

Private & Confidential

Roddy MacLeod
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Dear Roddy,

Local Government Pension Scheme (Scotland)

Amendments to the statutory underpin

Hymans Robertson LLP is pleased to provide its response to SPPA's consultation on the above topic. The Annex to this letter sets out our formal response to the questions set out in the consultation.

About Hymans Robertson LLP

Hymans Robertson has grown up with the LGPS. The firm was founded to provide advice to the LGPS in 1921, just as the first Funds were being created. Whilst our business has developed over the decades, working with the public sector remains at the heart of what we do.

We have a specialist public sector actuarial team, which employs over 60 people exclusively advising on the LGPS. Alongside our actuaries there is a team of 15 investment consultants providing investment advice and a team of governance, administration and project consultants providing advice to our LGPS clients.

We believe that we are well placed, therefore, to respond to the questions posed by SPPA in this latest consultation paper.

Yours sincerely

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Annex 1

Question 1 – Do you agree with our proposal to remove the discrimination found in the McCloud and Sargeant cases by extending the underpin to younger scheme members?

Yes. This would be consistent with the Court of Appeal's ruling.

Question 2 – Do you agree that the underpin period should end in March 2022?

The original underpin could not have applied to service after 31 March 2022 and ceasing the underpin period on that date is consistent with the original commitment that members within 10 years of retirement on 31 March 2012 would be no worse off. We see no case to extend the underpin period beyond this date.

Question 3 – Do you agree that the revised regulations should apply retrospectively to 1st April 2015?

The age discrimination began on 1 April 2015 so, in order to address it, regulations must be applied retrospectively.

Question 4 – Do the draft regulations implement the revised underpin which we describe in this paper?

Yes.

Question 5 – Do the draft regulations provide for a framework of protection which would work effectively for members, employers and administrators?

The protection would appear to work effectively, however the additional work required of employers and especially LGPS administrators should not be underestimated.

It is likely that a significant number of employers will not be able to provide every piece of data that is required to calculate the underpin across all eligible members e.g. historic salary details for ex-employees. Funds may therefore need to make assumptions to fill in any gaps in the data, which could undermine the effectiveness of the regulations. We would welcome guidance from SPPA/Scottish SAB on how funds should account for any missing data required to calculate the underpin and how this should be communicated with employers and impacted scheme members.

Question 6 – Do you have other comments on technical matters related to the draft regulations?

We note that the consultation document states, in respect of the death of an active member that "For a protected member in active service, their date of death will be both their underpin date and their underpin crystallisation date".

However, this will not always be the case and a member who dies in active service after their 2009 Scheme NPA will have a separate underpin date and underpin crystallisation date.

The proposed amendments to the LGPS Regulations address this point and confirm that;

(2A) A member's date of death shall be their underpin date in a relevant Scheme membership where that date is earlier than the date provided for by paragraphs (2)(a) [2009 NRA] or (2)(b) [date of leaving 2015 scheme]

Question 7 – Do you agree that members should not need to have an immediate entitlement to a pension at the date they leave the scheme for underpin protection to apply?

By extending the underpin to those who do not have an immediate entitlement to benefit (and by extension to those who have already retired without an immediate entitlement to benefit) the protection does more than simply address existing age discrimination. Under these proposals the underpin will now apply to members of all ages in more circumstances than was previously the case.

However, the original assurance to members of public service pension schemes was that “Anyone 10 years or less from retirement age on 1 April 2012 can be assured that there will be no detriment to their retirement income¹”. In practice, the underpin in its current incarnation can produce a scenario in which a member who was within 10 years or less from retirement on 1 April 2012 is worse off, just by virtue of retiring from deferred status.

We understand the government’s policy intention is to rectify this anomaly and we agree that the underpin should be extended to those members who leave without an immediate entitlement to pension.

Question 8 – Are there any other comments regarding the proposed underpin qualifying criteria you would like to make?

Our response to question 10 below sets out our views in relation to the provision of a further 12-month period for certain individuals to elect to aggregate previous LGPS benefits as a consequence of the proposed changes. Paragraph 43 of the consultation document states that those members who leave the LGPS without an immediate entitlement to a deferred pension (i.e. they have less than the 2 year qualifying membership period) would not have underpin protection “...as they would only be eligible for a refund of their contributions, aggregation with another LGPS record or a transfer to another scheme”. It is unclear if such individuals would be considered as qualifying members for the purposes of the revised underpin if they aggregated with another LGPS record.

Question 9 – Do you agree that members should meet the underpin qualifying criteria in a single scheme membership for underpin protection to apply?

The principle that should generally apply is that each period of LGPS membership should be administered as a discrete record. We see this principle in practice when it comes to preserving the final salary link or protected retirement ages. For example, a member with a deferred record prior to 2015, and a current active record, will not enjoy a final salary link for the pre 2015 period.

¹ Statement by the Chief Secretary to the Treasury, Rt Hon Danny Alexander MP on Public Service Pensions, 2 November 2011

There are examples that go against this principle within the LGPS, such as the administration of death grants, where Fund A cannot pay the correct death grant without knowledge of the member's record held in Fund B. This provides an unwelcome additional level of complexity and should be avoided where possible.

We agree that the underpin qualifying criteria should have to apply in a single record.

Question 10 – Do you agree with our proposal that certain active and deferred members should have an additional 12 month period to decide to aggregate previous LGPS benefits as a consequence of the proposed changes?

It follows that if the regulations are amended to require a member to meet the underpin criteria in a single record then there are members with unaggregated periods of service, who currently qualify, who will lose their underpin entitlement.

In the interests of fairness such members should be given the opportunity to aggregate their records in order to preserve their underpin entitlement.

We believe there should be a discretion to allow administering authorities to extend the 12-month aggregation window. While we would hope that the exercise can be completed within 12 months there may be cases where through no fault of the member the exercise is not completed in time and it would be unreasonable for the member to miss out in such circumstances.

Question 11 – Do you consider that the proposals outlined in paragraphs 50 to 52 would have 'significant adverse effects' in relation to the pension payable to or in respect of affected members, as described in section 23 of the Public Service Pensions Act 2013?

It is possible to construct a scenario where a member could argue they had suffered adverse effects as a consequence of introducing the requirement to aggregate service in order to retain the underpin.

Take the following example;

A member who was within 10 years of NRA in the 2009 scheme, has the following service;

Membership 1 – active from 2000 to 2013, finishing on a final salary of £75,000

Membership 2 – active from 2013 to 2030, joining on a salary of £30,000

The member chose not to aggregate benefits on the basis that their pay in Membership 2 will never exceed their final pay in membership 1 plus CPI.

Under the current underpin arrangement the member will still benefit from underpin protection for the period 2015 to 2022. Under the new proposals, they would not.

The member may still choose to keep their service records separate to benefit from the £75,000 salary in membership 1.

If the new underpin proposals are implemented, and the member's pay in Membership 2 rises in such a way that treating the period 2015 – 2022 as final salary would actually have been better than treating it as career average, the member may claim they are losing out.

However, this situation is likely to be extremely rare and the option to allow members to make a late election to aggregate goes some way to mitigating the impact.

Question 12 – Do you have any comments on the proposed amendments described in paragraphs 56 to 58?

No. The proposed amendments to widen or clarify the protections would appear to be consistent with the government's stated policy of ensuring appropriate protection for scheme members and their survivors.

It is appreciated, however, that the amendments to the protections will result in additional work for administrators potentially having to revisit underpin calculations where a protected member leaves active service, returns without a disqualifying break in service and elects to aggregate the two membership periods.

Question 13 – Do you agree with the two-stage underpin process proposed?

The two-stage approach is consistent with the government's stated policy intentions. The consultation document does acknowledge potential implications for annual allowance assessments, which we have covered off in our response to Q18 below.

Question 14 – Do you have any comments regarding the proposed approaches outlined above?

The proposed process for Club Transfers places a significant onus on the member as it requires them to make a decision as to how their benefits will be treated in the receiving scheme. This will inevitably be a complex financial decision and one where the "correct" answer will not be known until retirement. This is an area where a consistent approach across funds and clear communication to members will be important.

Question 15 – Do you consider there to be any notable omissions in our proposals on the changes to the underpin?

No.

Question 16 – Do you agree that annual benefit statements should include information about a qualifying member's underpin protection?

It would be useful for members who may be impacted by the underpin to receive underpin information in their annual benefit statements.

Question 17 – Do you have any comments regarding how the underpin should be presented on annual benefit statements?

The underpin will inevitably introduce additional complexity and it will be challenging to explain to members. Affected members will see their underpin value change from year to year and may see years when the underpin applies and years when it does not. We agree that a form of consistent presentation and wording for annual benefit statements would be helpful.

Question 18 – Do you have any comments on the potential issue identified in paragraph 109?

We believe that on balance it is appropriate to apply the annual allowance test at the underpin crystallisation date. This is the date at which the definitive value of the underpin is calculated and, therefore, the date at which the member experiences the actual pension growth attributable to the underpin. The approach would also be consistent with that already in place for the existing underpin.

We recognise that this approach could have the effect of causing a spike in the closing value of a member's benefits in the pension input period in which the underpin crystallisation date occurs. However, the benefit of this approach is that an affected member is more likely to have some unused annual allowance remaining from the previous 3 years which they can use to offset any tax charge.

The consultation document acknowledges that the proposed solution might not work for those members with relatively low career average pensions in respect of the underpin period, but relatively high final salary benefits as a consequence of career progression. Given that the effects of the revised underpin will be with us for many years into the future, we appreciate that the number of such cases over time might not be insignificant. We also appreciate that due to the level of career progression over time such individuals may no longer have unused annual allowance available to them to offset any breach.

There may be an argument, therefore, for requiring an annual assessment of the notional underpin against the annual allowance threshold, to ensure such individuals are not adversely impacted by the annual allowance.

This alternative approach of capturing the value of any notional underpin on a year by year basis may though have some unwelcome side effects for those individuals who do not enjoy an increase to final salary benefits through ongoing career progression. For example, applying the notional underpin in any given year may cause the member to breach the annual allowance, even though the member is a number of years away from retirement. The same member may then experience comparatively low pay growth over the years to retirement to an extent that, at the underpin crystallisation date, the underpin no longer applies. In these circumstances the member would have paid a tax charge on a benefit that was ultimately never realised.

At this stage, given that the effects of the revised underpin will be with us for many years, it is difficult to know what the scale of the issue might be in terms of the numbers who might be impacted and of those how many will not have the benefit of unused annual allowance to offset any breach. On balance, however, we support the proposal to apply the annual allowance test at the underpin crystallisation date rather than on an annual basis.

Question 19 – Do the proposals contained in this consultation adequately address the discrimination found in the ‘McCloud’ and ‘Sargeant’ cases?

We believe they do. The consultation itself suggests that active members between the ages of 41 and 55 would be more likely to benefit from the revised underpin, but this a function of the fact that final salary benefits in general tend to favour long serving members with good career progression.

Question 20 – Do you agree with our equalities impact assessment?

The assessments seem reasonable.

Question 21 - Are you aware of additional data sets that would help assess the potential impacts of the proposed changes on the LGPS membership, in particular for the protected characteristics not covered by the GAD analysis (age and sex)?

No.

Question 22 – Are there other comments or observations on equalities impacts you would wish to make?

No.

Question 23 – What principles should be adopted to help members and employers understand the implications of the proposals outlined in this paper?

Members will need to receive reassurance that the underpin process is fair and is being applied accurately. It will be important for members to understand that the process is an automatic one and does not require them to lodge a claim.

Some members may have misconceptions about the value of the underpin and should be made aware that the number of cases in which the underpin will actually ‘bite’ are likely to be small.

Communications with employers should focus on the practical requirements of providing the data required to operate the underpin and any assumptions being made where member data is missing.

Question 24 – Do you have any comments to make on the administrative impacts of the proposals outlined in this paper?

While the underpin will not actually take effect for most members, a large number of members are potentially affected and will require some form of ongoing record maintenance by employers and Funds. Our initial analysis suggested 1.2 million LGPS members (UK wide) would be in scope which means that many more records will need to be updated, and underpin calculations carried out, than will ever result in an underpin addition being paid.

Adopting these proposals will inevitably have a significant impact on LGPS administrative teams and proper planning will be critical to ensure successful implementation.

The first challenge will be to obtain the data required from employers. It is to be hoped that for the majority of records this will be relatively straightforward, however, there will inevitably be situations where employers will not be able to provide the required data. This may be due to those employers no longer existing or historic payroll data not being retained.

The second big challenge will be applying the underpin test retrospectively to members who have already retired or left. While administration systems can be adapted to carry out these calculations, there will inevitably be complex cases which will require manual intervention.

The most complex cases will be where a retrospective underpin results in a member receiving a backdated payment. Additional complications would arise if the backdated payment was in respect of a survivor's pension. Thankfully these cases will be extremely rare.

The scale and complexity of this exercise could also create a significant communications challenge for administering authorities.

Question 25 – What principles should be adopted in determining how to prioritise cases?

Cases where members have already retired (or died) should be the priority as the underpin could impact on a member's (or survivor's) current retirement income. Thereafter, members closer to their underpin crystallisation date should be prioritised.

Question 26 – Are there material ways in which the proposals could be simplified to ease the impacts on employers, software systems and scheme administrators?

Any attempts to simplify the proposals come with the effect of moving away from the policy intention.

There are some scenarios where the instances of the underpin applying will be extremely rare. For example, when applying the underpin calculation to an ill health case in which the member receives a tier 1 enhancement, the comparison will be between a 1/60th enhancement based on service to 65 and a 1/49th enhancement to NRA. The 2015 Scheme enhancement will realistically always exceed the 2009 Scheme enhancement. However, there could be cases of tier 1 ill-health where the member is very close to NRA and where the effect of the underpin on service between 2015 and 2022 is so great that the positive effect outweighs the impact of the tier 1 enhancement.

Removing the underpin for ill health cases would simplify matters, and for the overwhelming majority of cases have no effect. However, given that the intention is that no individual should lose out, taking this approach could mean that the policy is not being fully realised.

Question 27 – What issues should be covered in administrative guidance issued by the Scheme Advisory Board, in particular regarding the potential additional data requirements that would apply to employers?

One area where additional guidance would be welcome is what to do when an employer is incapable of providing historic member data. Ideally, SAB should publish a set of guidelines that provide a framework for employers and administering authorities when making assumptions about service and salary history in the absence of complete information.

Question 28 – On what matters should there be a consistent approach to implementation of the changes proposed?

We support a consistent centralised data template and communications. We believe that a centralised approach to dealing with employers who cannot provide the necessary data is also welcome (see answer to question 27).

Question 29 – Do you have any comments regarding the potential costs of McCloud remedy, and steps that should be taken to prevent increased costs being passed to local taxpayers?

As the LGPS is a 'balance of cost' arrangement with fixed member contribution rates, the cost of the McCloud remedy will ultimately be met by employers. Many of these employers are councils that are funded by local taxpayers. However, whilst an increase in LGPS liabilities is unavoidable, funds have local control over the pace at which these costs are managed over time. The majority of the costs will fall on employers with a long-term funding horizon and we generally don't expect material changes to contribution rates to arise from application of the remedy.

Our analysis suggests that the impact of the remedy might only add 0.2% to the liabilities of a typical LGPS fund, equivalent to less than £100m across all funds in Scotland. This is lower than the £355m estimate mentioned in paragraph 138 of the consultation, mainly because local funds assume that salary growth will be significantly lower than CPI + 2.2% pa.

At whole fund level, our estimate translates to a rise in typical primary contribution rates of 0.2% of pay, and a small change to secondary contribution rates of only 0.1% of pay. As requested by SPPA, we have built the proposed McCloud remedy into the 2020 valuation and so costs will be implicitly factored in when setting funding strategies and contribution rates payable from 1 April 2021.

Whilst at whole fund level the impact is small, it may be more material at individual employer level. The cost impact is likely to be higher for employers with youthful membership profiles, as there is a greater likelihood of the underpin 'biting' for younger members. Our analysis suggests that some employers may see their total liabilities increase by as much as 5-10% (equivalent to at least a 1% of pay contribution rate increase), whilst other employers will see no impact at all. There is also the potential for one-off significant cost increases e.g. for a small employer with only one active member who is awarded a significant pay increase.

The inclusion of McCloud in the national cost management valuation at 2017 will reduce the value of any cost savings that we understand are being anticipated. However we are unclear if the cost of McCloud will be sufficient to bring the total scheme cost to within 2% of pay of the original cost envelope (which would avoid triggering a package of benefit improvements effective from 1 April 2020).

Finally, aside from actuarial costs, the costs to funds in terms of administration and communications could be significant and could easily run into six figures in terms of extra FTE resource. These costs are typically recouped via an administration charge as part of employers' ongoing contribution rates.