HYMANS ROBERTSON

Actuarial update

Recent Regulatory Changes in the LGPS

Executive Summary

- The outcome of the McCloud court case ruled that the transition protections given to older members when the 2009 LGPS final salary scheme closed are age discriminatory. The remedy is to retrospectively apply the same protections to all members who were in the 2009 LGPS scheme on 31st March 2012. This will likely result in a small increase in liabilities at Fund level (increase for a typical fund is 0.2% of liabilities). Increases for some employers may be significantly higher. The effort required to implement the remedy will be significant and it is estimated the project will take 2 years or more to complete.

- The 2017 HMT cost management valuation process has recommenced and may result in changes to member benefits or member contribution rates. Any changes will be back dated to 1 April 2019. The 2020 HMT cost management valuation is expected to start shortly, although it is still subject to the outcome of an ongoing review into the cost management mechanism.

- The Goodwin case is another discrimination case addressing discrimination of the grounds of sexual orientation. Again, although the funding costs are small, this will be a further administration and communication burden to address.

Addressee and purpose

This paper has been commissioned by and is addressed to The Highland Council in its capacity as Administering Authority to the Highland Pension Fund ("the Fund"). It has been prepared by Hymans Robertson LLP (as Fund Actuary) to assist the Fund's Pension Committee and Local Pensions Board to understand the nature and impact of recent changes to the regulatory framework which the Fund operates within. This paper should not be used for any other purpose or published without our written consent.

Introduction

This paper addresses both funding and administration issues raised by the following regulatory changes and processes.

- McCloud (funding implications and cost)
- Cost management valuations for 2017 and 2020
- Goodwin ruling regarding equality of survivor benefits in same sex marriages again including the funding implications for your Fund and employers

The McCloud judgement

The cause: transitional protections

One feature of the reform of all public sector pension schemes in the first half of the 2010s was the commitment to protect older members from scheme benefit changes that came into force in April 2015. For the LGPS, this protection took the form of an underpin. From 1 April 2015, an eligible member would receive the better of benefits earned under the old 2009 scheme (60ths accrual, final salary, retirement age of 65) or the new 2015 scheme (49ths accrual, Career Average Revalued Earnings (CARE), retirement age equal to State Pension Age).

The format of the protections differed between public sector pension schemes, however they were all uniform in applying the eligibility criteria – the protections would only be applicable to members who were:

- active in the scheme as at 31 March 2012;
- within 10 years of their Normal Retirement Age (as defined under the pre-reform scheme rules, 65 in the LGPS) as at 1 April 2012.

Who benefits from the underpin?

A summary of the benefit changes introduced in 2015 are shown below:

	Final Salary scheme	CARE scheme	Impact
Accrual rate	1/60th	1/49th	Increase of 22%
Revaluation rate	Salary increases	Consumer Price Index	Depends on an individual's salary growth
Retirement age	65	State Pension Age (SPA)	Decrease for members where SPA is after 65

Due to the significant increase in benefit being earned each year through the increased accrual rate in the 2014 CARE scheme, a member would only benefit from the underpin if salary increases throughout their working life were significantly higher than inflation.

Challenge to the protections

In 2016/17, a member of the Judicial Pension Scheme (named McCloud) brought a claim of age discrimination against the Ministry of Justice (MOJ) due to the imposition of the transitional protections. The member contested that, by applying the protections only to those members within 10 years of retirement at March 2012, younger members of the scheme were at a disadvantage.

The Ministry of Justice conceded that the protections did put younger members at a disadvantage, however they argued that this treatment was justified. The justification being that the members in scope of the protections would likely already have made advanced plans for financing their retirement and any change to their pension scheme may adversely affect these plans.

A separate but similar challenge was also launched by a member of the Firefighters' Pension Scheme (Sargeant).

The Employment Tribunal found against the MOJ and the member's complaints were upheld.

This original decision was appealed by the Government until it reached the Court of Appeal for consideration in November 2018. On 20 December 2018, the Court of Appeal ruled that:

- the Government's appeal was to be dismissed; and

- the claim of discrimination of the grounds of age is valid.

Following on from this ruling, in the first half of 2019 the Government sought leave to appeal this ruling at the Supreme Court. However, in June 2019, the Supreme Court refused the Government's application to appeal, meaning that the Court of Appeal's decision was final.

Following the Court of Appeal's decision at the end of 2018, in January 2019 the decision was been taken by the Government to suspend the ongoing Cost Cap valuations[1]. Further detail about the Cost Cap valuation, its interaction with McCloud and impact on funding is contained later in this note.

After the Supreme Court confirmed they would not hear the Government's appeal, in July 2019, the Government accepted[2] that the protections put in place were discriminatory and committed to remedying the situation. The court cases to date were only in respect of the Judicial and Firefighters' Pension Schemes. However, the Government also accepted that the ruling would, if tested, also apply to all other public sector pension schemes which implemented age-based transitional protections during the reform process. This includes the LGPS.

Since then, discussions have been taken place to assess how best to resolve the discriminatory elements of the benefit structure (what has now become commonly referred to as "finding a solution" to "McCloud" or "the McCloud judgement"). It is not a viable option to entirely remove the transitional protections as that would involve reducing the accrued rights of some members (i.e. those eligible for the original protections and who would have benefitted, via higher benefits, from the existence of the protections). Therefore, the discussions have been focussed on how to adequately "level up".

Remedy

On 31st July 2020 SPPA published consultation documents[3] setting out detailed proposals for addressing the discrimination. The consultation process closes 23 October 2020. Hymans Robertson will shortly be publishing their response to SPPA's consultation (as it was released in mid-July, we have already published our response to MHCLG's consultation regarding England & Wales which can be found at the link below[4]).

In summary, the proposed 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 in the scheme at 2012, 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 2015;
- The underpin period applies between 1 April 2015 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; and

[1] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2019-01-30/HCWS1286/
[2] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2019-07-15/HCWS1725/
[3] https://pensions.gov.scot/local-government/scheme-governance-and-legislation/consultations
4 https://www.hymans.co.uk/media/uploads/Hymans_Robertson_McCloud_Consultation_Response.pdf

- The normal pension age for CARE benefits (State Pension Age) can be after the normal pension age for final salary benefits (65). The underpin requires the impact of any applied actuarial reductions to be considered in assessing which benefit is higher.

The proposed 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.

There is significant complexity in the detail of how the underpin will apply and the consultation addresses the topics of early leavers, deaths in service, early and late retirements, ill health retirements, members with multiple posts, breaks in service and aggregations of service across different LGPS employments, transfers between public sector schemes, annual allowance implications and the requirement to include information on the underpin on members' annual benefit statements.

Impact on funding and employer costs

At whole fund level, we don't expect the McCloud remedy to have a significant impact on the funding position and hence on employer costs.

Based on typical LGPS funding assumptions, we estimate that total liabilities could increase by c.0.2% (or by 0.6% of active liabilities). This figure may be different from other estimates, the difference is due to a combination of factors, with the pay growth assumption being a crucial one for the reason set out above. The Government estimate uses CPI +2.2% pa which is significantly higher than that used by a typical LGPS fund. For this Fund, the pay growth assumption is CPI + 0.8%.

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 across the employers in the Fund.

The variation in McCloud underpin impact arises due to differing membership profiles, and particularly age. Younger members will have a longer period of future 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 in the Fund may see their total liabilities increase by as much as 5-10% whilst other employers will see no impact at all. There is also the potential for employers to award one-off significant pay increases which may result in an impact greater than noted above. It is worth noting that the 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.

Formal valuation approach

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.

Administration impact of McCloud

Despite the relatively small liability impact of the McCloud ruling, the administration impact will be significant. In conjunction with key stakeholders, the Fund will have to initiate and deliver a project to adjust member's records to reflect the new underpin and to correct any benefits which have already come into payment.

This project will take many months, and potentially years of effort depending on the membership affected. Key stages will include:

Understanding McCloud and establishing a project plan

The key outcomes from this stage will be to identify who is going to be working on the project, the key stakeholders and ensuring that they have the right level of knowledge. This stage would be expected to last until after the consultation process concludes and some outstanding policy decisions have been made. The UK Government have indicated that final Regulations may not be available until 2022/23 but have urged Funds to begin work in the interim.

Identifying cases

Cases in scope then need to be identified using the key criteria set out in the consultation. In most funds around 20 -25% of members are impacted. Work has already begun on identifying cases in order to identify the groups and employers of members impacted within this Fund.

Adjusting records

Member records need to have the correct information to enable an underpin calculation to be completed. This is one of the most challenging areas of the project and will involve significant engagement with employers to gather salary and working hours data back-dated from 1 April 2015. In some funds, this data has not previously been collected, as it wasn't needed to administer CARE benefits. This will be challenging as some employers will have left the Fund, some may have changed payroll providers and some simply won't have kept the records required. There will be a need for policy decisions on how to approach situations where it isn't possible to complete the data record but the Fund must ensure the members' benefits are calculated accurately and the underpin applied fairly. The data specification for employers will have to be changed in order to ensure the correct data is captured within future processes.

Recalculation of benefits

When the data is sourced for identified cases, the members' benefits will need to be re-calculated. For members still in service, or those who have left the Fund before retirement, their accrued pension may have changed and their annual benefit statement may need to be adjusted. There may be annual allowance tax implications for some members. Some of these calculations will be complex as a result of some of the issues mentioned above. Liaison with system providers is underway to specify changes required to the administration software to support the recalculation processes and ongoing requirements to assess the underpin. Early indications are that it may take around 12 months for administration providers to fully develop the calculation routines required.

Calculate arrears and interest and then pay arrears

Arrears and interest payments may be due for some members whose benefits are already in payment, if the McCloud underpin would have resulted in a different pension for these members. In some cases where benefits are changing there may also be tax charges for members. The tax implications of these proposals are complex as members who would not have breached annual allowance under the CARE scheme may breach annual allowance if they become eligible for an underpin.

Final record adjustment to both the administration and payroll record if applicable

Finally, the member administration and payroll records will need to be updated with the calculated position and this must be maintained going forward.

Audit check and Stakeholders

There is a significant list of stakeholders who will be involved in the project including current and former employees, their dependents, fund employers, your actuary, pensions committee and board, SPPA and Treasury departments, Scottish SAB and others. Different stakeholders require different levels of involvement at the different stages of the project but communication across all groups about progress, issues and outcomes and costs will be vital. Given the complexity of the project checking and audit processes will also have to be robust.

Project management

The size and complexity of this project means that it will also require proportionate project management resource and expertise.

McCloud summary

Remedying the discrimination identified by the McCloud judgment will be a significant undertaking for the Fund's administration team. We expect further updates to be provided to Pensions Committee in due course.

Cost Management Valuations 2017 and 2020

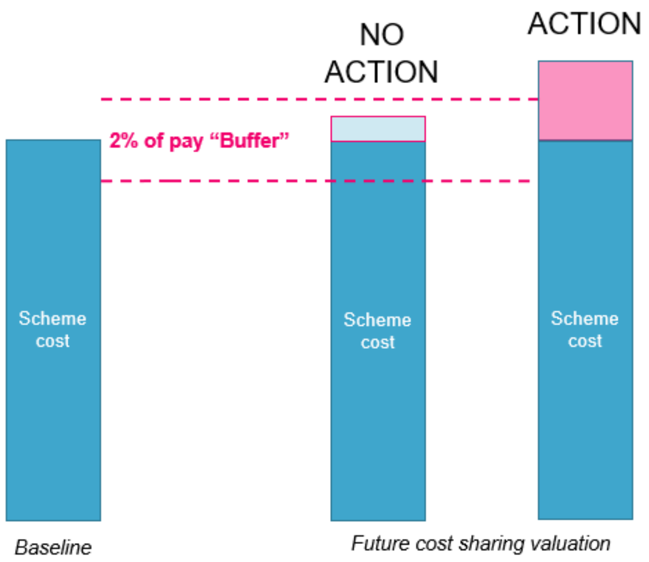
In addition to McCloud, the "Cost Management Valuations" are an ongoing national process which are resulting in current uncertainty around the benefit structure of the LGPS. These valuations where similarly borne out of the public service pension reform in the early 2010s.

Background

As part of the reforms discussed earlier in this note, a mechanism was put in place which sought to put in a safety valve and protect employers from significant increases in future pension costs and to support the long-term sustainability of a defined benefit pension offering.

Historically, any variations in pension costs fell to the employer to fund as both benefits earned and employee contributions were defined in the Regulations. The cost management mechanism sought to re-distribute the risk and share any cost variations with members. Prior to this mechanism being introduced, employer contributions had been on an upwards trend across a number of valuation cycles.

The cost management mechanism works on the basis that every 3 or 4 years (the frequency varies between public sector pension schemes), a valuation at national level will be carried out by the Government Actuary's Department on behalf of the Government to assess the overall cost of pension provision for each public sector pension scheme. The assessed cost will then be compared against a benchmark cost. If the difference between the assessed costs and the benchmark cost is equivalent to more than 2% of pay, then action will be taken to amend the benefit structure or employee contribution rates such that the changes result in the current cost matching the benchmark cost. If the variation is less than 2% of pay then no action is taken.



The cost management valuation is carried out on a set of assumptions set by HM Treasury, and differ from those used for the purposes of your formal valuation to set employer contributions. One of the key features of the cost management valuation is that it limits the factors for inclusion to those that have an impact on the benefit received by a member e.g. life expectancy, level of ill health retirements etc.. Critically, it makes no allowance investment returns earned on assets.

The mechanism was originally intended to act as a capping mechanism on costs i.e. action would only be taken if costs were higher than expected. However, during the reform implementation, the mechanism was amended to a symmetrical design i.e. there would be a cap and a floor on cost. Therefore, if costs were less than expected, then action would be taken to improve the benefit structure to restore the cost to its benchmark level. In essence, the Cost "Cap" became Cost "Sharing".

The first cost management valuations were carried out as at 31 March 2016 for the unfunded pension schemes (e.g. NHS, Teachers, Police, Fire etc.) with initial results communicated in Autumn/Winter 2018 to the relevant Scheme Advisory Boards. These valuations showed a significant reduction in the cost of pension provision. The typical result was a saving of around 3-5% of pay. This was mainly attributable to reductions in life expectancy and an extension of restricted salary increases.

As this cost variation was more than 2% of pay, and the wording of the governing regulations gave no option but to, the benefits in affected schemes would need to be improved or employee contribution rates reduced. These changes were due to be come into force under the relevant regulations by 1 April 2019.

Interaction with McCloud Case

Whilst the Government was dealing with the emerging cost management valuation results, they also learnt of the Court of Appeal's ruling in the McCloud case.

It was the Government's opinion that any increase in benefits due to McCloud should be factored into the ongoing cost management valuations. Given that the McCloud remedy will result in an increase in pension costs, it may be of such a magnitude that the cost saving identified at the cost management valuations reduces to less than 2% of pay. If this were to be the case then no action would be needed to amend benefits from 1 April 2019. (Note that at this stage we are unable to assign a probability to how likely this outcome is).

Therefore, the Government announced in January 2019 that the cost management valuation process would be put on hold until McCloud was resolved. After the resolution, the Cost Cap valuations would be restarted and, if any changes are required to be made to benefits or contributions, then they would be backdated to 1 April 2019.

Legal challenge

The action by Government to suspend the implementation of scheme changes as a result of the cost management valuations has recently been challenged by four Unions (Fire Brigades Union, Public and Commercial Services Union, the Professional Trades Union for Prison, Correctional & Secure Psychiatric Workers and the GMB Union). In April 2020, these Unions have filed court proceedings against the UK Government arguing that the suspension breaches the cost management regulations (which states benefits changes must come into force from 1 April 2019)[5].

The challenge also effectively asserts the Unions' belief that the costs associated with resolving McCloud sit outside the cost management mechanism.

The case is still ongoing, however, on 16th July the Treasury announced that the cost management process for will be re-started and a further direction will follow on how McCloud will be allowed for in the cost management valuations.

[5] https://www.fbu.org.uk/news/2020/04/25/firefighters-take-government-court-over-pension-%E2%80%98robbery%E2%80%99

Impact on LGPS Scotland

The first cost management valuation of LGPS Scotland is as at 31 March 2017 and carried out by the Government Actuary's Department (GAD). Due to the suspension of the 2016 cost management valuations, we 0understand that GAD have not made any significant progress on the LGPS Scotland 2017 cost management valuation.

However, given the factors that gave rise to the savings observed at the 2016 valuation were life expectancy and salary increases i.e. national factors, it is reasonable to expect that the result of LGPS Scotland's cost management valuation will be similar i.e. a saving of around 3-5% of pay. This would result in a change to the scheme benefit structure or employee contribution rates from 1 April 2020.

Impact on the 2020 valuation

If the LGPS Scotland cost management results are similar to the savings observed in the 2016 valuations then this represents a significant source of upward pressure on employer contribution rates, which may not be balanced out by McCloud remedy costs. SPPA's letter to administering authorities also discussed cost management but gave no information, suggestion or guidance at the current time on how they would expect this risk to be incorporate or treated during the 2020 valuation (see Appendix for further details).

Ideally funds would start communicating such pressure with employers with as much notice as possible. Therefore, it is disappointing to not have any further information on the outcome of GAD's 2017 cost management valuation. We are hopeful that GAD, via SPPA, will be able to share more information (even if this is a rough indication of the result) within the next few weeks so that the Fund can incorporate it into the 2020 valuation funding plans with an element of uncertainty.

In the absence of any further information, the Fund will need to consider how best to manage the uncertainty around the cost of benefits due to the cost management. This will be closely monitored and discussed during the next few months.

The future of the cost management mechanism

The results of the 2016 cost management valuation were likely to have been unexpected when agreeing to implement a symmetrical design. The rigid regulations that were put in place gave the Government no option but to implement benefit increases following the publication of the cost management valuation results.

For many public service schemes, an increase to future benefits was announced at the same time as an increase to contributions (which arose due to a change in the HMT valuation assumptions, primarily the discount rate which is a factor not included in the cost management valuation).

In light of the unexpected results, the Government confirmed in September 2018[6] (when the first initial results started to emerge) that the cost management mechanism will be reviewed ahead of the next round of cost management valuations (due to take place as at 31 March 2020) to ascertain whether it still meets the policy intent.

However, until such a review has not been completed, existing legislation requires that the next round of cost management valuations should also take place. We understand that data will be requested for the 2020 cost management valuation in Autumn 2020 by the Government Actuary's Department.

[6] https://hansard.parliament.uk/commons/2018-09-06/debates/18090633000015/PublicServicePensionSchemesQuadrennialValuations

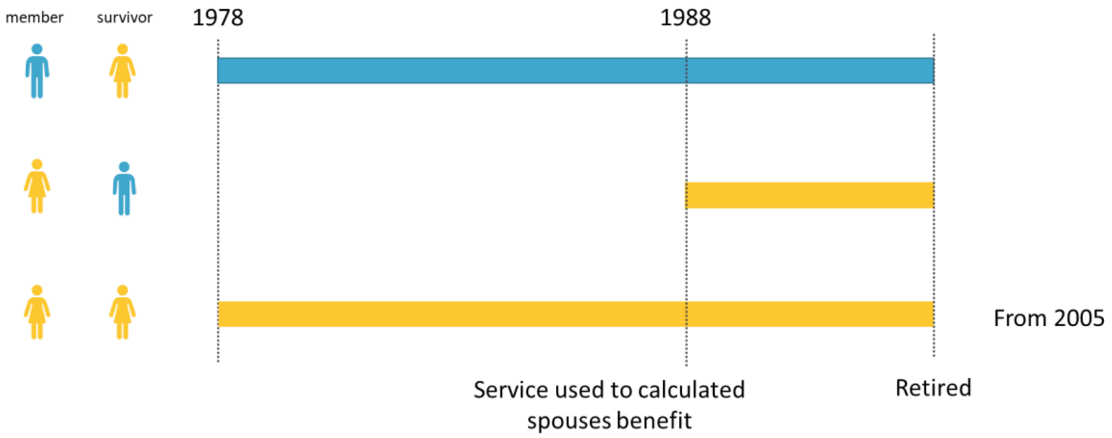
Goodwin ruling

The Goodwin tribunal was raised in the Teacher's Pension Scheme (TPS). It claimed members, or their survivors, were discriminated against due to their sexual orientation. The claim was because the TPS provides a survivor's pension for a female scheme member which is less favourable for a widower or surviving male partner than for a widow or surviving female partner . On 30 June 2020, the employment tribunal found in favour of the claimant and agreed there was discrimination which needs to be rectified. This finding and remedy is expected to apply across all public service pension schemes, including the LGPS, as the conditions that cause the discrimination are common to all schemes.

The conditions of the case are quite specific. They only apply to those member who:

- Entered into their partnership/marriage after leaving active status;
- Accrued benefit between 1978 and 1988; and
- Died after 2005.

The diagram below illustrates the inequality, with further explanation underneath.



The first case considers a male member who entered into their partnership/marriage with their spouse or partner after leaving active status. All of this member's service from 1978 until retirement would count towards the calculation of the survivor's pension.

The second case considers a female member who entered into their partnership/marriage with their **male** spouse or partner after leaving active status. Even if they had identical service histories to the male member in the first case, the survivor's pension would only be based on service from 1988 until they retired (if they entered into their partnership or marriage after leaving active employment). Historically, this situation was identified as unfair and female members were given an option to purchase the "missing service" to uplift their dependent's benefit.

However, in 2005, following on from the Walker Case[7] the definition of spouse in the regulations was expanded to include same sex relationships. In effect, from 2005, if a female had a female spouse or partner and their partnership/marriage was after they left active status, all their service since 1978 counted towards their survivor's pension and they weren't required to pay additional contributions to benefit from this uplift. Therefore, the tribunal found discrimination on grounds of sexual orientation.

[7] https://www.supremecourt.uk/cases/docs/uksc-2016-0090-judgment.pdf

Remedy

A group of members, namely females who have a male survivor, may have their survivor's pension uplifted to include any service accrued between 1978 and 1988.

In order to administer this all post-2005 deaths of female members will need to be investigated. In some circumstances, the Fund may not have any data on survivors or their whereabouts which could prove to be a significant challenge. This would be an unwelcome burden alongside McCloud activity.

For employers, the impact is likely to be a small increase in their liabilities. For a typical Fund these increases are estimated to be:

	Increase in Pensioner liability	Increase in Deferred liability
Overall increase for Fund	0.4%	0.1%
Worst employer increase	3.9%	1.0%
Proportion of employers with an increase in liabilities greater than 0.1%	18%	72%

Similarly to McCloud the impact is largely administrative rather than on pension scheme funding but could be significant at employer level depending on membership profile.

This issue is still evolving and we expect further announcements on rectification and remedy to be made in the coming weeks and months.

Summary and Next Steps

This paper highlights several important regulatory changes that will directly impact both members and employers over the coming months. Together, they represent a significant challenge to Fund administration processes and bandwidth, especially given the challenges of the current working environment. The Fund will have to consider how to manage this change program including:

- Project planning and management;
- Stakeholder communications;
- Resource requirement;
- Risk management; and
- Appropriate audit and oversight.

We would be pleased to provide further information or support on any of the topics mentioned above.

Reliances, limitations and professional notes

This paper should not be released or disclosed to any third party without our prior consent. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability.

This report complies proportionately with the relevant Technical Actuarial Standards set out below:

- TAS 100 (Principles of Technical Actuarial Work)

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For and on behalf of Hymans Robertson LLP

11 September 2020