BARNETT WADDINGHAM
beyond the expected

London Borough of Merton Pension Fund

Report to Pension Committee - Update on consultations impacting the LGPS

We have been asked by the London Borough of Merton, the administering authority for the London Borough of Merton Pension Fund (the Fund), to provide a report setting out updates and progress in relation to the various consultations that could affect the Fund.

This report provides the background to each consultation, the issues and potential impacts to stakeholders and any actions the Fund can and should be considering. The impacts on stakeholders are often wide ranging and varied so this report cannot provide specific advice but its purpose is to consider these impacts at Fund level.

The McCloud Judgement

Background

Based on the recommendations of the Hutton report, all public sector pension schemes were reformed in 2015 and benefits were changed going forwards. As part of this reform, transitional provisions were given to members, who in 2012 were within 10 years of their normal retirement age. The laudable aim was to ensure that any changes would not impact those members closest to retirement.

However, on 20 December 2018, these protections were deemed to be unlawful on the grounds of age discrimination. After a legal battle that saw firefighters and judges joining forces to claim discrimination on the grounds of age, Ms Sargeant and her peers were granted their claim by the Court of Appeal in 2018. In June 2019, the Supreme Court refused the government's application to appeal the court case, by then known as McCloud, which marked the end of the legal process.

The case through the Courts identified unjustified age discrimination in transitional protection arrangements in the Judicial and Firefighters' Pension Schemes. However, in relation to the LGPS, this difference in treatment exists between two groups of LGPS members:

- those who were in service on 31st March 2012 and were within ten years of NPA on 1st April 2012, therefore benefiting from underpin protection and potentially 'better off' than the second group; and,
- those who were in service on 31st March 2012 and were more than ten years from NPA, were not eligible for underpin protection and therefore potentially 'worse off' than the protected members (as they were not guaranteed a pension of at least the level they would have received in the final salary scheme).

Although the judgements are not about the **Local Government Pension Scheme** (LGPS), as rulings in public sector schemes, a remedy will need to be made across all public sector schemes. On 16 July 2020, HMT published a consultation on proposed remedies for the LGPS to remove the age discrimination. The consultation closed on 8 October 2020.

The Consultation

The consultation sets out how MHCLG propose to amend the statutory underpin to reflect the Courts' findings in the McCloud and Sargeant cases. Primarily, the proposals are to remove the age requirements from the underpin

qualification criteria. However, there are additional proposals to ensure that the underpin works effectively and consistently for all qualifying members following the extension of the underpin to younger members.

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

From April 2022, it is proposed that the period of underpin protection will cease and all active LGPS members will accrue benefits in the career average scheme, without a continuing final salary underpin.

The underpin will be checked at the underpin date (on leaving reaching NPA or death) and at the underpin crystallisation date, when the member takes their benefits. This will take into account any early/late retirement adjustments.

Impact on members

Analysis shows that on average members will see a small increase in benefits, however this will not be evenly spread. Younger members are likely to benefit more from the underpin as they have longer until retirement and the link to their final salary means that salary increases may outstrip the better accrual rate of the 2014 CARE scheme. In general older members are likely to receive higher benefits from the 2014 CARE scheme and so will not benefit from the underpin, but there will be variations by member.

Impact on funding and contributions

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 specific employer costs) as our certified contributions will have already anticipated these increases. Any further differences will be captured at the 2022 valuation.

Impact on administration

There is a significant amount of work to do for the administering authority, namely

- Historic data collection
- Updating pension processes and systems
- Retrospective and future underpin calculations and any backdated pension adjustments as appropriate
- Communications with employers and members

It is recommended that the Pension Committee consider resource requirements and plan accordingly.

BARNETT WADDINGHAM
beyond the expected

Public sector exit payments

Background

The aim of these changes are to avoid members receiving excessive pension and employment benefits on redundancy.

On 7 September 2020, the Ministry of Housing, Communities and Local Government (MHCLG) published a consultation on exit payment reform in the Local Government Pension Scheme (LGPS). The proposals, set out by MHCLG are of immediate relevance to English **Local Government Pension Scheme** (LGPS) funds. The consultation closed on 9 November.

The Consultation – the proposed cap

Under the existing LGPS Regulations members over age 55 are entitled to receive an immediate unreduced pension if they are made redundant. The resulting strain cost of providing this unreduced pension can be significant. It is proposed that the strain cost is included in the value of the total redundancy package, together with statutory redundancy pay and any other discretionary pay and the total cost of the redundancy package should not exceed £95k. If the cap is exceeded the redundancy package must be scaled back.

The problem for administering authorities

On 4 November 2020 the Restriction of Public Sector Exit Payments Regulations 2020, came into force. This does, however, bring into existence a potential conflict between the two sets of regulations – the Exit Cap Regulations and the LGPS Regulations - where both are applicable and where a member over the age of 55 is made redundant. As the LGPS draft Regulations are still under consultation until 18 December 2020, then in the intervening period there will be a simultaneous obligation that:

- Funds must pay out unreduced pension benefits to the member immediately, including that element above the £95k cap, in line with the current LGPS Regulation 30 (7)
- Employers must not fund any element of the strain cost above the £95k cap, in line with the new Exit Cap Regulations

As things stand there is a serious inconsistency between the exit cap regulations that employers have to adhere to, and the LGPS regulations that bind Administering authorities and employers.

What can we do about it?

The LGA has now published guidance in the form of exit cap information for LGPS employers and for administering authorities. The guide for employers goes step by step through employer obligations and decisions under the exit cap regulations now in force. In particular it sets out the risks of making a cash alternative payment at the moment. The guide for administering authorities sets out the decisions which authorities need to make now including a useful step by step guide that will help with liaising with scheme employers.

Administering authorities and employers should take urgent legal advice if they find themselves with any members that will be affected by the cap before the regulatory conflict is resolved. Administering authorities should, without delay, decide on a policy for paying pensions to members affected by the exit payment cap, following the LGA guidance.

How will members be affected?

What is clear from the latest proposals is that more members are likely to be affected by the cap than perhaps originally envisaged.

For example, as the proposals are currently written, even in cases where the total value of the exit package is less than £95k, some members who are made redundant with an early retirement strain cost becoming payable, would still have their pension reduced by an amount based on their statutory redundancy pay. It is also likely that no additional discretionary pay would be permissible.

This appears to go well beyond the Treasury's expectations when they set the ball rolling on these reforms around 5 years ago and will have the politically undesirable effect of penalising low earners. It seems unfair why a member, whose exit package is well below the £95k cap, should be expected to, in effect, give up all of their redundancy pay - particularly when an element of it is statutory.

To tackle some of these issues an element of choice is being introduced for members as follows:

- Immediate partially reduced pension, receives statutory redundancy pay but no discretionary pay
- Immediate full pension but potentially no statutory redundancy or discretionary pay
- Immediate fully reduced pension, receives statutory redundancy and discretionary pay
- Defer pension until normal retirement, receives statutory redundancy and discretionary pay

Key considerations for the Fund

The Fund needs to decide whether to pay the reduced or full pension benefits to a member over age 55 being made redundant. There is no best option for administering authorities only a least worst option. It is likely funds will comply with the exit cap regulations and pay the reduced benefit with a potential increase to members in the future if there is a challenge or change in approach. Any benefit options or illustrations should be caveated appropriately.

Funds also need to decide what actuarial factors to adopt – the fund specific factors or the GAD factors. Previously this only impacted the timing of when employers funded the strain cost. However, now this matters as it could impact on members' benefit amounts.

We have provided the Fund with a modeller to help work through the different member options, employer' costs and impact on members benefits.

Management of employer risk

On 26 August the Government issued a partial response to the "Changes to the Local Valuation Cycle and the Management of Employer Risk" consultation issued in May 2019. This is the second partial response, this time focussing on flexibilities for employers in the LGPS and contributions payable. There are three main areas that have been considered.

Contribution reviews

The Government response suggests that contribution reviews should be available when an employer sees a significant change in liabilities and/or covenant but that an employer can make a request for a review at any time.

The Fund will need to carefully consider when it is appropriate to review an employer's contribution rate in between valuation dates and therefore a clear policy will be needed in the Fund's Funding Strategy Statement. It's important that this is communicated to employers and that they understand this policy to avoid inappropriate requests and also that any costs should be met by the employer.

Exit payments

There was overwhelming support from funds for additional flexibility on paying any exit debt. This will allow employers to spread any exit payments over a period of time, as agreed with and at the discretion of, the administering authority so as not to expose other employers in the Fund to additional risks. It also addresses the issue of the "too expensive to stay in, too expensive to get out" problem that many employers faced. Therefore, having clarity around this will help the Fund manage any employers with exit debts that are unaffordable as a single payment, which may have forced them into insolvency.

Deferred debt arrangements

Deferred debt arrangements will allow employers to continue to participate in the Fund without any active members. These arrangements are already well established in the private sector for multi-employer schemes and responses to this element of the consultation were also strongly in favour. In fact, it has been the cause of debate in the LGPS community as it wasn't clear whether these types of arrangements were possible under the existing Regulations and there are some of these arrangements already in place. They differ to spreading of exit payments as the value of the debt can be revisited with payments adjusted accordingly and so will require more regular monitoring, and their existence would remain subject to the ongoing agreement of the administering authority. This means the employer retains the risk of good or bad experience and so may end up paying more or less than the amount calculated at the date of exit.

At the time of writing, the Scheme Advisory Board has issued draft guidance for administering authorities and employers that is being considered by a working group.

Key considerations for the Fund

The Fund will need to consider the following, for example:

- What approach the fund wants to take to each option by considering the following:
    - When is it more appropriate to adopt a deferred debt arrangement or spreading an exit payment?
    - What situations could trigger a contribution review i.e. closed employer, merger, significant redundancy exercise or outsourcing. What evidence should be provided by the employer
    - The period where a review is possible e.g. is an employer review sensible in a valuation year when this is happening anyway
    - Should there be more detail in the FSS about how covenant is monitored and measured to tie in with trigger events for a contribution review?
    - What approach would be taken to employers who approach the fund for a contribution review as a result of budget restraints?
    - Which employers each policy does/doesn't apply to?
    - How regularly should deferred debt arrangements be reviewed? Does the Fund need a policy or is this on a case by case basis?
- Communicating the policy to employers
- Further training for Committees/Pension Boards
- Review any existing arrangements in place similar to deferred debt arrangements and consider whether any additional documentation needed

BARNETT WADDINGHAM
beyond the expected

- Consider any templates the Fund could use to simplify the process e.g. for deferred debt arrangements

Changes to male survivors benefits (The Goodwin case)

The Goodwin case affects male survivors (of female members) by extending the applicable service for calculation of benefits from 1988 back to 1978. This only impacts survivor benefits coming into payment after 2005. This doesn't affect who is entitled to benefit, it just impacts the amount to be paid to widowers.

Same-sex survivors were originally entitled to survivor benefits taking into account the member's service from April 1988, however retrospective amendments will be made with effect from 5 December 2005 (the date when civil partnerships became possible), such that those survivor benefits now take into account the member's service from 6 April 1978. Following the Goodwin Tribunal, regulatory amendments will now need to be made with effect from the same date to extend that entitlement to male survivors of female members.

No statutory guidance has been issued from MHCLG as the position is not clear on how retrospection of benefits affects the finality of transfers out or trivial commutation. This has a minimal impact on the Fund's liabilities but the administering authority may need to calculate any increase in benefit for these members.

Barry McKay, FFA

Partner