HYMANS ROBERTSON

Sixty second summary

Rain drops keep falling on our heads…

- **The remedy and costs associated with the McCloud case are highly uncertain**
- **It is very likely that funds will have local discretion over how to manage the uncertainty and risk at the 2019 valuation**
- **Agree the risk management approach with your Fund Actuary, and ensure it is communicated to employers and documented in your Funding Strategy Statement.**

Although most LGPS funds and employers have just dried out after the inconvenience the McCloud case caused to year end accounts, the deluge continues as we now start to consider what impact it will have on the 2019 valuation.

Glossing over the rather tedious weather-related title and introduction (I am typing this looking out on a lovely Scottish summer day of heavy rain and cloud), the recent developments in the McCloud case highlight it as a specific funding risk that we would expect all funds to consider as part of the 2019 valuation.

Why is it a risk to LGPS funds?

After the Supreme Court denied the Government leave to appeal the McCloud and other associated cases on 27 June 2019, a written ministerial statement confirmed that as 'transitional protection' was offered to members of all the main public service pension schemes, the difference in treatment will need to be remedied across all those schemes, including the LGPS.

As the remedy will involve 'levelling up' member benefits, it is expected that any agreed outcome will increase the cost of LGPS pensions. However, at the time of writing, there is no certainty about how much this additional cost will be.

Why is there uncertainty around the additional cost?

The uncertainty stems from the fact that no one currently knows what form any remedy will take in the LGPS. The most obvious solution would be to apply the current protections, offered to those within 10 years of retirement at 2012, to all members in the scheme. However, as with all things to do with pensions and discrimination laws, it is not quite that simple. For examples, decisions need to be made around areas such as:

- Eligibility – would it only apply to scheme members who were active in 2012? Or all those active when the scheme changed at 31 March 2014 (2015 in Scotland)? What about re-joiners who choose to link up their benefits?
- Operating period of the underpin – will the underpin only apply to service accrued up to 2022 i.e. 10 years after 2012? Or will it apply for all service accrued from 1 April 2014 until retirement?
- Retrospection- how will the benefits for members who have left service since 2014 (or 2015 in Scotland) be rectified? Will interest be applied to any payments that should have been made had an underpin been in place?
- Administration – any remedy needs to be relatively easy to administer to avoid placing administration teams under even more strain. What may seem an obvious remedy may actually be very complex to administer so an alternative approach may be more appropriate.

And there are many more issues than just those listed above. As each decision about the form of a remedy is likely to have a material impact on the overall cost, you can start to see why no one can be certain about the cost of the McCloud case on both future and past service benefits.

What's the impact on the 2019 valuation?

On 14 May 2019, the Scheme Advisory Board published an advice note covering the implications of the McCloud case on the 2019 valuation. The key points from the advice note were:

- For the purpose of the 2019 valuation, if no remedy is agreed by 31 August 2019, LGPS funds should value the benefits as per the current LGPS Regulations.
- Funds should consider how to factor in the uncertainty and risk associated with the McCloud case when setting employer contribution rates
- Once the McCloud case is remedied, funds should revisit employer contribution rates to ensure they remain appropriate in light of any additional costs.
- The Cost Cap process will be suspended until the McCloud case is resolved.

Given that we are nearly at the end of July, it is very unlikely that a remedy will be agreed in the LGPS (or any public service pension scheme) by 31 August 2019. Therefore, we can be fairly certain that for the 2019 valuation we will be valuing benefits as per the current Regulations. This then leaves funds to consider locally how best to manage the uncertainty and risk associated with McCloud.

How to manage the McCloud risk?

There are various approaches and options LGPS funds can take to managing the uncertainty around the cost of benefits due to the McCloud case. We discuss some below along with issues associated with each.

- Add an explicit loading onto employer contribution rates e.g. X% of pay – this could be in the form of the same loading across all employers or it could vary by employer based on factors such as membership profile. Funds would need to consider how to derive such a loading given the uncertainty around what form any remedy will take. Funds would also need to consider how to communicate this approach to employers given the final remedy could result in a cost that is very different from any loading.
- Increase the level of prudence in the funding plan – in the three-step approach we use to set employer contribution rates, this would involve increasing the likelihood of success e.g. from 66% to 70%. The result would be a higher employer contribution rate (compared to if no action was taken) in recognition that pension costs are likely to increase. As per the first approach, it is unlikely that any increase in rate as a result of this approach would match the actual cost increase once the McCloud case is resolved, so careful communication with employers would be required.
- Do nothing – as with any risk, one option is always to do nothing. Funds taking this route may justify it on the grounds that there is so much uncertainty currently associated with McCloud that making any allowance is not feasible at this stage. Funds taking this route would need to communicate this carefully with employers and Committees to avoid any issues around future contribution rate increases once the case is resolved.

We would expect the range of approaches to vary across LGPS funds depending on Officers' and Committees' view on this risk. Whatever your current view, we would strongly suggest that it is carefully discussed and considered with your Fund Actuary during the valuation process. The justification and reasoning for any decision should be carefully communicated and documented in the Funding Strategy Statement, employer communications and final valuation report.

Please get in touch with your usual Hymans Robertson contact to discuss McCloud – or any other aspect of the valuation – in more detail.