

# Spotlight: McCloud Consultation

August 2020

*The Ministry of Housing, Communities and Local Government (MHCLG) published its long awaited [consultation](#) on draft Regulations introducing amendments to the statutory underpin for the Local Government Pension Scheme (LGPS) in England and Wales on 16 July 2020. The proposals are designed to remedy the unlawful discrimination caused by the protection of older members when the scheme was reformed in April 2014. The consultation is estimated to affect around 1.2 million members of the LGPS by extending the underpin to all qualifying members, regardless of their age. This Spotlight sets out Aon's views on the impact of the proposals set out in the consultation, considering the administering authority, scheme employer and scheme member perspective. It also set out some steps that administering authorities may wish to take to get their McCloud implementation programme underway.*

## McCloud – Introduction

When the new CARE scheme was introduced for the LGPS in England and Wales (E&W) on 1 April 2014, all active members started to accrue benefits on a CARE basis, but members within ten years of their 2008 Scheme normal pension age on 31 March 2012 were granted transitional protection by means of a final salary underpin. Similar protections were provided when the other public service pension schemes were reformed in April 2015.

In December 2018, in what became known as the McCloud and Sargeant judgements, the Court of Appeal found that protections introduced to the judges' and firefighters' pension schemes were unlawful. The Government confirmed in July 2019 that the judgements had implications for all public service pension schemes (including the LGPS) and that they would address discrimination for all affected members, not just those who made a claim.

The draft regulations set out in the MHCLG consultation for the LGPS in England and Wales will:

- (i) remove the condition that requires a member to have been within ten years of their 2008 Scheme normal pension age on 1 April 2012 to be eligible for underpin protection
- (ii) introduce a number of supplementary changes to ensure the revised underpin works effectively and consistently for all members.

The consultation closes on 8 October 2020. A similar consultation is being held in respect of the LGPS in Scotland and is expected to be published soon in Northern Ireland.

This Spotlight sets out Aon's views on the impact of the proposals set out in the consultation. It is intended to assist administering authorities and other stakeholders in formulating their own response to the questions asked in the consultation document and to enable them to make progress with their McCloud implementation programme.

## Key proposals

### Who is affected?

The proposals introduce the term “qualifying member” for someone who meets the following criteria, regardless of age:

- was an active member of the LGPS on 31 March 2012, and
- has accrued benefits in the 2014 Scheme, and
- has no disqualifying break in service.

### Underpin period

The underpin will apply in respect of service between 1 April 2014 and 31 March 2022, or the member's "underpin date" (their 2008 Scheme normal pension age) if earlier.

The final salary link will remain until the member leaves active membership or reaches their underpin date, if earlier.

Accrual will be on a CARE basis only for all members from 1 April 2022.

### Retrospective effect

The changes will be retrospective, and so benefits for all qualifying leavers since 1 April 2014 will need to be revisited to determine whether the underpin will produce a higher benefit. Qualifying leavers include retirements, deferred leavers, deaths, transfers out, trivial commutations, etc.

### Two-stage underpin calculation

The underpin check will be a two-stage process, with a provisional check on leaving active membership, or reaching the underpin date (if later), and a final check when benefits are taken (the "underpin crystallisation date").

This is so that the effect of early and late retirement factors on the 2008 Scheme and 2014 Scheme benefits can be taken into account in calculating whether the underpin gives a higher benefit.

### Removal of requirement for immediate entitlement to benefit to be removed

Under the current underpin rules, the member must leave with an immediate entitlement to benefits in order to qualify. Because this rule could lead to further age discrimination, it is not included in the draft regulations meaning that the underpin will, in future, also apply to leavers with a deferred benefit entitlement.

### Aggregation

Another proposed change relates to aggregation. In order to simplify administration, members will be required to aggregate benefits to qualify for the underpin. This isn't the case currently and so the consultation also proposes that active and deferred members who haven't aggregated previously are given an additional 12-month window in which to do so. It should be noted that this only applies where failure to aggregate benefits would mean that the member loses entitlement to the underpin.

### Adjustments for early or late retirement

When the current underpin comparison is carried out, no account is taken of the fact that the 2008 Scheme has a lower normal pension age (generally 65) than the 2014 Scheme (linked to state pension age). In future, to ensure a fairer comparison of the 2008 Scheme benefits and the

2014 CARE benefits, early and late retirement factors will be taken into account.

### Death benefits

Something of a grey area under the current underpin rules, the consultation proposes that the underpin will apply to death benefits in future.

### Summary

What the proposed changes mean is that rather than the underpin ceasing to be a consideration for administration after 1 April 2022, when the older members who currently have protection would have largely retired, many younger members will now have a period of underpin protection to be taken into account in calculations until they retire.

## Impact on members

### Who will benefit?

MHCLG's consultation sets out the likely impact of the proposed changes on the membership of the LGPS:

- Older members are more likely to be entitled to the new underpin than younger members
- Active members aged 41 to 55 are more likely to be better off as a result of the underpin
- Men are marginally more likely to benefit than women, in line with the membership profile of the LGPS.

### Active members

Active members who meet the qualifying criteria will be entitled to the new underpin until 31 March 2022, or their underpin date if earlier.

The underpin will be provisionally calculated when the member reaches their underpin date using their final pay at that time and, if later, it will be recalculated on their underpin crystallisation date to take account of cost of living increases and any early or late retirement factors.

We estimate that around a third of all active members of the LGPS will be affected by the proposed changes.

### Pensioners

All qualifying pensioners who retired on or after 1 April 2014 will need to have their benefits revisited to see if the new underpin produces higher benefits. This includes members who qualified for original underpin protection, as the proposed

underpin will operate differently, e.g. actuarial adjustments may need to be applied.

If a member left active membership prior to retiring and became a deferred pensioner, the two-stage underpin calculations will need to be carried out.

As well as pensions and lump sums, lifetime allowance and annual allowance calculations could be affected if the underpin applies.

We estimate that around 15% of the total pensioner population will qualify for the new underpin.

## Other leavers since 1 April 2014

Other types of leavers since April 2014 will also fall into scope of the changes and may be affected retrospectively, including deferred benefits, deaths, trivial commutations, transfers between public service schemes and the LGPS, and other transfers out.

For deaths, any pension-related death grants and survivors' benefits will need to be checked to see whether the underpin applies. If so, these will need to be increased retrospectively.

Transfers between public service pension schemes are a particular challenge, and both HM Treasury and MHCLG have set out proposals for the unfunded schemes and the LGPS respectively which may lead to members being able to choose between final salary membership and a career average pension in respect of the transferred membership.

Trivial commutation values and transfers to private pension schemes may need to be recalculated where a qualifying member's benefits increase because of the underpin.

All these types of leavers since April 2014 are likely to have to be revisited. Given the likely number of cases involved, administering authorities will want to ensure that the work is carried out as efficiently as possible, therefore the development of bulk data extracts, uploads and calculations will be key to reduce the impact on administration teams and employers. In addition to this, external resource may be required to process the casework.

## Annual allowance

The consultation document maintains that the interpretation and application of tax legislation is down to individual administrators, but MHCLG does express the view that it would be correct to only carry out an annual allowance check in

respect of the underpin at the underpin crystallisation date. It recognises that this could disadvantage some members, for example those who were at an early stage of their career between 1 April 2014 and 31 March 2022 but who go on to become a high earner at a late stage in their LGPS career. MHCLG therefore seeks views on this issue as part of the consultation.

We note that HM Treasury's consultation on changes to the unfunded schemes takes a different approach, looking back over each year's accrual to see whether an annual allowance charge arises, subject to a maximum of four years. The unfunded schemes are different from the LGPS in that members of those schemes will be given a choice as to which scheme they wish to accrue benefits in for the relevant period. This may justify the difference in treatment but those members of the LGPS who find themselves disadvantaged by the "crystallisation test" approach set out in the consultation may have been better off under the approach adopted by the unfunded schemes.

## Impact on administration

Implementing the changes is likely to represent the biggest challenge for administering authorities since the introduction of the CARE scheme in 2014/15. We estimate that around a quarter of the total fund membership will fall into scope of the proposed changes to the underpin resulting from the McCloud ruling.

There are many different aspects of work that will need to be carried out to implement the changes and to administer the changes once they take effect. These include:

- ongoing administration changes
- benefits review for leavers
- member communication
- employer communication
- data
- systems
- specialist areas

Whilst MHCLG doesn't envisage that many members will actually see an increase in benefits as a result of the new underpin, the underpin calculations will still need to be carried out for a large number of members, both on an ongoing basis and as a retrospective exercise for leavers.

## Ongoing administration

Administering authorities will be concerned about being ready to administer the scheme in compliance with the new regulations from the commencement date which we expect to be 1 April 2022.

All processes, communications, and systems will need to be reviewed to see which are affected by the new regulations. Administering authorities will then need to decide who will make the changes, who will review them, how long will it take and how much resource will be required.

Another consideration is whether more administration resources will be needed to administer the underpin going forward and whether they need to be more highly skilled.

Bearing in mind that around a third of active members may be affected by the McCloud changes, there will be a significant impact on administration going forward.

## Retrospective review of leaver benefits

All qualifying leavers will need to have their benefits reviewed to check whether the new underpin provides higher benefits. This will extend to retirements, deferred leavers, deaths, trivial commutations and transfers out.

In order to carry out the review, administering authorities will need to be able to identify all qualifying members with 100% accuracy and they will need to collect the data needed to calculate the final salary underpin.

Once they have identified members and collected the necessary data, administering authorities will need to calculate the final salary underpin and compare this with the 2014 Scheme benefits. They'll need to consider whether this will require an individual calculation by an administrator, whether it will be automated, or whether a bulk calculation routine is possible. This will help determine how much input and resource is required from the administration team to enable resource planning to take place.

If benefits have increased because of the new underpin, the administering authority must decide how and when they will make the extra payments to members or survivors.

In summary, the review of benefits for leavers is one of the biggest challenges of the McCloud implementation programme and therefore one in which forward planning and preparation will really support delivery and minimise the impact on business as usual.

## Communication

Administering authorities will need to think about the content and the delivery of communications to members and employers, e.g. what is appropriate to the audience they wish to communicate with, what will they say, how will it be delivered and when. Another consideration is how they will deal with questions from stakeholders, e.g. will they set up and maintain an FAQ section on their website.

Some business-as-usual (BAU) communications will need to be amended to take account of McCloud between now and the commencement date, e.g. regular newsletters may mention McCloud in the run up to the commencement date. It may be helpful to create a calendar of communications that are expected to be sent out between now and 1 April 2022 and then consider which of these need to mention McCloud. This will allow sufficient time for wording to be drafted in order to meet sign off and/or print deadlines.

Some communications will be stand-alone McCloud communications, e.g. a letter to a qualifying member telling them about the change in legislation.

Another aspect of the McCloud programme relates to all the day-to-day communications that funds have with various third parties. These must be amended to make sure they are compliant with the new regulations from the commencement date. It will therefore be useful for administering authorities to create a log of all BAU communications and use this to identify which ones need to be changed to comply with the new regulations. This will cover a wide range of communications, e.g. the fund's website content, statements, letters, forms, guides, videos, etc.

The Scheme Advisory Board (SAB) is expected to produce some standard communication material, which will be a useful starting point. Administering authorities will wish to think about how they adapt these standards for their members and employers and how they will actually get the message out. They may wish to do more to support their key stakeholders, for example by running member webinars or employer forums.

Once administering authorities have considered what they want to say, they should think about how to resource the communications workstream:

- Do they have capacity to deliver the McCloud communications alongside BAU and other projects?



- Do they need to recruit more people to do this in-house?
- How will the administration team deal with additional queries from members affected by McCloud?
- Will they need to use external resources, e.g. to draft, review or deliver communications and presentations?

## Data

One of the more immediate challenges for administering authorities will be making sure they have all the data needed to calculate the final salary underpin back to 1 April 2014 for those who qualify.

They will also need to ensure that the information used to identify who is in scope of McCloud is reliable, for example the date joined fund, service breaks history, aggregations and transfer-in details need to be present and accurate.

In order to communicate with members, administering authorities will need to make sure that addresses are up to date for pensioners and other leavers. This could be a particular challenge for deferred members and may require address tracing and mortality screening exercises to be carried out.

Part-time hours and service break history will be required to calculate the underpin. Some funds will have this information dating back to 1 April 2014 already, some will have it but won't have loaded it onto their administration system, but many will have to undergo a significant exercise to obtain it from employers. This information also needs to be provided on a regular basis going forward until the end of the underpin period on 31 March 2022, which may require changes to be made to the monthly or annual return information currently provided by employers.

Many funds will also need to collect final pay and pensionable pay for members who have remained in active service beyond their 2008 Scheme normal pension age. This is because the underpin must be calculated as at the 2008 Scheme normal pension age in these circumstances and we understand that not all funds have been requesting the pay figures as at that date.

Data collection is likely to represent a major challenge for many administering authorities, involving extensive resource in their own teams and for fund employers, so advance engagement and planning will be key to its success.

Finally, funds will need to decide what to do in cases where they simply can't obtain the data needed to calculate the underpin. MHCLG

recognises that this will be an issue and plans to ask the SAB for guidance. The consultation asks what guidance administrators would like to see and so this may be a key area in which to provide feedback.

## Systems

This workstream brings together all aspects of system changes that will need to happen to:

- collect the McCloud data,
- carry out the retrospective review of benefits,
- administer the scheme going forward, and
- communicate with scheme members and employers.

Other workstreams will be heavily dependent on the systems workstream and so it will be important to make sure that the system requirements are established at an early stage in the programme and delivered when planned.

Engagement with software suppliers early in the programme will be essential in order to discuss and influence their development plans and minimise the impact on BAU through maximum use of bulk uploads and calculations.

System interfaces, calculations and workflows will need to be reviewed to see which will be affected on an ongoing basis. All changes will need to be tested and so administering authorities may wish to be involved in that testing process, but if so they will need to plan the time and resource and build it into their overall McCloud programme plan.

## Funding and accounting implications

### Accounting under IAS19 / FRS102

Allowance for McCloud will have already been made by some employers in the 2019 and 2020 IAS19 / FRS102 accounting figures, but the approach taken may have changed as more became known about the remedy. The publication of the consultation document will allow the approach to be updated and, where there are material differences between the proposals and the remedy previously assumed, this will need to be accounted for. Firms who produce accounting figures for LGPS employers are likely to be expected by auditors to review their approach for the accounting exercises as at 31 July and 31 August.

If employers are recognising a McCloud liability for the first time, Aon will present this as a Past Service Cost in the Income and Expenditure

statement of employers' accounting schedules. For employers who already accounted for McCloud last year, the impact of any updates to the allowance will be recognised through the Other Comprehensive Income.

## Funding Strategy

Consideration will have already been given to the potential costs of McCloud in the 2019 valuations, although in some cases the allowance may have been implicit via an increase in prudence (Aon made an explicit allowance for funds where we are the Actuary). Publication of the consultation should lead to the review of individual Funds' Funding Strategy. In particular the review should consider the approach taken to funding for new employers and exiting employers, to ensure any additional liabilities resulting from McCloud are funded appropriately.

It would also be sensible to consider the impact on any work in progress, which may include negotiations on bulk transfers for example, or accounting figures if the fund's actuary's approach does not reflect the latest proposals.

Funds and their actuaries will of course also need to consider their approach to the 31 March 2022 actuarial valuation, which may in turn depend upon the outcome of the cost management process. It would also be worthwhile taking steps to understand how the proposed remedy will impact on different employers. At a whole of fund level, the headline impacts are not expected to be material and McCloud may have been allowed for to a certain degree in the 2019 valuation, but at employer level the situation could look very different, with some employers seeing increases to liabilities and others seeing no increase at all. It is worth assessing this impact so that any outliers can be identified. This will also enable the administering authority to engage early with some employers if they believe they will be adversely impacted.

Regarding the real monetary impacts of McCloud, although the consultation has been published, it is not currently expected that contribution rates will be reviewed ahead of the next valuation, (assuming that it is in 2022), although a possible exception is for employers due to exit before 2023 and where the cost of McCloud may need to be factored into the exit calculations. This also assumes no further changes to the regulations.

## LGPS Cost Management

Legislation requires HM Treasury and SAB to undertake periodic valuations to monitor the cost of the LGPS to ensure it remains sustainable and affordable. The SAB process takes place first,

and earlier calculations for the 2016 process found that the cost "floor" had been breached, which meant that improvements to benefits or changes to member contributions would be required (with effect from 1 April 2019) to bring the cost of the LGPS back to the target level. However, the processes were paused pending the outcome of McCloud.

On 16 July 2020 the government announced that the 2016 HM Treasury process would be restarted, and the SAB process is expected to be un-paused soon. Both will now take into account the changes brought in by McCloud in the cost assessment.

Before the cost management process was paused, a cost/benefit change package had been proposed under the SAB process which was expected to improve member benefits and reduce member contributions for some members, and these changes were expected to increase employer costs by 0.9% of pay on average.

Once the costs of McCloud rectification are allowed for in the un-paused cost management process this may reduce or eliminate the need for any further cost/benefit changes. However, it may be the case that even allowing for McCloud, changes the cost cap "floor" has still been breached and further benefit improvements will be required.

It is worth noting that while, ultimately, the costs of McCloud rectification are expected to be allowed for in the cost cap process there will be differing impacts at an employer level. In particular, whilst the cost management process is carried out at Scheme level, how McCloud costs and any cost management outcome affects employers could be quite different depending on how any cost management changes are implemented.

Further it is worth remembering that before the 2016 SAB cost management was paused, a cost/benefit change package had been proposed which was expected to increase overall employer costs by 0.9% of pay, so it might be expected that once the costs of rectification are allowed for this would reduce the need for any further cost/benefit changes. There is no SAB process in Northern Ireland or Scotland so changes there were significantly higher, e.g. in NI they were 3.2% of pay.

The original SAB cost management proposals in England and Wales included reductions to member contributions. It is not clear if or how such changes could be backdated to 1 April 2019.

Whilst not part of the McCloud consultation, administering authorities may wish to consider the potential administration consequences of the un-paused cost management process and advise the

SAB and the responsible Government Department of their views on how any additional administration burden could be mitigated.

## Next steps

Now that the consultation has been published and the SAB has published the data collection template, administering authorities are likely to be in the early planning stages. Some key steps that administering authorities may wish to take in order to progress their plans include:

- **Identify the core McCloud team** – Who will lead the programme, who will lead each workstream and who will be the programme manager. There are different strands to implementing McCloud and with such a large programme it will be essential to set up a formal programme and assign a programme manager. Assigning someone to lead each area will ensure that the deliverables within each workstream are owned.
- **Set up the programme and commence planning** – Set up the programme charter, put in place governance arrangements and commence immediate tasks such as Pensions Committee and Pension Board training, data collection and communication.
- **Carry out a member impact analysis** – This will help administering authorities identify data collection requirements and will enable them to start planning their resources
- Now that the SAB has issued guidance on data collection, administering authorities should be considering what data they will collect and how they will upload it. They should already be engaging with employers to alert them to the data requirements.
- Consider their response to the consultation – the deadline is 8 October 2020.

## How can we help?

Aon offers a suite of services, ranging from help with initial planning and training for funds intending to deliver the McCloud programme mostly in-house, to full programme delivery for those who do not have the resource to do the work themselves. This support includes:

- Programme management
- Data collection support
- Oversight/assurance/compliance

- Identification of in-scope members
- Interactive workshops
- Consultation response support, i.e. responses to the specific questions set out in the consultation document.
- Retrospective benefits review
- McCloud training – Board, Committee, administration team
- Member and employer communication
- Changes to ongoing administration.

If you would like further information or if we can support you in any of the areas set out above, please get in touch with your usual consultant or the contacts below.

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