BARNETT WADDINGHAM
beyond the expected

Briefing

McCloud and Sargeant: what are the implications for the LGPS?

RISK | PENSIONS | INVESTMENT | INSURANCE

Since the last article we posted on the McCloud and Sargeant judgements, we are still not much closer to agreeing a remedy and the amount of 'new' information is limited. Despite this, it's important to understand what some of the financial implications on the Local Government Pension Scheme (LGPS) might be, to afford yourself enough time to plan ahead.

Extension of the underpin protections

In response to the judgements, it looks as though the remedy may be a form of extension of the current underpin. As a reminder, the current underpin in the LGPS was put in place following the Hutton reforms with the laudable aim of protecting those closest to retirement — specifically, active members who were within ten years of retirement in 2012. These protections, therefore, would have stopped from 2022. The underpin looks at the retirement benefits for each member that would have accrued under the 2008 Final Salary (FS) Scheme and the 2014 Career Average Revalued Earnings (CARE) Scheme. It then gives the member the better of the two.

The 2008 FS Scheme was based on an accrual rate of 60ths, whereas the 2014 CARE Scheme was based on an accrual rate of 49ths. So, assuming the same salary, a year of pension would have been around 22%* more valuable in the 2014 Scheme (i.e. salary x 1 year of service divided by 49 = pension). However, the FS pension is calculated using salary at retirement but the CARE pension is calculated using the relevant salary from each year and then adding up the annual accrued pension amounts.

Therefore due to the low salary inflation environment in recent years, we understand that the underpin has only 'bitten' in a handful of scenarios. This is largely as a result of promotional salary increases, as salaries have not increased sufficiently to outweigh the more generous accrual rate awarded under the CARE Scheme.

> The simplest idea is that the remedy will be some form of extension of the underpin to all members. It may also involve extending the protection period.

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Principal and Actuary

*Ignoring other changes the accrual rate has improved by 60/49 = 1.22 or 22%

The table below summarises the current situation.

What we know	What we don't know	Immediate actions
Upwards remedy	Who is in scope	Keep data (especially hours and service information)
HMT will set parameters	For how long protections last	There will be two working groups forming (policy and implementation)
LGPS treated separately	Timescales	
Extension of the underpin	Tax implications	
	Cost cap impact	

In terms of immediate actions there is a lot of work going on in the background so that agreement can be reached on how to deal with this issue as efficiently as possible. There will be two working groups alongside the implementation group, made up of actuaries, officers, software providers and other stakeholders. In the meantime, we would recommend keeping hold of historic data, especially relating to part time hours and service information, in case you need to go back and recalculate historic FS benefits.

On 4 March 2020 the Scheme Advisory Board issued a notice for administering authorities and employers to stress that any remedy will be done automatically, so as to provide reassurance that members do not need to take any action.

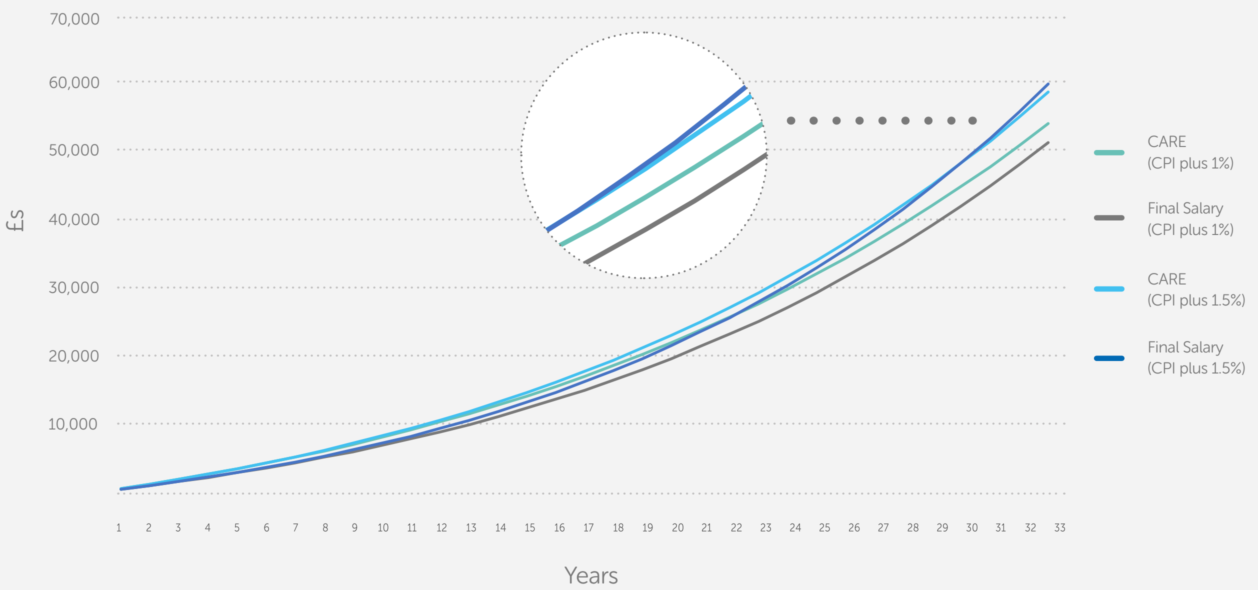
Financial implications on LGPS funds

What is clear is that the impact will vary by member and, therefore, by employer and Fund. What is also clear from our calculations is that the financial implications on funding are very sensitive to the actuarial assumptions used at the latest funding valuation. However, there are some rules of thumb which can generally be followed for different assumptions, as set out in the table below.

Salary increase assumption	Withdrawal assumption	Age profile
Higher = more effect (underpin more likely to bite).	Stronger = more leavers (underpin less likely to bite).	Younger = more effect (time).
Difficult to allow for individual member risk.		Final salary has longer to outrun CARE.
		More exposure to salary risk (promotions).

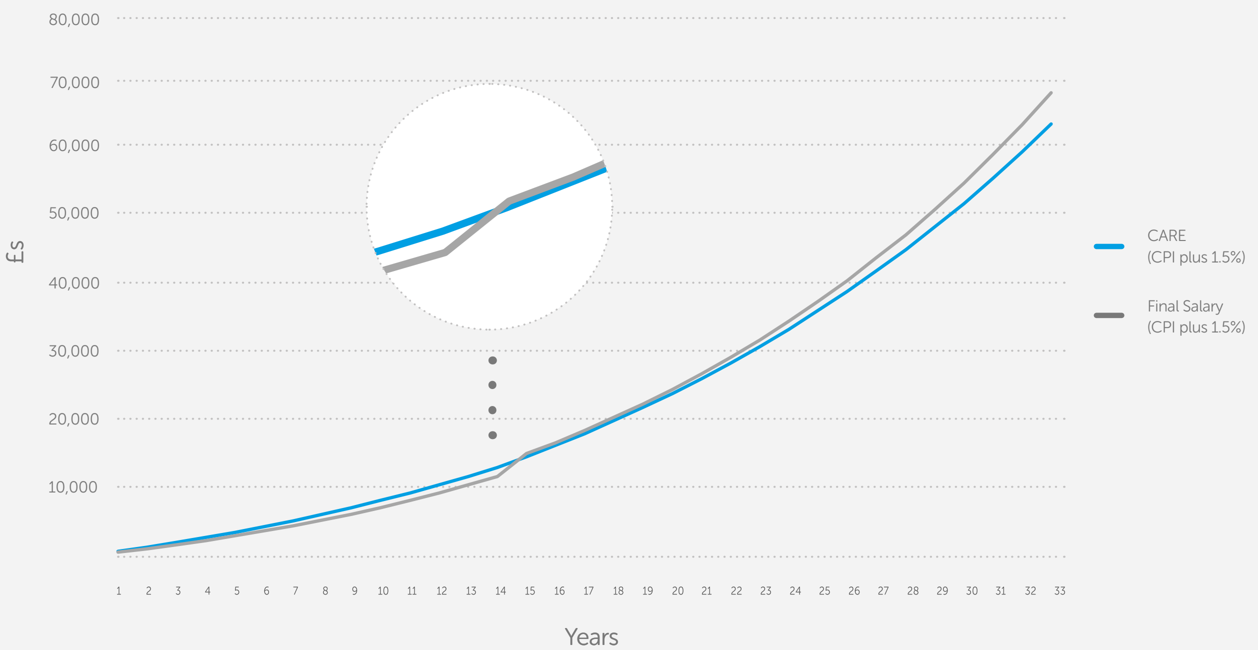
For the majority of our LGPS funds in England and Wales we have adopted a long-term salary increase assumption of CPI plus 1% for the purposes of the 2019 valuations. If we use this assumption (and assume that there are no further promotional increases) you can see from the graph below that the underpin of the final salary pension never bites, so the member would always be better off in the CARE scheme. Even if you assume a salary increase assumption of CPI plus 1.5%, then the underpin still only 'bites' after around 30 years of service.

CARE PENSION VERSUS FINAL SALARY PENSION OVER TIME



Of course, any promotional increases can quickly change this conclusion. In the graph below we use the same long-term salary increase assumption of CPI plus 1.5%. However, in this scenario the member receives a promotional increase of 20% in year 15, which causes the underpin to bite in year 15.

CARE PENSION VERSUS FINAL SALARY PENSION OVER TIME ALLOWING FOR A ONE OFF SALARY INCREASE IN YEAR 15



The above examples are designed to show you how sensitive the conclusions are to these various assumptions. Therefore, the longer the underpin is in place, the more exposed funds and employers would be because of future uncertainties of members' pay progression. A CARE scheme was intended to bring more stability to the LGPS and more certainty around the cost of future benefits. The extension of the underpin will serve to remove that certainty.

Changing the protection period

As previously mentioned, at this stage we do not know if, or for how long, the underpin may be extended. However, we have looked at the possible financial implications on the value of the active liabilities for an average fund under a range of periods. What we have found is the higher the salary increase assumption used in our estimates, the more significant the impact is assumed to be (as the value of the final salary benefits will be higher). This is perhaps an obvious conclusion. However, what is not so obvious is that if you restrict the protection period, this also results in a more significant assumed financial impact.

This is possibly counter intuitive at first. However, the rationale is that the final salary pension is potentially more 'valuable' when accrued early in the career because there is more time for future salary increases to outstrip future CPI revaluation and the better accrual rate under CARE (assuming the member remains active). CARE pension accrued in later years is assumed to be based on a salary that is closer to the final salary. So for the pension accrued in later years, there is less time for future salary increases to impact the pension amount, relative to CPI revaluation.

Please note that this is only true where a member has had stable salary increases. These conclusions do not allow for those promotional increases previously mentioned; a one-off increase later in a member's career can easily change these conclusions for individual members.

By having an unlimited protection period, this increases the exposure to promotional increases and therefore the costs may well end up being higher.

> Whatever the remedy, we won't know the cost until we know the actual salary increases over the next 40 plus years – which is why it is difficult to make any concrete conclusions.

Impact on different LGPS employer types

Using these rules of thumb, we have made some general conclusions about the impact on different LGPS employer types.

Please see the table below.

Councils	Academies	Admission bodies
Older profile so overall effect may be smaller.	Generally younger profile so overall effect may be higher.	Impact likely to be even more volatile as there is a larger range of membership profiles and smaller membership.
Individual member risk exposed to promotional salary increases.	Impact likely to be more volatile due to smaller membership numbers.	
Impact likely to be less volatile due to higher membership numbers.	Lower salary increases in general, which will result in fewer cases where the 'underpin bites.'	

What assumptions have we used?

Our conclusions are based on a number of assumptions and limitations. It is therefore important to note the below:

- We have assumed there is effectively no difference between the salary used to calculate the FS pension and the salary used to calculate the CARE pension and that the CARE pensionable salary is effectively the part-time final pensionable salary. In practice these benefits have slightly different definitions and the salary used to calculate the CARE pension could be higher.
- We have used dummy data based on membership data used at the 2019 valuation, but this is not meant to be reflective of a specific Fund. The experience of each individual Fund will vary with their membership profiles and individual salary experience.
- We have only considered the change in the salary increase assumption in our calculations and have not considered how changing the other assumptions used in our valuations will affect the conclusions.
- The remedy applied is based on the underpin applying to all members previously not protected by the underpin, but the actual scope has not yet been determined.

What are some non financial considerations?

Our view is that, whatever the remedy, the financial impact is going to be relatively small. Other considerations include the below.

- **Administration.** If the underpin is to be applied indefinitely, there will be members still having an underpin check in 40 years' time. It is important to keep hold of data now and gather any missing data around part time hours and service information. This is the most important consideration and where we expect the most work will be.
- **Tax.** There could be secondary effects on previous calculations of the annual allowance which may need to be revisited.
- **Reputation.** We are keen to work on the implementation working group in order to ensure that any remedy is implemented as efficiently as possible in order to reduce the risk of future challenges, complaints and any negative views of the LGPS.
- **Other public sector schemes.** This note only covers our thoughts around the LGPS but the judgements will affect all public sector schemes.

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:

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