution rate calculation in advance of the 2022 valuation if necessary.

Project management

There is no doubt that this is a significant project which will require project management. Considerations will therefore need to be made around fund resource as well as the other issues raised in this briefing note. At Barnett Waddingham we have the knowledge and experience to help you with preparing for this project and in managing and delivering it. Please get in touch with [Annemarie Allen](#) for more information.

Consultation response

We will be replying to the consultation and would be happy sharing this with you in case it helps to inform your response. In the meantime, if you have any queries please get in touch with your usual Barnett Waddingham contact or via the details below.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

✉ info@barnett-waddingham.co.uk

☎ 0333 11 11 222

www.barnett-waddingham.co.uk

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