Local Government Newsletter
July 2020

Hello and welcome to the latest edition of our newsletter.

As COVID-19 restrictions continue to ease, we look this month at the potential impact on future mortality assumptions on pension schemes. Following the release of the long awaited McCloud consultations, we also look at the potential impact of McCloud on schemes. In addition, we look at various other topics that we have been discussing with our clients, including cashflow management and strain on fund factors.

Fiona

People news

We have had another quiet month from the point of people news. Now that (home) schools have shut for the summer, we are seeing more relaxed parents gearing up for some alternative holiday plans with their families.

Though we mostly continue to work from home, the Aon offices in a few UK locations have now re-opened for business. This has been with significantly reduced numbers (the Bristol office has up to six colleagues in the premises on any given day!) as we take steady steps to what the new, better normal might be. We are moving forward with client service and colleague wellbeing foremost in our mind and will continue to update you as things change.

COVID-19

Mortality Update & the LGPS

The Continuous Mortality Investigation (part of the Institute and Faculty of Actuaries) published their mortality monitor document for the second quarter of 2020 here. As the second quarter almost entirely covers the period of the coronavirus outbreak to date, the monitor shows that mortality during this period has been exceptionally high. At the start of the quarter, the cumulative improvement (compared to 2019) was −0.1%; by the quarter end it had fallen to −10.9%. This is by far the lowest improvement for any year for which weekly data has been published.

The CMI does not consider it appropriate to feed these statistics into its improvement model with no adjustment. It is considering various options for its annual improvement model (CMI_2020) and plans to consult with subscribers in late-summer or early-autumn on the preferred approach.

Aon's Demographic Horizons™ team also continues to monitor the impact the pandemic could have on funds from a longevity perspective as information emerges on a daily basis and their latest briefing can be found here.

The update from the previous month continues to be that actual excess deaths to the week ending 10 July were higher than official COVID-19 death counts, with cumulative deaths in 2020 to date well outside the range of the outcomes seen in recent years

Further useful resources can be found on Aon's Covid-19 response site – see here.

What does this mean for the LGPS?

If population experience is reflected in pension fund membership, liabilities may have fallen relative to expected levels (ignoring other changes such as changes in financial assumptions and other membership movements). However, it is not clear to what extent the membership of the LGPS is representative of the population as a whole.

In order to provide some insights into this, Aon is carrying out a pilot analysis of mortality experience of an LGPS fund to 30 June 2020 for the Scheme Advisory Board to help inform the debate. It cannot be assumed that membership of one fund is representative of the membership of other funds, so if any administering authorities are interested in a similar analysis for their membership they should let us know.

QAS Institute and Faculty of Actuaries Quality Assurance Scheme

Actual experience is one way in which mortality affects the liabilities. But there is another, potentially more significant effect, which relates to the assumptions made for future mortality experience. The next valuation for LGPS funds is not until 2022 (2023 in Scotland) so funds and their actuaries should have a greater degree of clarity over the medium to long-term impact of COVID-19 before there is a requirement to update the mortality assumptions. If assumptions did need to be set now, our current view is that it is reasonable to leave the long-term median best estimate unchanged at this time.

Care is therefore needed when considering how COVID-19 affects the funding position of LGPS funds, and administering authorities may wish to consider what messages to give to employers who may be assuming liabilities have been falling due to the effects of the pandemic and that this could offset asset falls. We have not (yet) had any requests from employers with July or August year-ends for potential COVID-19 effects to be allowed for in their accounting disclosures under IAS19/FRS102 but that is something which cannot be ruled out, particularly for organisations whose financial position is not strong or if it's something auditors take a keen interest in.

If you would like any further information or to discuss this further please do get in touch.

Business Continuity

As we emerge out of lockdown we consider this is an appropriate time for LGPS administering authorities to reflect on the experience of recent months and consider lessons learnt as part of robust business continuity planning for the future. TPR Recording Keeping Guidance published in September 2019 says that "You [the Scheme Manager] should have a business continuity plan in place. This sets out the actions to take if certain events occur that affect the running of the scheme." The experience of Covid-19 is unprecedented and is likely to change the way in which we work into the medium and longer term. These changes mean it's important to (re)consider your business impact analysis, which should be the main technique to assess your fund's business continuity requirements in the future. The findings from that assessment can feed into your fund's business continuity plan, testing plans and disaster recovery activity. Please get in touch with your regular Aon contact or Mary Lambe directly if this is an area you would like more information on.

Industry developments

Update on McCloud

The long-awaited "McCloud" consultations for the unfunded schemes and the LGPS (in England and Wales) were published on 16 July by HM Treasury and MHCLG respectively, setting out proposed changes aimed at removing unlawful age discrimination introduced by the protections for older members adopted by the 2014/2015 public service pension scheme reforms. Government proposes to remove discrimination by extending the protections that were previously only given to older members to all qualifying members, regardless of age. Similar consultations are expected in respect of the LGPS in Scotland and Northern Ireland.

Unfunded schemes (NHS, Teachers, Civil Service, Armed Forces, Police, Fire and Rescue, etc.)

In the unfunded schemes, qualifying members are those in service on or before 31 March 2012 **and** on or after 1 April 2015, including those with a qualifying break in service of less than 5-years. They will be given a choice as to which scheme they accrue benefits in for the period from 1 April 2015 (when the reformed schemes were introduced) to 31 March 2022 (the end of the remedy period). The consultation seeks views on whether this choice should take place as soon as possible after the regulations take effect, or when the member eventually takes their benefits. In both cases the member's choice would be irrevocable. The choice the member makes could affect their benefits, survivors' benefits, tax free lump sum, contributions and tax relief so good communication will be essential to enable members to make informed choices.

Local Government Pension Scheme

Whilst LGPS members will not have to choose the scheme in which they accrue benefits, the administrative challenge of implementing the changes should not be underestimated. In the LGPS a revised final salary underpin will be extended to all qualifying members, regardless of age. This underpin will be different to the existing underpin in order to avoid any age discrimination arising from its application and to ensure that it delivers the original policy intent. For example, the requirement for an immediate entitlement to benefits will be dropped, and early and late retirement factors will be taken into account in order to ensure a fairer comparison between 2008 Scheme benefits and 2014 Scheme benefits. Other key elements of the proposals include:

- Underpin accrual will extend from 1 April 2014 to 31 March 2022 (or member's underpin date if earlier), with final salary link extending to the member's date of leaving active membership
- A qualifying member is someone in active membership on 31 March 2012 who accrued benefits in the 2014 Scheme, with no disqualifying break (this is slightly different to the qualifying criteria for the unfunded schemes)
- The underpin will apply retrospectively to leavers (including retirements, deferred members, deaths, transfers out and trivial commutation) meaning benefits will need to be recalculated for leavers since April 2014
- Members must aggregate benefits for protection to apply (there will be a 12 month period to aggregate benefits where failure to do so would mean protection was lost)
- Survivors' benefits will take account of the underpin
- There will be a two-stage process for calculating the underpin (i) at the "underpin date" (broadly the earlier of date of leaving active membership and the member's 2008 Scheme NPA) and (ii) the "underpin crystallisation date" (broadly the date on which the member takes their benefits), taking account of any cost of living increases and early and late retirement adjustments.
- Annual benefit statements must show the underpin
- All members will accrue CARE benefits only under the 2014 Scheme from 1 April 2022

It will come as a relief to Administering Authorities that MHCLG believes that the calculation of the underpin for purpose of comparing with the allowances for tax purposes is only necessary at the underpin crystallisation date, rather than a calculation having to take place every year.

The Scheme Advisory Board has provided a summary of the proposals here.

Separately, the employer cost cap process has been restarted and will take account of the McCloud changes.

Next steps for Administering Authorities

- Establish your core McCloud implementation programme team and create a plan
- Prepare to start collecting "McCloud" data from employers going back to April 2014
- Ensure that upcoming member communications contain appropriate wording in relation to McCloud
- Consider your response to the consultation
- Revisit your decisions regarding any allowance for McCloud costs in exit valuations and new employer contribution rate calculations

For a chat to see how we can help you get started, please contact your usual Aon consultant or Virginia Burke.

Exit Payments Cap

Government has now responded to the consultation launched in April 2019 about restricting exit payments in the public sector. They plan to make some tweaks to the draft legislation, but the main structure of the proposals remains.

The consultation response and updated guidance confirm that the level of the cap remains at £95k.

The main change is that the cap will no longer be implemented in two stages, which means that when legislation comes into force it will affect all the included public sector bodies.

However, the payments in scope remain as per the 2019 consultation so pension strain payments will still be included in the list of exit payments counted towards the cap. There is no specific detail so we assume the previously proposed exemptions for Firefighters, notably where a Fire and Rescue Authority exercises its discretion to remove the current commutation lump sum restriction that applies to certain members of the 1992 Firefighters' Pension Scheme will be included in the final regulations/guidance. It is not clear whether the exemption "being considered" (as per the 2019 consultation) for payments made by FRAs in respect of firefighters who are unable to maintain operational fitness through no fault of their own and where the FRA has agreed to put into payment an authority initiated early retirement pension will be part of the final changes.

Government has also indicated an intention to proceed with the previously set out waiver process and hints at further departmental guidance potentially being available. One concession is extension of mandatory waiver to include health and safety related detriment and unfair dismissal claims which will be included in updated directions.

The consultation response also confirmed that Government intends to move forward with legislation covering the clawback of exit payments where someone starts a new public sector role within a year of receiving an exit payment from a previous public sector role.

The response does not say anything about timescales, although we understand the intention is for the cap to be in force by the end of the year.

We now need to wait to see when the revised legislation and guidance will be issued. We believe that MHCLG may publish proposals for related amendments required to the LGPS regulations within the next few weeks and, as explained below, we have been discussing with funds how this might affect the calculation of strain costs in future.

USS consultation on secured debt

On 8th July 2020, the Universities Superannuation Scheme (USS) released a consultation on its proposed Framework for ongoing covenant monitoring (focused primarily on employer debt levels) and debt pari-passu. The Framework primarily consists of two elements:

1. Regular covenant monitoring via annual employer submissions of financial data.

2. Provision of debt pari-passu where secured debt levels exceed certain de-minimis thresholds.

Debt pari-passu means the provision of equally ranking security to USS in the event that security is granted to third-party lenders.

It is not unusual for universities to participate in both the LGPS and USS (including post-92 institutions). In such circumstances, the LGPS and USS will both rank as unsecured creditors. Where a university raises secured debt breaching USS's pari-passu thresholds, any enhancement of USS's creditor position ahead of an LGPS fund could have a materially detrimental impact to any future recoveries for the fund.

We suggest all LGPS funds take note of the proposed Framework, consider their exposure to employers who also participate in USS, and make an informed decision as to whether they should contact their university employers to ensure fair and equal treatment with USS. Aon's specialist covenant team have been involved in advising USS employers on the proposed Framework and would be happy to discuss the potential impacts and considerations for LGPS funds. If you would value such a discussion, please get in touch with Alison Murray or your usual Aon contact.

What we've been talking to our clients about

Cashflow Management

An increasing number of LGPS funds are becoming cashflow negative, and funds therefore need to ensure they have a robust policy in place to manage their cashflows. We have investment specialists we are working closely with to assist clients in understanding their asset and liability cashflows, together with stress testing how their cashflow approach would cope under a number of scenarios.

We have found that the requirements and circumstances of funds can differ significantly. If you have any questions on this, then please speak to your usual Aon contact.

Strain on fund factors

Many funds will have been reviewing their strain factors following completion of the 2019 valuation. However, the recent announcements on the £95K cap (see earlier article) puts administering authorities in a difficult position. For those funds where the process is not yet complete, we have been recommending a discussion on how they wish to proceed to avoid the time and cost associated with new Fund-specific factors that may not be in force for very long, if at all.

Retaining the existing factors is not without risk and we remain concerned that the standard calculations may materially understate strain costs because they do not correctly allow for post-2014 CARE benefits. In addition, any LGPS-wide factors set by GAD cannot, by definition, take into account the specific funding strategy and assumptions for the Fund so could result in greater differences between the strain payment and the actual funding cost of the early retirement. Whilst this may not be a material issue for the main public sector employers, it could be for the Tier 3 employers to which the cap does not apply and which can be considered higher risk employers. In addition, if there were to be material redundancy exercises funds may wish to ensure that employers are aware of how this might affect the 2022 valuation results.

A further complication is that it is likely that any new national factors will correctly allow for post-

2014 CARE benefits, plus it is possible the underlying method of calculation will change, and this will require changes to the software systems.

This is an issue which we raised some time ago when the cap was previously discussed and we will raise it again at the meeting with GAD next month. There is of course a risk that systems changes are not made before the cap is implemented and manual calculations are then required. We have a model which can be made available to funds to calculate strain costs and, whilst some funds do find this very helpful, we understand that others are very keen to ensure everything is done within the administration software system.

Ultimately it is a question of practicality and administrative ease of having one set of factors for all employers, weighed up against the benefit (and associated risk reduction) of having factors that more closely reflect the true funding cost of the early retirement. We expect different approaches will be appropriate for different funds bearing in mind their funding strategy, employer profile and expected redundancy exercises. We would encourage funds to speak to their actuary to agree the best approach for them. We will of course be feeding back to our clients following the meeting with GAD next month.

Recent events

SAB Investments, Governance and Engagement Committee

Mary Lambe attended a virtual committee meeting on 13 July, where items included the Good Governance project, responsible investment guidance and the recent Supreme Court judgement.

Upcoming events

CIPFA McCloud Webinar

Virginia Burke and Chris Darby will be presenting on the CIPFA McCloud Webinar – Are You Ready For McCloud? on 6 August.

Research and Publications

The latest research and publications by Aon Thought Leaders:

- July investment market update
- Aon's paper on COVID-19 longevity impact

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