HYMANS ROBERTSON

Actuarial update

Brent LGPS Fund – COVID-19 and Regulatory Changes

Executive Summary

- **COVID-19** has had a substantial impact on the global economy and the financial markets in 2020, with a corresponding impact on the funding level and funding risks. It is too early to say what the long term impact could be, including the impact on mortality rates.
- The outcome of the **McCloud** court case last summer ruled that the transition protections given to older members when the 2008 LGPS final salary scheme closed are age discriminatory. The remedy is to retrospectively apply the same protections to all members who were in the 2008 LGPS scheme on 31st March 2012. This will result in a small increase in liabilities at Fund level of c£1M or 0.1%. Increases for some employers may be significantly higher. The effort required to implement the remedy will be significant and it is estimated the project will take 2 years or more to complete.
- The 2016 **HMT cost management** valuation process has recommenced and may result in changes to member benefits or member contribution rates. Any changes will be back dated to 1 April 2019. The 2020 HMT cost management valuation is expected to start shortly.
- HMT have announced that an **exit payment cap of £95,000** applying to all exits from public sector employers will be in place by the end of the year. Exit payments include redundancy payments, severance payments and pension strain costs. If the total value of such payments including strain costs exceeds the £95,000 cap then an employee's pension will be reduced.
- MHCLG have also proposed further changes to **redundancy pay for public sector** employees, notably that people over 55 will no longer be able to receive both redundancy pay and immediate pension in full.
- The **Goodwin** case is another discrimination case addressing discrimination of the grounds of sexual orientation. Again, although the funding costs are small, this will be a further administration and communication burden to address.
- The Government published a response to its consultation on "**management of employer risk**" on 26 August with changes to regulations coming into force on 23 September 2020. Administering Authorities will now have increased powers to review employer contribution rates between valuations and to enter into repayment plans with exiting employers. It also introduces a "deferred employer" status for employers, whilst also giving employers the power to request a review of their contribution rate.

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Addressee and purpose

This paper has been commissioned by and is addressed to the London Borough of Brent in its capacity as Administering Authority to the London Borough of Brent Pension Fund ("the Fund"). It has been prepared by Hymans Robertson LLP (as Fund Actuary) to assist the Fund's Pension Sub-Committee to understand the nature and impact of several recent changes to Regulations on the Fund as well as recent market movements. This paper should not be used for any other purpose or published without our written consent.

Introduction

This paper addresses the following current issues, regulatory changes and processes:

1. funding and administration issues raised by COVID-19
2. McCloud (funding implications and cost)
3. Cost management valuations for 2016 and 2020
4. Proposed legislation on the £95k cap including some discussion on how it may impact on employer early retirement and redundancy strain calculations for some employers
5. Goodwin ruling regarding equality of survivor benefits in same sex marriages again including the funding implications for your Fund and employers
6. Employer contribution options, particularly around changes in contributions and potential employer exits.

1. COVID-19

COVID-19 has led to a worldwide increase in deaths and a significant shock to the global economy with large movements and increased volatility in stock market values and financial difficulties for some employers. Whilst the short-term impact on the number of deaths and the economy is significant, it is unclear at this stage what will be the medium and longer term impact.

This section focuses on what this means for the funding of defined benefit pension schemes like the Local Government Pension Scheme ("LGPS"). In particular, we consider the impact of:

a) recent market movements on the funding level since the 2019 actuarial valuation;

b) economic lockdown on employer covenant and risks; and

c) the impact of higher death rates.

We also consider what measures the Fund could take to mitigate the identified risks. As the pandemic evolves, and the economic and political environment reacts, the conclusions contained within this paper may also evolve. Therefore we would recommend that the Fund and the Pension Fund Sub-Committee keep this situation and its response under regular review.

Employer funding strategies: a brief reminder

Before discussing the impact in further detail, it is useful to recap how the Fund approaches the funding of benefits to members. The focus of the funding strategy is to take a long term view and ensure that each employer's own circumstances are taken into account. To do this, the Fund used a 'risk based' approach at the 2019 valuation to set contribution rates for all employers.

For each employer, three elements were considered:

1. What is the funding target?

The target is determined using the assumptions that were agreed at the valuation and described in the Funding Strategy Statement ("FSS").

2. What is an appropriate time horizon over which the employer should reach this target?

The funding time horizon will depend on various employer-specific factors. For example, contractors or charities that are closed to new entrants tend to have short time horizons, typically less than five years. Secure, long term employers, such as councils, that are open to new entrants have much longer time horizons of up to 19 years.

3. How sure do you want to be that each employer will reach the target?

The Fund needs to rely on both contributions and investment returns to pay members' benefits in the future. The more the Fund relies on investment returns, the less employers will pay in contributions, and vice versa. Given that future asset returns are unknown, there is an element of uncertainty when setting funding plans. Understanding the level of uncertainty is useful from a risk management point of view but it also allows the Fund to reflect the financial strength ("covenant") of its employers. Asset liability modelling (ALM) was used at the 2019 valuation to quantify the likelihood of an employer meeting its funding target over its time horizon given a proposed contribution rate and investment strategy. For example, if an employer met its funding target in 4,000 out of 5,000 possible future scenarios modelled in the ALM, there would be an 80% likelihood of the funding strategy being successful. Employers with strong financial covenants have lower likelihoods than those for less secure employers.

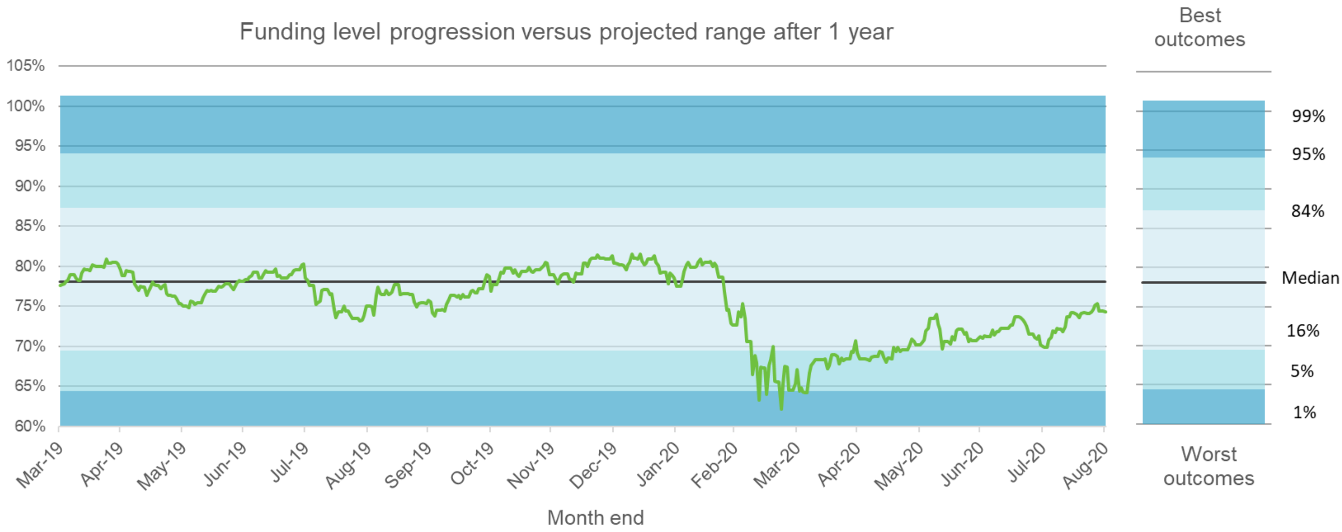
Full details of the funding strategies that apply to the Fund's employers are contained in the Funding Strategy Statement. This was reviewed and updated as part of the 2019 valuation.

As each employer has different circumstances, time horizon and covenant, the funding impact and risks resulting from the COVID-19 pandemic should be considered at both a Fund and employer level.

Impact analysis

a) Market movements

As at 31 March 2019 the Fund held assets of £856m against liabilities of £1,104m, corresponding to a funding level of 78%. The green line in the following chart shows how the funding level is estimated to have evolved since 31 March 2019 to a recent date (31 August 2020) by allowing for market movements over the period. Volatility in the funding level measure is to be expected given that the Fund is invested in assets whose day-to-day value can fluctuate significantly e.g. equities. However, it is insightful to understand how the current observed level of funding level volatility compares against the expectation at the last formal valuation. The blue shading in the below chart's background represents the 'corridor of potential funding levels' predicted by the ALM at the 2019 valuation, with the darker shading representing the less likely (i.e. more extreme) outcomes. Further detail on interpretation of the chart is provided underneath.



The key on the right hand side provides the likelihood of a funding level being below that level. For example, a funding level below c64% is expected in 5% (or 1 in 20) of all future outcomes. A funding level above c94% is similarly only expected in 5% of cases. The lightest shaded area represents funding levels between c69% and c87%, and indicates these are expected between the 16th and 84th percentiles, i.e. two thirds of the time.

The chart shows that as at the time of writing. the funding level remains comfortably within the 'corridor' of outcomes predicted by the ALM at the 2019 valuation. For the majority of the period of COVID-19 volatility the funding level remained within the two-thirds band of outcomes (with a few weeks when the level fell to a 1 in 20 outcome at worst). This can be seen by following the green line on the chart above over time. Some further notes on the funding progress are below:

- The funding level became increasingly volatile from February 2020 onwards as COVID-19 started to affect global markets. In particular, the FTSE100 suffered its second largest one day crash in its history, and the biggest since the 1987 market crash.
- Whilst there was a sharp fall in the funding level in March, there has been some 'bounce-back' in recent months. It is yet unknown if this will be sustained due to the continuing uncertainty in the global economy. The timing and shape of any rebound is uncertain and depends on containment of the virus and the effectiveness of policy responses in preventing temporary disruption to businesses and consumers from causing permanent damage.

b) Employer covenant and risks

Many businesses and institutions in all sectors have been affected significantly by COVID-19. The impact will vary by sector and by source of funding. The key challenges include:

- Payment of salaries – should staff be furloughed? Do redundancies have to be made and how are associated costs covered?
- Ensuring cash flow in the business is sufficient to cover costs as trading revenue dries up
- Weakened reserves and reduced financial strength (“covenant”), including the threat of insolvency
- Speed and ability to recover once lockdown measures are lifted
- Affordability of pension contributions resulting in requests for the Fund to reduce or suspend payment

The main funding risks posed to the Fund by its participating employers are:

- Inability to make contributions when the fall due; and/or
- Insolvency resulting in an employer ceasing in the Fund whilst a deficit exists, and that deficit therefore passing to remaining employers to Fund.

Below we consider the impact on covenant for each of the Fund’s main employer groups. Note that within these groups there will be variation between employers. The comments in this paper are general in nature and do not reflect on any one specific employer.

Long term secure, tax-backed employers

The majority of the Fund’s employers are public sector bodies, such as councils and academies, where the covenant is strong and backed by statute or the Department for Education guarantee. These types of bodies are unlikely to pose an insolvency risk to the Fund. Similarly, they are likely to able to make contributions when they fall due, albeit some who may face cashflow challenges whilst balancing reduced income and increased outgo due to funding pandemic-related activity. This may be more of an issue as the timeframe of the pandemic extends.

Other employers

The most significant impact on covenant is in respect of other employers including those who are close to exit, are not publicly-funded and/or had a weak covenant at the 2019 valuation. The specific employer funding issues that should be considered include the following:

- Contractors – these employers tend to only participate in the Fund for a few years. Recent market movements may have opened up large deficits in their funding positions requiring a cessation payment at the point of exit. This may be counter to the position as at the 2019 formal valuation where such employers may have been in surplus and expecting an exit credit to be paid on cessation. Trading ability and covenant may also be an issue in stressed market conditions depending on the function they carry out.
- Charities and other third sector employers – these bodies are usually closed to new entrants, may already have had weak covenants prior to COVID-19 and may have seen income streams reduce. This group is likely to be one of the most significantly impacted and some will have little financial reserves to call upon to tide them through.
- Leisure centres - their ‘trading revenue’ will be badly hit by lockdown measures although ceding council support may be available

c) Higher death rates

The tragedy of increased death rates due to COVID-19 that is currently unfolding in the UK and globally will inevitably affect all pension schemes. The key impacts of higher mortality from a funding perspective are:

- Liquidity risk – ensuring the Fund has sufficient cash to pay out lump sum death benefits promptly to beneficiaries
- Death-in-service 'strains' – the death benefits for an active member may be significantly bigger than the valuation liability. Whilst such strains tend be 'absorbed' easily by large employers, a strain for a small employer with very few actives could materially reduce its funding level. In normal circumstances, these would be very rare events, however they may increase in occurrence due to the level of excess deaths linked to COVID-19.
- Reduced liabilities – higher deaths than expected amongst pensioners will lead to lower liabilities. Mature employers, with higher proportions of pensioner members, may be most 'affected'.

The evidence of deaths related to COVID-19 is emerging, but it is difficult at this stage to attach any certainty to mortality rates (not least because testing has not been widespread in the UK). However, as the majority of deaths are occurring at older ages, it is reasonable to assume that the overall impact will be a reduction in liabilities and a general improvement to funding levels, all else being equal. The impact is unlikely to offset market movements to any material extent e.g. an infection rate of 33% across the pensioner population might reduce liabilities by around 1% for a typical employer.

At this stage, it is not possible to extrapolate the longer-term impact of a higher death rate in 2020/21 either on future mortality or morbidity rates. There are a number of factors to consider. The responses to COVID-19 including social distancing, increased hygiene measures and the resulting improved air quality and lifestyle changes may act to improve life expectancy. Additionally, the virus may have sadly hastened the deaths of some of the population which would have died anyway of other causes resulting in a lower death rate over the next few years. This may be offset or outweighed if the virus persists over time, like influenza or if there is a long-term impact on the health of those who recover from COVID-19 (which could result in future higher ill health retirement rates. Data is still being collected and analysed and we will monitor any future impacts on life expectancy at subsequent valuations or sooner if necessary.

Risk mitigation measures

There are a number of measures that the Fund may take to mitigate the funding risks outlined above.

a) Market movements

The 2019 valuation was positive with all LGPS funds reporting an improvement in funding over the preceding three years, driven by asset outperformance. Whilst a reduction in funding level is clearly not welcome, it must be remembered that the LGPS is an open scheme with a strong covenant and is able to take a long-term outlook when considering the high-level funding implications of external shocks. This has been the case during past events, such as the "Credit Crunch" or the "Dot Com bubble", and in both cases the Fund did not make knee-jerk reactions to contribution rates for long-term employers.

No one knows what the long-term impact of COVID-19 may be on the economy and ultimately on the long-term cost of funding defined benefit pensions. We suggest that the Fund

- continues to monitor the funding level and outlook for the long-term economy and returns on the Fund's assets on a regular basis; but
- does not revisit contribution rates for long-term employers at this stage.

The asset allocation of different LGPS funds will result in a variety of returns over the period since the 31 March 2019 valuation date. LGPS funds each have their own investment strategy, beliefs and attitude to risk. As ultimately the two levers of funding are contributions and investment returns, the Fund should consider if it remains happy with the relative dependence on each for employers and the Fund as a whole as more information about the long-term economic impact comes to light. Whilst these are not immediate risk mitigation measures, the Fund may also wish to consider, when appropriate, how investment strategy may be used to mitigate the funding risks for exiting employers.

b) Employer covenant and risks

Taking the various employer types in turn:

All employers

- The Fund may wish to agree a policy for consistent handling of any requests to defer, reduce or suspend contributions to ensure that each is treated equitably and transparently.

Contractors

- Communicate ongoing uncertainty to employers by reviewing funding positions for those due to cease before 31 March 2023 and discuss whether adjustments are needed to contribution rates prior to exit.
- Consider communication with guarantors/letting authorities in relation to the above pension funding risks. (It is likely the letting authority is actively managing all aspects of contracts in the current climate).
- Check that paperwork on any security e.g. bond or indemnity, is in place and up-to-date

Charities and other third sector employers

- Seek to understand impact on covenant through sector analysis or direct engagement with employers
- Review funding positions for those that might cease before 31 March 2023 and discuss whether adjustments are needed to contribution rates.
- Consider if it is appropriate to commence discussions in relation to post-cessation funding on a case by case basis if cessation by the planned exit date is likely to risk insolvency and a default on the cessation payment due (either in part or in full).
- Check that paperwork on any security e.g. bond or indemnity, is in place and up-to-date.

Leisure centres

- Monitor sector's financial position over coming weeks and months and review covenant if deemed necessary through direct engagement with employer(s).

c) Higher death rates

- Liquidity – the Fund may already have some idea of the likely increase in death benefits from the first few months of the pandemic. Sensitivity around increased death benefit payments can be provided to feed into this.
- Death-in-service 'strains' - identify and communicate risk to small employers with few actives. The Fund may wish to consider a period of risk sharing / self-insurance of this risk given the extreme nature of the event. This could be carried out as a one-off exercise or via an adjustment at the 2022 formal valuation of the Fund.
- Reduced liabilities – the Fund already manages its longevity risk via Club Vita. This involves the regular collection of mortality data from the Fund and many other LGPS and private sector schemes, allowing accurate longevity assumptions to be set at actuarial valuations and emerging trends and experience to be quantified for future discussion.

2. The McCloud judgement

The cause: transitional protections

One feature of the reform of all public sector pension schemes in the first half of the 2010s was the commitment to protect older members. For the LGPS, this protection was transitional and took the form of an underpin. From 1 April 2014, an eligible member would receive the better of benefits earned under the old 2008 scheme (60ths accrual, final salary, retirement age of 65) or the new 2014 scheme (49ths accrual, Career Average Revalued Earnings (CARE), retirement age equal to State Pension Age).

The format of the protections differed between public sector pension schemes, however they were all uniform in applying the eligibility criteria – the protections would only be applicable to members who were:

- active in the scheme as at 31 March 2012;
- within 10 years of their Normal Retirement Age (as defined under the pre-reform scheme rules, 65 in the LGPS) as at 1 April 2012.

Who benefits from the underpin?

A summary of the benefit changes introduced in 2014 are shown below:

	Final Salary scheme	CARE scheme	Impact on value of member's benefits
Accrual rate	1/60th	1/49th	Increase of 22%
Revaluation rate	Salary increases	Consumer Price Index	Depends on an individual's salary growth vs CPI inflation
Retirement age	65	State Pension Age (SPA)	Decrease for members whose SPA is after 65

Due to the significant increase in accrual rate, the underpin only kicks in if salary increases throughout their working life outweigh the additional 22% of CARE benefit (revalued in line with CPI) that had been earned each year. The difference in retirement age could also make a difference, particularly for marginal cases.

The challenge

In 2016/17, members of the Judicial Pension Scheme (including one member named McCloud) brought a claim of age discrimination against the Ministry of Justice (MOJ) due to the imposition of the transitional protections. The members contested that, by applying the protections only to those members within 10 years of retirement at March 2012, younger members of the scheme were at a disadvantage.

The Ministry of Justice conceded that the protections did put younger members at a disadvantage, however they argued that this treatment was justified. The justification being that the members in scope of the protections would likely already have made advanced plans for financing their retirement and any change to their pension scheme may adversely affect these plans.

A separate but similar challenge was also launched by a member of the Firefighters' Pension Scheme.

The Employment Tribunal found against the MOJ and the members' complaints were upheld.

This original decision was appealed by the Government until it reached the Court of Appeal for consideration in November 2018. On 20 December 2018, the Court of Appeal ruled that:

- the Government's appeal was to be dismissed; and
- the claim of discrimination of the grounds of age is valid.

Following on from this ruling, in the first half of 2019 the Government sought leave to appeal this ruling at the Supreme Court. However, in June 2019, the Supreme Court refused the Government's application to appeal, meaning that the Court of Appeal's decision was final.

Following the Court of Appeal's decision at the end of 2018, in January 2019 the decision was been taken by the Government to suspend the ongoing Cost Management valuations[1]. Further detail about the Cost Management valuation, its interaction with McCloud and impact on funding is contained later in this note (section 3).

After the Supreme Court confirmed they would not hear the Government's appeal, in July 2019, the Government accepted[2] that the protections put in place were discriminatory and committed to remedying the situation. The court cases to date were only in respect of the Judicial and Firefighters' Pension Schemes. However, the Government also accepted that the ruling would, if tested, also apply to all other public sector pension schemes which implemented age-based transitional protections during the reform process. This includes the LGPS.

Since then, discussions have been taken place to assess how best to resolve the discriminatory elements of the benefit structure (what has now become commonly referred to as "finding a solution" to "McCloud" or "the McCloud judgement"). It is not a viable option to entirely remove the transitional protections as that would involve reducing the accrued rights of some members (i.e. those eligible for the original protections and who would have benefitted, via higher benefits, from the existence of the protections). Therefore, the discussions have been focussed on how to adequately "level up".

Remedy

On 16th July 2020 MHCLG published consultation documents[3] setting out detailed proposals for addressing the discrimination. The consultation process closes on 8 October. Hymans Robertson have published our response to the consultation which can be found at the link below[4].

In summary, the proposed remedy extends the 'transitional protections' underpin (that was promised to active members in 2012 who were within 10 years of normal retirement age) to all other active members, regardless of age. The underpin gives the member the better of CARE or final salary benefits for the eligible period of service.

In general terms, the key features of the underpin are:

- Eligibility is restricted to members who were active in the LGPS on 31 March 2012 and have accrued benefits since 1 April 2014;
- The underpin period applies between 1 April 2014 and 31 March 2022, but ceases when the member leaves active membership or dies in service;
- The final salary for comparison purposes applies at the point that the member leaves active status or reaches age 65 if sooner; and

[1] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2019-01-30/HCWS1286/
[2] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2019-07-15/HCWS1725/
[3] https://www.gov.uk/government/consultations/local-government-pension-scheme-amendments-to-the-statutory-underpin
[4] https://www.hymans.co.uk/media/uploads/Hymans_Robertson_McCloud_Consultation_Response.pdf

- The normal pension age for CARE benefits can be after the normal pension age for final salary benefits. The underpin requires the impact of any applied actuarial reductions to be considered in assessing which benefit is higher.

The changes will be retrospective and will apply to anyone who has left, retired or died and who didn't meet the old underpin criteria but meets the new one. In some cases, this will mean retrospectively recalculating benefits for pensioners, and paying arrears and interest.

There is significant complexity in the detail of how the underpin will apply and the consultation addresses the topics of early leavers, deaths in service, early and late retirements, ill health retirements, members with multiple posts, breaks in service and aggregations of service across different LGPS employments, transfers between public sector schemes, annual allowance implications and the requirement to include information on the underpin on members' annual benefit statements.

Impact on funding and employer costs

At whole fund level, we don't expect the McCloud remedy to have a significant impact on the funding position and hence on employer costs. For the Brent Fund, assuming pay growth assumption of CPI + 0.3%, we estimate that the McCloud underpin may add around 0.1% to the liabilities.

Previous estimates of the impact of McCloud were typically higher than this as they assumed that all members of the Fund would be eligible. Estimates from the Government Actuary were also higher because they tended to assume a higher rate of future salary increases

Whilst at whole Fund level the impact is small, it may be material at individual employer level. This is where the LGPS differs from the other public sector schemes - everything is funded at employer level and contributions can and do vary materially across the employers in the Fund.

The variation in McCloud underpin impact arises due to differing membership profiles, and particularly age. Younger members will have a longer period of salary increases compared to older members (especially once promotional increases are considered, which tend to be higher at younger ages). There is therefore a higher likelihood that the underpin 'bites' for younger members. Our modelling suggests that some employers may see their total liabilities increase by as much as 0.5% whilst other employers will see no impact at all. There is also the potential for one-off significant events which may result in an impact greater than noted above, for example, an employer with only one member who is awarded a significant pay increase.

It is worth noting that the introduction of the underpin to all eligible members, and the fact that the link to final salary will be retained up until the member retires, means that another source of volatility and uncertainty is introduced into the funding of LGPS benefits. We may see employers' funding positions and contribution rates changing by larger amounts between valuations because of this factor.

Formal valuation approach

SAB asked funds and actuaries to allow for McCloud costs at the 2019 valuation in England and Wales when setting funding strategies. For this Fund, we increased the required likelihood of achieving full funding for employers (e.g. from 66% to 70% or 70% to 75%) to build in some margin for McCloud costs. The approach taken to allow for the uncertainty caused by McCloud is set out in Section 2.7 of the Funding Strategy Statement.

Administration impact of McCloud

Despite the relatively small liability impact of the McCloud ruling, the administration impact will be significant. In conjunction with key stakeholders, including the Local Pensions Partnership as administrators, the Fund will have to adjust member's records to reflect the new underpin and to correct any benefits which have already come into payment.

This project will take many months, and potentially years of effort depending on the membership affected. Key stages will include:

Understanding McCloud and establishing a project plan

The key outcomes from this stage will be to identify who is going to be working on the project, the key stakeholders and ensuring that they have the right level of knowledge. This stage would be expected to last until after the consultation process concludes and some outstanding policy decisions have been made. The UK Government have indicated that final Regulations may not be available until 2022/23 but have urged Funds to begin work in the interim.

Identifying cases

Cases in scope then need to be identified using the key criteria set out in the consultation. In most funds around 20-30% of members are impacted. We would strongly suggest that work should commence to identify the groups and employers of members impacted within this Fund.

Adjusting records

Member records need to have the correct information to enable an underpin calculation to be completed. This is one of the most challenging areas of the project and will involve significant engagement with employers to gather salary and working hours data back-dated from 1 April 2014. This data has not previously been collected, as it wasn't needed to administer CARE benefits. This will be challenging as some employers will have left the Fund, some may have changed payroll providers and some simply won't have kept the records required. There will be a need for policy decisions on how to approach situations where it isn't possible to complete the data record but the Fund must ensure the members' benefits are calculated accurately and the underpin applied fairly. The data specification for employers will have to be changed in order to ensure the correct data is captured within future processes.

Recalculation of benefits

When the data is sourced for identified cases, the members' benefits will need to be re-calculated. For members still in service, or those who have left the Fund before retirement, their accrued pension may have changed and their annual benefit statement may need to be adjusted. There may be annual allowance tax implications for some members. Some of these calculations will be complex as a result of some of the issues mentioned above. Liaison with system providers is underway to specify changes required to the administration software to support the recalculation processes and ongoing requirements to assess the underpin. Early indications are that it may take around 12 months for administration providers to fully develop the calculation routines required.

Calculate arrears and interest and then pay arrears

Arrears and interest payments may be due for some members whose benefits are already in payment, if the McCloud underpin would have resulted in a different pension for these members. In some cases where benefits are changing there may also be tax charges for members. The tax implications of these proposals are complex as members who would not have breached annual allowance under the CARE scheme may breach annual allowance if they become eligible for an underpin.

Final record adjustment to both the administration and payroll record if applicable

Finally, the member administration and payroll records will need to be updated with the calculated position and this must be maintained going forward.

Audit check and Stakeholders

There is a significant list of stakeholders who will be involved in the project including current and former employees, their dependents, fund employers, your actuary, your administrator, pensions committee and board, MHCLG and Treasury departments, SAB and others. Different stakeholders require different levels of involvement at the different stages of the project but communication across all groups about progress, issues and outcomes and costs will be vital. Given the complexity of the project checking and audit processes will also have to be robust.

Project management

The size and complexity of this project means that it will also require proportionate project management resource and expertise.

McCloud summary

Remedying the discrimination identified by the McCloud judgment will be a significant undertaking for the Fund's administration team. We expect further updates to be provided to Pension Sub-Committee in due course.

3. Cost Management Valuations 2016 and 2020

In addition to McCloud, the "Cost Management Valuations" are an ongoing national process which is resulting in current uncertainty around the benefit structure of the LGPS. These valuations were similarly borne out of the public service pension reform in the early 2010s.

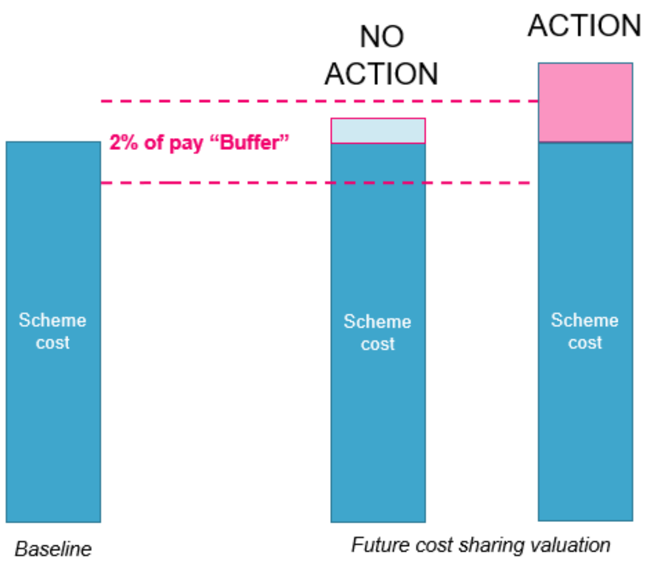
Background

As part of the reforms discussed earlier in this note, a mechanism was put in place which sought to put in a safety valve and protect employers from significant increases in future pension costs and to support the long-term sustainability of a defined benefit pension offering.

Historically, any variations in pension costs fell to the employer to fund as both benefits earned and employee contributions were defined in the Regulations. The cost mechanism sought to re-distribute the risk and share any cost variations with members. Prior to this mechanism being introduced, employer contributions had been on an upwards trend across a number of valuation cycles.

This mechanism works on the basis that every 3 or 4 years (the frequency varies between public sector pension schemes), a valuation at national level will be carried out by the Government Actuary's Department on behalf of Treasury to assess the overall cost of pension provision. The assessed cost will then be compared against a benchmark cost, and if the difference is equivalent to more than 2% of pay, then action will be taken to amend the benefit structure or employee contribution rates such that the current cost matches the benchmark cost. If the variation is less than 2% of pay then no action is taken.

This valuation is carried out on a set of assumptions set by HMT, and differ from those used for the purposes of your formal valuation to set employer contributions. One of the key features of the Cost Management valuation is that it limits the factors for inclusion to those that have an impact on the benefit received by a member. Critically, it makes no allowance investment returns earned on assets.



The mechanism was originally intended to act as a capping mechanism on costs i.e. action would only be taken if costs were higher than expected. However, during the reform implementation, the mechanism was amended to a symmetrical design i.e. there would be a cap and a floor on cost. Therefore, if costs were less than expected, then action would be taken to improve the benefit structure to restore the cost to its benchmark level. In essence, the Cost "Cap" became Cost "Management".

Alongside the Treasury Cost Management process (TCM) described above, the LGPS in England and Wales also has a SAB Cost Management process (SCM). The SCM is carried out ahead of the TCM and takes into account different factors from the TCM, including factors which are unique to the LGPS. Importantly, any change in benefits as a result of the outcome of the SCM process is allowed for within the TCM.

The SCM also works slightly differently in how it may implement amendments to benefits if the costs of the scheme have moved.

- A movement of between 0% and 1% from the target in either direction **may** result in agreed recommendations for action to move back to the target.
- A movement of between 1% and 2% from the target in either direction **should** result in agreed recommendations for action to move back to the target.
- A movement of 2% or more from the target in either direction **must** result in agreed recommendations for action to move back to the target.

By contrast, for the TCM mechanism, no corrective action will be required to move the costs back to the target unless there is a movement of 2% or more from the target in either direction. This gives SAB the opportunity to make a small change in the benefit structure during the SCM to avoid a larger change being triggered by the TCM process.

The first Cost Management valuations were carried out as at 31 March 2016 and initial results communicated in Autumn/Winter 2018. Early indications were that the cost of the scheme had fallen as a result of falling improvements in life expectancy and lower than expected pay growth. The SCM process reported a fall of around 1% of pay and the TCM process was expected to report a fall in excess of 2% of pay below target therefore requiring future benefit improvements.

The SCM process proposed benefit improvements of around 1% of pay, mainly involving changes to employee contributions, and it was expected that after these benefit improvements were implemented no further action would be needed by the TCM process as their assessment of the scheme cost would be restored within the 2% of pay buffer.

These changes were due to be come into force under the relevant regulations by 1 April 2019.

Interaction with McCloud

Whilst the Government was dealing with the emerging Cost Cap results, they also learnt of the Court of Appeal's ruling in the McCloud case.

It was the Government's opinion that any increase in benefits due to McCloud should be factored into the ongoing Cost Management valuations. Given that the McCloud remedy will result in an increase in pension costs, it may be of such a magnitude that the cost saving identified at the Cost Management valuations reduces to less than 2% of pay when assessed using their approach. If this were to be the case then no action would be needed to amend benefits from 1 April 2019. (Note that at this stage we are unable to assign a probability to how likely this outcome is).

Therefore, the Government announced in January 2019 that the Cost Management valuation process would be put on hold until McCloud was resolved. After the resolution, the Cost Management valuations would be restarted and, if any changes are required to be made to benefits or contributions, then they would be backdated to 1 April 2019.

Legal challenge

The action by Government to suspend the implementation of scheme changes as a result of the Cost Management valuations has recently been challenged by four Unions (Fire Brigades Union, Public and Commercial Services Union, the Professional Trades Union for Prison, Correctional & Secure Psychiatric Workers and the GMB Union).

In April 2020, these Unions have filed court proceedings against the UK Government arguing that the suspension breaches the Cost Management regulations (which states benefits changes must come into force from 1 April 2019)[5].

The challenge also effectively asserts the Unions' belief that the costs associated with resolving McCloud sit outside the Cost Management mechanism.

The case is still ongoing, however, on 16th July 2020 the Treasury announced that the Cost Management processes for the LGPS will be re-started assuming that the McCloud costs are included in the calculations.

The future of the Cost Management

The results of the 2016 Cost Management valuation were likely to have been unexpected when agreeing to implement a symmetrical design. The rigid regulations that were put in place gave the Government no option but to implement benefit increases following the publication of the Cost Management valuation results. It is also worth noting that in the absence of agreement on the proposed benefit increases, the default approach is to increase the accrual rate to restore the scheme cost to the benchmark level.

For many public service schemes, an increase to future benefits was announced at the same time as an increase to contributions (which arose due to a change in the HMT valuation assumptions).

In light of the unexpected results, the Government confirmed in September 2018[6] (when the first initial results started to emerge) that the Cost Management mechanism will be reviewed ahead of the next round of Cost Management valuations (due to take place as at 31 March 2020) to ascertain whether it still meets the policy intent.

However, until such a review has been completed, existing legislation requires that the next round of Cost Management valuations should take place. We understand that data will be requested for the 2020 Cost Management valuation in late 2020.

[5] https://www.fbu.org.uk/news/2020/04/25/firefighters-take-government-court-over-pension-%E2%80%98robbery%E2%80%99

[6] https://hansard.parliament.uk/commons/2018-09-06/debates/18090633000015/PublicServicePensionSchemesQuadrennialValuations

4. Public Sector Exit Payments

The government first announced plans to cap exit payments in the public sector in 2015. On 10 April 2019 HM Treasury (HMT) launched a consultation on draft regulations, guidance and Directions to implement the cap. HMT published its response to the consultation[7] on 21 July 2020, and MHCLG issued their consultation for local government on 7 September 2020[8].

Statutory redundancy pay and early retirement strain

The consultation included an unexpected proposal affecting redundancy pay (both statutory and discretionary). This relates to all public sector workers being made redundant with an immediate entitlement to an early retirement pension (i.e. those at or over age 55 but below normal pension age). Under the proposals, affected employees would not be able to take both their full redundancy pay and their full unreduced pension immediately. Instead, they would have to give up all or part of either one, with the decision being up to them. This rule would apply to anyone in these circumstances, regardless of the value of their redundancy pay or pension strain cost relative to £95k.

Exit Payments £95k Cap

The cap will apply to all public sector employers. The exit payment cap is set at a total of £95,000 with no provision for this amount to be index-linked. Exit payments include redundancy payments (including statutory redundancy payments), severance payments, ***pension strain costs*** – which arise when an LGPS pension is paid unreduced before a member's normal pension age – and other payments made as a consequence of termination of employment. Although statutory redundancy is included as an exit payment it cannot be reduced. If the cap is exceeded, therefore, other elements that make up the exit payment must be reduced to achieve an exit payment of £95,000 or less.

Applying the cap in the LGPS

The major impact of the regulations will be on LGPS members aged 55 or over who currently qualify for an unreduced pension because of redundancy or efficiency retirement as well as a severance payment under The Local Government (Early Termination of Employment) (Discretionary Compensation) (England and Wales) Regulations 2006.[9] We understand that changes to those regulations will prevent the payment of severance in addition to a pension strain cost. Not only will a severance payment no longer be payable but if a pension strain payment cannot be made in full because of the cap, then the member's pension would be reduced.

Pension strain cost

Currently the pension strain cost that an employer pays on the early retirement or redundancy of a member over the age of 55 is calculated at a local fund level using factors provided by your actuary which reflect your local funding assumptions. These factors were most recently reviewed following the 2019 valuation process. These factors are intended to reflect the difference in cost arising to the Fund as result of paying benefits sooner than expected and for a longer period of years. The local approach to calculating the strain could mean that members in different LGPS funds with the same accrued pension may have a different strain cost to take into account in the calculation of the exit payment limit and hence a different reduction. Therefore, MHCLG have asked the Government Actuary's Department (GAD) to produce standardised factors for use in these calculations.

[7] https://www.gov.uk/government/consultations/restricting-exit-payments-in-the-public-sector

[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/916615/Reforming_local_government_exit_pay_consultation.pdf

[9] https://www.legislation.gov.uk/uksi/2006/2914/contents/made

This will result in equity between members in different funds but will lead to less accurate assessments of the strain costs for the employers and could result in employers paying less in strain costs at the time of exit. Any shortfalls will feed into an employer's position at the next triennial valuation and may result in contribution increases at that time.

How much are pension strain costs?

GAD have not yet published the factors to be used in these calculations so we cannot yet assess with certainty the pension strain amounts. However, using current strain factors for a typical Fund, some case studies are shown below, noting that in all four cases the member's LGPS pension would be a similar amount (broadly £15,000 p.a.).

Member	A	B	C	D
Salary	£30,000	£45,000	£90,000	£150,000
Exit Age	55	55	60	64
Service	30 years	20 years	10 years	6 years
Early retirement pension strain	£112,000	£112,000	£58,000	£12,000

Implementation Issues

Although this policy was first announced back in 2015, there is now a very short timeframe for implementation and for the required changes to Regulations to be made. Any member leaving from an employer subject to the cap, after the end of the year, will have to have the employer strain cost calculated using the new standardised strain factors when available and members' pensions reduced as appropriate. As a result, it will be difficult to provide redundancy cost estimates to employers over the next few months.

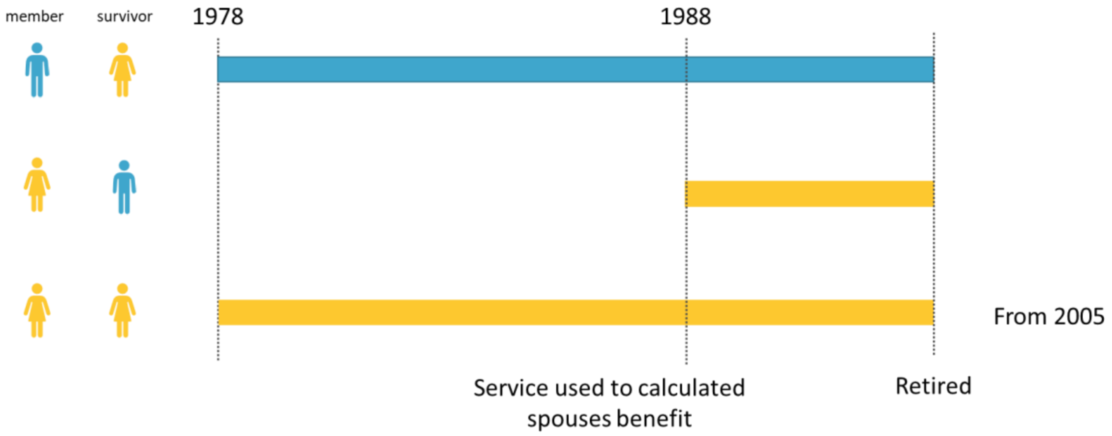
There will now be two different processes for early retirements for employers who must apply the public sector exit cap and for employers who are outside of the public sector exit cap, whose members are still entitled to benefits unreduced regardless of the strain cost.

The regulations to put this into practice are expected to come into force in the near future: this obviously has immediate implications for any employers planning redundancy exercises, as any quotes issued now may no longer be accurate when the time comes to pay them. Although the changes do not affect the Fund directly, it should alert employers to the changes as soon as possible. There will also be non-trivial administrative process implications.

5. Goodwin ruling

The Goodwin tribunal was raised in the Teachers' scheme. It claimed members, or their survivors, were discriminated against due to their sexual orientation. The claim was because the Teachers' scheme provides a survivor's pension which is less favourable for a widower or surviving male partner, than for a widow or surviving female partner of a female scheme member. On 30 June 2020, the Tribunal found in favour of the claimant and agreed there was discrimination.

This finding and remedy is expected to apply across all public service pension schemes, including the LGPS. The diagram below illustrates the inequality.



The first case considers a male member who entered into their partnership/marriage with their spouse or partner after leaving active status. All of this member's service from 1978 until retirement would count towards the calculation of the survivor's pension.

The second case considers a female member who entered into their partnership/marriage with their **male** spouse or partner after leaving active status. Even if they had identical service histories to the male member in the first case, the survivor's pension would only be based on service from 1988 until they retired if they entered into their partnership or marriage after leaving active employment. This was viewed as unfair and female members were given an option to purchase the "missing service" to uplift their dependent's benefit.

However, in 2005, following on from the Walker case the definition of spouse in the Regulations was expanded to include same sex relationships. In effect, from 2005, if a female had a female spouse or partner and their partnership/marriage was after they left active status, all their service since 1978 counted towards their survivor's pension and they weren't required to pay additional contributions to benefit from this uplift. The only remaining discrimination was therefore against female members with male partners. Therefore, the tribunal found discrimination on grounds of sexual orientation.

Remedy

A group of members, namely females who have a male survivor, may have their survivor's pension uplifted to include any service accrued between 1978 and 1988.

In order to administer this all post-2005 deaths of female members will need to be investigated. In some circumstances, the Fund may not have any data on survivors or their whereabouts which could prove to be a significant challenge. This would be an unwelcome burden alongside McCloud activity.

For employers, the impact is likely to be a small increase in their liabilities. For the Brent Fund these increases are estimated to be:

	Increase in Pensioner liability	Increase in Deferred liability
Overall increase for Fund	0.1%	0.1%
Increase for most-affected employer	6.4%	1.6%
Proportion of employers with an increase greater than 0.1%	18%	37%

Similar to McCloud the impact is largely administrative rather than on pension scheme funding but could be significant at employer level depending on the membership profile.

6. Regulation changes to support management of employer risk

In May 2019, MHCLG launched its consultation "Local Government Pension Scheme: Changes to the Local Valuation Cycle and the Management of Employer Risk". The consultation sought views in the following areas:

a) Changes to the LGPS local fund valuation cycle

b) Increased flexibility for Funds to carry out interim valuations and/or review employer contributions between formal valuations

c) Proposals for flexibility around employer cessation debts

d) Proposals for policy changes for payments of employer exit credits

e) Potential changes to employers required to offer LGPS membership.

The outcome of the exit credit consultation (d) was published in February this year. The Fund now has a policy on repayment of exit credits. There has been no update on changes to the valuation cycle proposals (a) or to the employers who are required to offer LGPS access (e).

The response published in August 2020[10] dealt with items (b) and (c), with Regulation changes coming into force on 23 September 2020, allow the Fund to recalculate employer contributions in the following circumstances:

- There has been a significant change to the liabilities of an employer
- There has been a significant change in the employer's covenant
- At the request of the employer.

This publication also allows greater flexibility around managing the exit of an employer from the Fund. On exit from the Fund, where the employer is in deficit, the following options are available:

- The Employer pays a full cessation payment carried out in line with regulation 64(4) of the 2013 LGPS Regulations
- The Fund can agree a repayment schedule with an employer to allow them to spread the exit payment over a number of years
- Enter into a Deferred Debt Arrangement (DDA) where an employer can continue in the Fund with no active members but continue to pay secondary contributions as determined at formal valuations. An employer entering into this arrangement would be known as a "deferred employer".

Whilst many Funds have entered into these arrangements, these are now supported by the regulations.

The Fund's officers will be working with the Fund's actuaries to consider the Brent Fund policy on these new freedoms and will report back to Pension Sub-Committee in due course.

10 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/911792/Government_response_Exit_payments_and_review_employer_contributions.pdf

Summary and Next Steps

This paper highlights several important regulatory changes that will directly impact both members and employers over the coming months. Together, they represent a significant challenge to Fund administration processes and bandwidth, especially given the challenges of the current working environment. The Fund will have to consider how to manage this change program including:

- Project planning and management;
- Stakeholder communications;
- Resource requirement;
- Risk management; and
- Appropriate audit and oversight.

We would be pleased to provide further information or support on any of the topics mentioned above.

Reliances, limitations and professional notes

This paper should not be released or disclosed to any third party without our prior consent. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability.

This report complies proportionately with the relevant Technical Actuarial Standards set out below:

• TAS 100 (Principles of Technical Actuarial Work); and

• TAS 300 (Pensions).

Prepared by:-

Douglas Green FFA

Fund Actuary

For and on behalf of Hymans Robertson LLP

17 September 2020