Local Government Pension Scheme

Potential impact of McCloud/Sargeant ruling on pension accounts disclosures

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Michael Scanlon FIA

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Summary

1. Local authorities and Local Government Pension Scheme ('LGPS') funds need to determine an appropriate accounting treatment for the potential impact of the McCloud judgement. With the consent of the Ministry of Housing, Communities and Local Government (MHCLG), the LGPS Scheme Advisory Board (SAB) Secretariat have commissioned GAD to prepare an assessment of the potential financial impact on a LGPS E&W scheme wide basis. This report sets out the results of that assessment.
2. The estimated costs are sensitive to the assumed rates of increases of the final salary benefits and CPI (which is used in the 2014 scheme CARE revaluation). We have estimated the potential impact in the following scenarios:

	Scenario 1 Earnings = CPI + 1.5%	**Scenario 2** Earnings = CPI + 0%
Nominal discount rate	2.4% pa	2.4% pa
Earnings	3.8% pa	2.3% pa
CPI	2.3% pa	2.3% pa

3. The table below sets out the potential impact on the scheme liabilities and service cost in the two scenarios above

	Scenario 1 Earnings = CPI + 1.5%	**Scenario 2** Earnings = CPI + 0%
Impact on scheme liabilities (expressed as a percentage of active liabilities)	3.2%	Less than 0.1%
Impact on service cost (expressed as a percentage of pensionable pay)	3.0%	Less than 0.1%

4. These results are based on the form of potential remedy, data, methodology and assumptions, and are subject to the limitations, set out in this report. The results may be significantly higher or lower if any of the following were changed:
    a. the assumed form of potential remedy
    b. the age profile of the membership
    c. State Pension ages
    d. the assumptions regarding:
        i. future increases in salaries and CPI
        ii. promotional salary increases
        iii. withdrawal (ie leaving active membership without an entitlement to immediate benefits)

Results

5. The Local Government Pension Scheme (England and Wales) (LGPS) introduced a new CARE benefit structure with effect from 1 April 2014 ('the 2014 scheme'). For members who were 10 years or less from Normal Retirement Age on 1 April 2012 (ie aged 55 or above[1]), an underpin was provided based on the existing final salary scheme ('the 2008 scheme'). In December 2018, the Court of Appeal found that similar transitional provisions in the pension schemes for firefighters and the judiciary resulted in unlawful age discrimination. The Government is seeking permission to appeal this judgment. More details on this legal challenge can be found in the next section.
6. As set out in the CIPFA briefing note of April 2019[2], administering authorities should consider the materiality of the impact of the McCloud judgment for their annual accounts. This is notwithstanding the uncertainty on the outcome of the case, the remedy to be agreed, and the extent to which the judgment impacts on the LGPS. The SAB Secretariat have therefore commissioned GAD to prepare figures that would assist administering authorities in considering the materiality of the case.

Comparison to old schemes

7. The following table sets out the main benefits provided by the LGPS 2008 scheme and the 2014 scheme:

	2008 scheme	**2014 scheme**
Pension scheme type	Final salary	CARE
Accrual rate	1/60	1/49
Normal pension age	65	State Pension age

8. The accrual rate in the 2014 scheme is 22% better than the 2008 scheme. However 2008 scheme can still provide higher benefits for members:
    a. With State Pension age greater than 65, and / or
    b. With significant salary progression
9. The underpin is set out in the Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) Regulations 2014 (SI 2014 No. 525)[3], and a detailed explanation is provided in the Local Government Association's Scheme Administrator Guide "The Underpin"[4]. The underpin applies to members who have an immediate entitlement to a pension on leaving LGPS but not to those who leave before age 55 without such an entitlement.
10. The following chart compares the cost of:
    a. The 2014 scheme CARE benefits

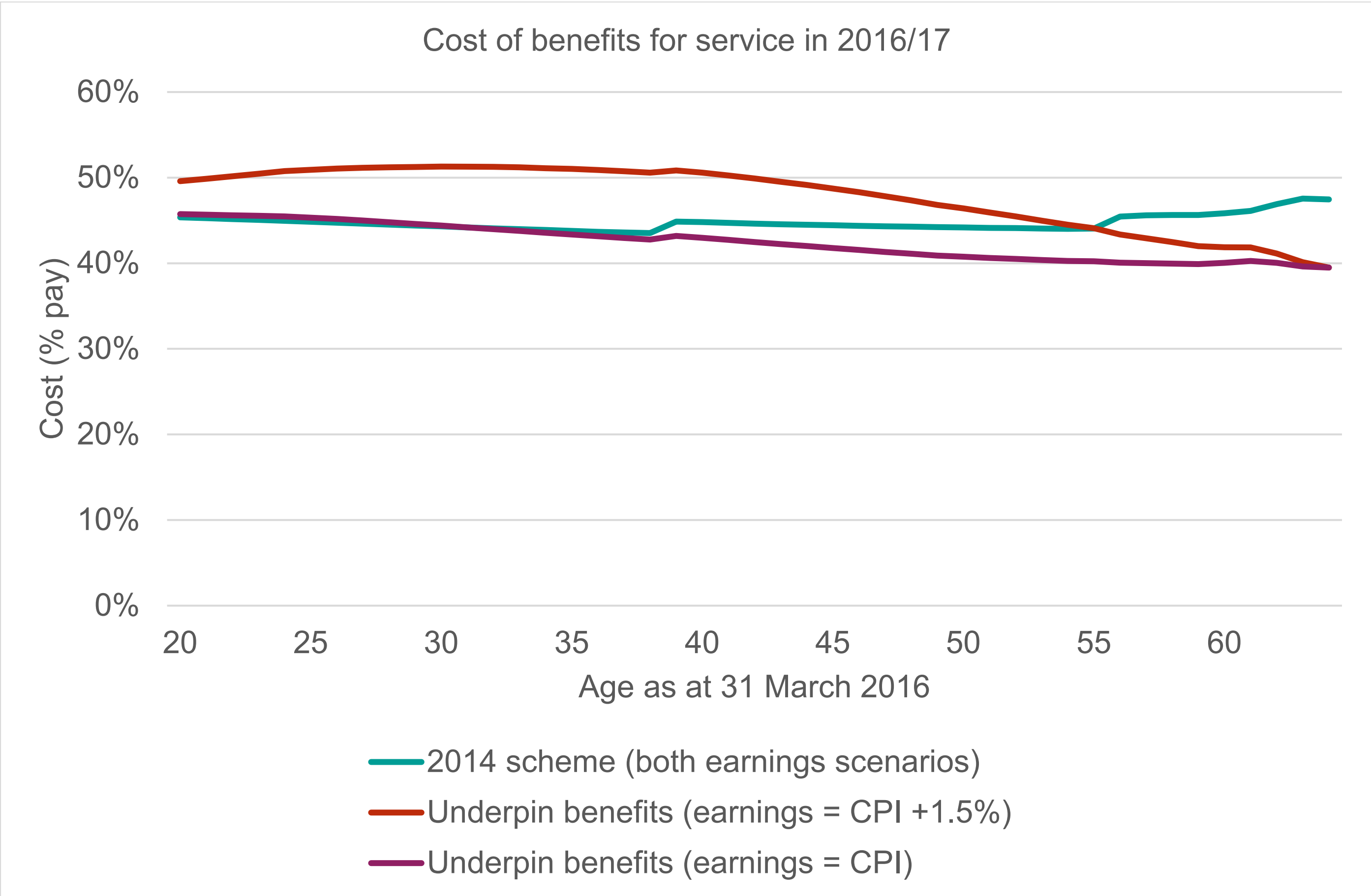
[1] Except for a small minority of members who had a normal retirement age of 60 in the 2008 scheme.
[2] https://www.cipfa.org/services/networks/pensions-network/documents-and-guidance/mccloud-briefing-note
[3] https://www.legislation.gov.uk/uksi/2014/525/regulation/4/made
[4] https://www.lgpsregs.org/resources/guidesetc.php

b. The underpin benefits based on:

   i. the 2008 scheme for members who retire with an entitlement to immediate benefits (either on age retirement or in ill health),

   ii. the 2014 scheme CARE benefits for members who leave before retirement without an immediate entitlement to a pension

Chart 1: Cost of 2014 scheme CARE benefits and underpin benefits



11. The underpin currently applies to those who were aged 55 or above in 2012[5], who are aged 59 or above in 2016. At these ages the cost of the 2014 scheme CARE benefits (blue line) is significantly higher than the underpin benefits (red line / purple line), because at these ages State Pension age is 65 or 66 and the 2014 scheme benefits are more valuable for all except those with very significant salary progression. That is, in the majority of cases the underpin will not 'bite' and there will be no cost.

12. However at younger ages, in Scenario 1 (Earnings = CPI + 1.5%) the 2014 scheme is less valuable than the underpin, because:

    a. State Pension age increases to 67 and 68: see the 'steps' in the red line in chart above around ages 55 (members born 1960/61) and 38 (members born 1977/78)

    b. Younger members have a longer period to earn salary increases so that their final salary is higher than their career average (revalued) salary.

[5] Except for a small minority of members who had a normal retirement age of 60 in the 2008 scheme.

13. As noted above, the average cost of potential remedy in Scenario 1 (Earnings = CPI + 1.5%) might be about 3% of pensionable pay. However this cost is very dependent on the age profile of the members – for example, for members aged 30 the potential remedy might cost 7% of pensionable pay (cost of 51.3% pay compared with 44.3% pay for the 2014 scheme – ie the underpin is worth 116% of the value of the CARE scheme), so the cost for a fund or employer will depend on the age profile of their membership.
14. The costs are very sensitive to the earning assumption. In Scenario 2 (Earnings = CPI) the costs of the underpin are minimal, even at the younger ages.

McCloud/Sargeant legal case

Background

15. Two employment tribunal cases were brought against the Government in relation to possible discrimination in the implementation of transitional protection following the introduction of the reformed 2015 public service pension schemes from 1 April 2015. In the unfunded schemes, transitional protection enabled some members to remain in the pre-2015 schemes after 1 April 2015 until retirement or the end of a pre-determined tapered protection period. The claimants challenged the transitional protection arrangements on the grounds of direct age discrimination, equal pay and indirect gender and race discrimination.
16. The first case was heard in November 2016 and was brought by McCloud and other members of the Judicial Pension Scheme against the Lord Chancellor and the Ministry of Justice. The tribunal ruled in favour of the claimants.
17. The second case was heard in January 2017 and was brought by Sargeant and other members of the Firefighters' Pension Scheme against the Fire & Rescue Authorities and the Government (in England and Wales). The tribunal ruled against the claimants.
18. These two cases were appealed to the Employment Appeal Tribunal, and subsequently to the Court of Appeal.
19. In December 2018, the Court of Appeal ruled that the transitional protections gave rise to unlawful discrimination. The Government is currently seeking permission to appeal this decision to the Supreme Court, with an unknown timeframe for this permission to be granted or denied.
20. If permission to appeal is denied, it would likely result in a requirement to compensate certain members for any discrimination suffered as a result of the transitional protections. At the moment there is uncertainty over the form that this compensation would take. The read across to other public service pension schemes is unknown, but given that the transitional protection arrangements are very similar it is possible the implications may be the same.

Form of potential remedy

21. LGPS SAB Secretariat have instructed us to prepare figures on the basis of a worst case scenario for the potential legal remedy, as follows:
    a. Underpin to apply to all members of all ages
    b. Underpin to apply to all members (including those who joined between 2012 and 2014, and those who joined after 2014)
    c. Underpin to be assessed at the earlier of retirement or 2008 Scheme Normal Retirement Age (even if that is after 2022)
    d. Underpin to apply to members entitled to immediate benefits on leaving, but not those who leave service without any entitlement to an immediate pension
22. As usual for accounting calculations, we have considered only service up to the balance sheet date (31 March 2019) but the final salary element of the underpin is based on salary projected to retirement or earlier leaving.

Methodology, Data and Assumptions

Methodology

23. The calculations compare the cost of:
    a. The 2014 scheme CARE benefits
    b. The underpin benefits based on:
        i. the 2008 scheme for members who retire with an entitlement to immediate benefits (either on age retirement or in ill health),
        ii. the 2014 scheme CARE benefits for members who leave before retirement without an immediate entitlement to a pension
24. The cost of accrual in each case is calculated using the projected unit method with a one year control period.
25. The additional liability for each year was then calculated by taking the difference in the cost of accrual and multiplying it by the relevant payroll at each age. The total additional liability i.e. the estimated cost of potential remedy from 1 April 2014 to 31 March 2019 is calculated by projecting the cost of accrual each year (by unwinding short-term pay increases and allowing for future mortality improvements) and applying this to a static pay profile each year. We then accumulated these costs with interest at the relevant accounting discount rate.
26. These costs assume that potential remedy is based, for the element in the pre-2015 schemes, on the member's final salary at retirement (and not at some earlier date e.g. 2019). These costs are based on assumptions relevant to an average member rather than allowing for each member's actual career progression and salary increases. Allowing for variations in individual members' future service or salary progression will produce higher costs, because final salary will be better for 'high flyers' with significant salary progression, but not for those with flatter salary progression.
27. No allowance has been made for the underpin cost for those who left the scheme prior to 31 March 2016. We would not expect such costs to be material.

Data and assumptions

28. These results are based on the 2016 valuation data and assumptions. A summary of the data is provided at Appendix A and a summary of the assumptions is provided at Appendix B.

Compliance and limitations

29. This report has been prepared for MHCLG at the request of the LGPS SAB Secretariat. It is acknowledged that this report may be relevant to LGPS funds, participating employers and their advisors in preparing their 2018/19 accounts.
30. Other than those outlined above, no person or third party is entitled to place any reliance on the contents of this report, except to any extent explicitly stated herein. Other than MHCLG, GAD has no liability to any person or third party for any action taken or for any failure to act, either in whole or in part, on the basis of this report.
31. We are content for MHCLG or the SAB Secretariat to release this report to third parties, provided that:
    a. it is released in full;
    b. the advice is not quoted selectively or partially;
    c. GAD is identified as the source of the report, and;
    d. GAD is notified of such release.
32. This work has been carried out in accordance with the applicable Technical Actuarial Standard TAS 100 issued by the Financial Reporting Council (FRC). The FRC sets technical standards for actuarial work in the UK.
33. These results show the estimates of the cost of the remedy if the LGPS underpin was found to result in unlawful age discrimination, expressed as a single capital sum in today's terms. They are not cashflows of extra benefits paid out (which will instead emerge more slowly as members retire), or extra employer contributions to pay for higher benefits (which will depend on how/when McCloud costs are treated in local valuations).
34. The form of potential remedy is not yet decided and if this differs from that assumed here, results will be different. One such example is which members are given potential remedy. In these figures, potential remedy is given to all members. If potential remedy was limited to members that joined before April 2012, or before April 2014, costs would be lower (all else being equal). This report does not consider any costs that may arise from any other claims against the scheme.
35. These results show the costs of giving the average member at a particular age the underpin benefits based on the assumptions adopted. Allowing for variations in individual members' future service or salary progression will produce higher costs, because the underpin may bite for 'high flyers' with significant salary progression, but not for those with less salary progression.
36. This estimate is based on the assumptions adopted. If different assumptions were adopted, results would be different.

Appendix A: Data

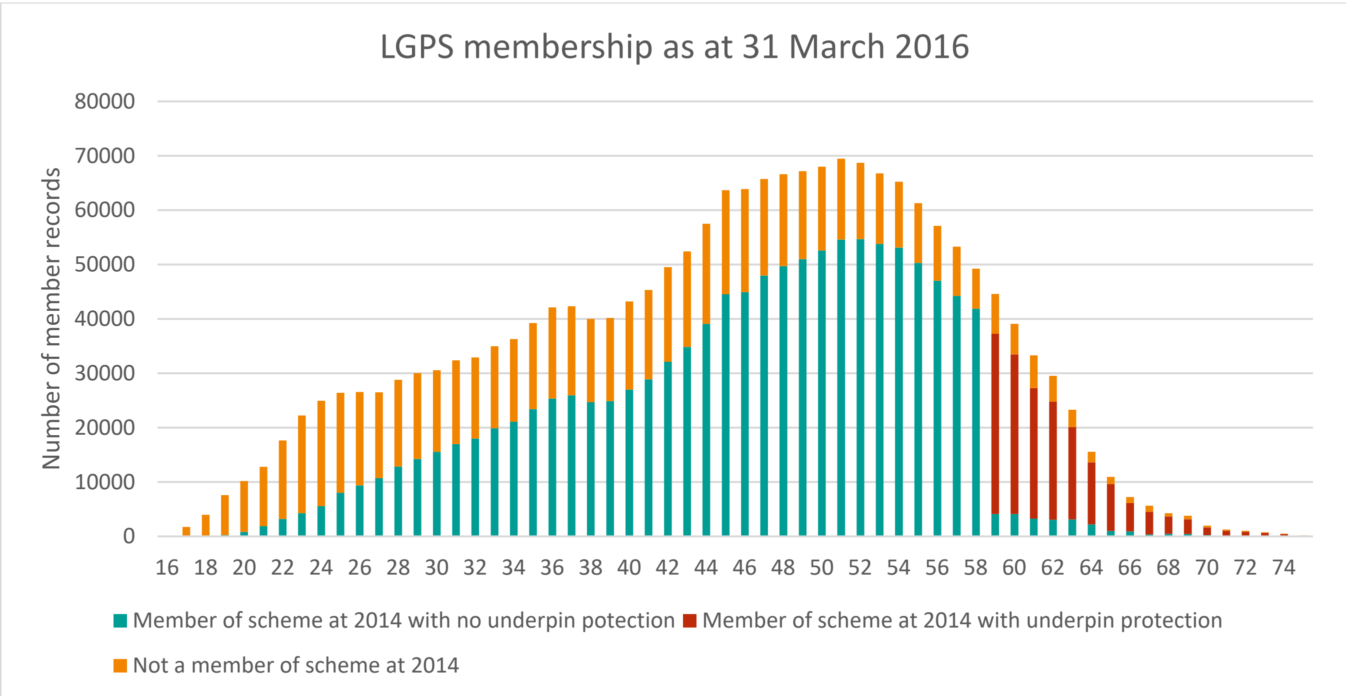
37. This report is based on the data provided for the 2016 valuation, as detailed in our draft report "Local Government Pension Scheme (England and Wales) Actuarial valuation as at 31 March 2016 Report on membership data" of 11 May 2017. The concerns associated with the data set out in that report also apply to this advice.

38. The following table sets out a summary of the data for active members.

Table A1: Active data as at 31 March 2016

	Number of records 000s	Actual pensionable salary £m	FTE pension-able salary £m	Average Actual salary £	Average age[6] years	CARE pension £m
Member of the scheme on 1 Apr 2014 – underpin protection	165	3,066	3,812	18,637	61.7	122
Member of the scheme on 1 Apr 2014 – no underpin protection	1,163	22,121	27,553	19,019	46	858
Not a member of the scheme on 1 Apr 2014	640	7,901	11,718	12,349	39.5	168
Total	**1,967**	**33,088**	**43,083**	**16,818**	**45.9**	**1,147**

39. The following chart sets out the distribution of the membership by age



40. The members of the scheme at 2014 without underpin protection are those who were:

[6] Weighted by Actual Pensionable Salary

a. aged under 55 in 2012 (and so under 59 in 2016), or
b. joined the scheme between 2012 and 2014

Appendix B: Assumptions

41. This report is based on the assumptions recommended for the 2016 valuation, as detailed in our draft report "Local Government Pension Scheme (England and Wales) Actuarial valuation as at 31 March 2016 Advice on assumptions" of November 2017. The limitations associated the assumptions as set out in that report also apply to this advice.

42. The estimated cost of extending the underpin is sensitive to assumptions that have different impacts on the benefits payable under the 2014 scheme and the underpin benefits, in particular assumptions regarding:

    a. Future increases in salaries and CPI

    b. Promotional salary increases

    c. Withdrawal (ie leaving active membership without an entitlement to immediate benefits)

43. These assumptions are detailed below. Other assumptions used are as set out in our report of November 2017.

44. The following table sets out the main financial assumptions.

Table B1: Financial assumptions

	Scenario 1 Earnings = CPI + 1.5%	**Scenario 2** Earnings = CPI + 0%
Nominal discount rate	2.4% pa	2.4% pa
Earnings	3.8% pa	2.3% pa
CPI	2.3% pa	2.3% pa

45. The following table sets out the assumed promotional pay salary scales:

Table B2: Promotional salary scales for all members

Age	Men	Women
20	90	95
25	92	96
30	100	100
35	105	103
40	109	104
45	112	106
50	115	107
55	115	107
60	115	107
65	115	107

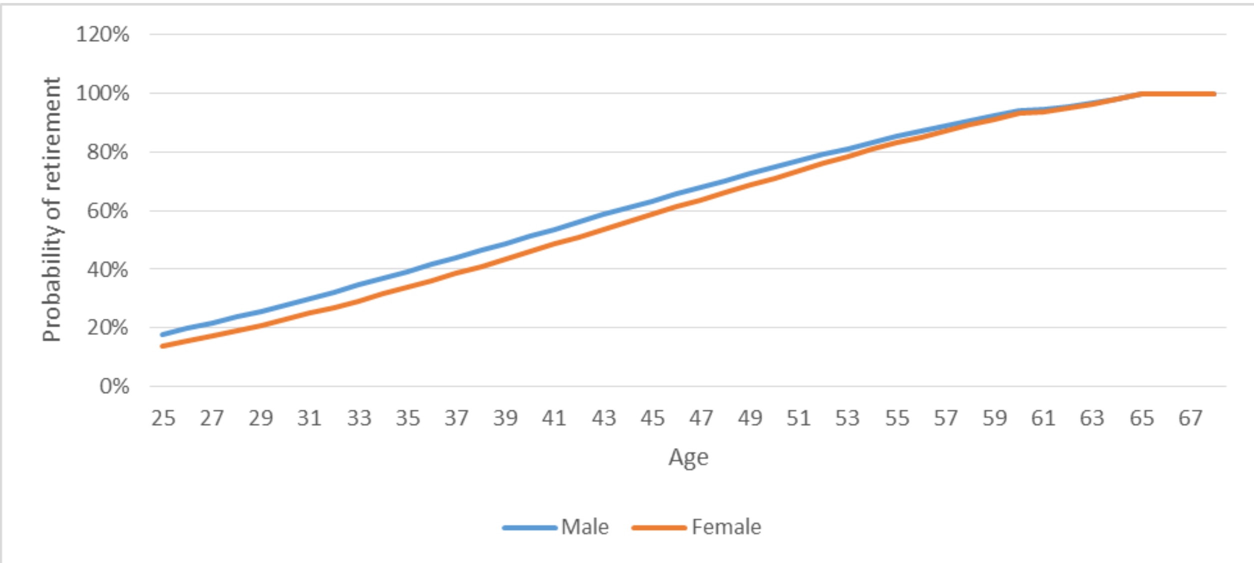
46. The following table sets out the assumed rates of withdrawal:

Table B3: Voluntary withdrawal rates for all members

Age	Men	Women
20	0.1171	0.1282
25	0.0921	0.1017
30	0.0725	0.0807
35	0.0570	0.0640
40	0.0448	0.0507
45	0.0353	0.0403
50	0.0278	0.0319
55	0.0218	0.0253
60	0.0172	0.0201
65	0.0135	0.0159

47. The following chart sets out the proportion of members who are assumed to retire with an entitlement to immediate benefits (either on age retirement or in ill health):

Chart B1: Retirement with an entitlement to immediate benefits



48. Those aged 65 and above are certain to leave with an entitlement to an immediate benefit, but of those aged 25 less than 20% are expected to ultimately leave with an entitlement to immediate benefits and potentially benefit from the underpin if extended to all members of the scheme at 2014.