Surrey Local Pension Board
12 November 2020

The impact of McCloud and the Exit Cap

Recommendations:

The Board is asked to **note** the content of this report and **make recommendations** to the Pension Fund Committee if appropriate.

Background

1. This paper explores two key pieces of pension related legislation, McCloud and the exit cap, which are likely to have a big effect on pension administration.

2. It tries to anticipate the potential effects of the changes and it considers the resources that are likely to be required in order to implement them efficiently.

Content

The McCloud and Sargeant cases

1. Although the stem cases concerned the Judges' and the Firefighters' pension schemes the principles are deemed to have general applicability across the public sector.

2. Certain LGPS members who were within ten years of retirement on 31st March 2012 were offered a top up if the old final salary pension scheme would have delivered a better outcome than the new CARE scheme in respect of the period 1st April 2014 to 31st March 2022.

3. The ruling determined that the top up, known as the underpin, was age discriminatory.

4. This consultation seeks to address that injustice by extending the underpin to all age groups who meet the new criteria.

The proposed remedy

5. Restricted to members who were active on both 31st March 2012 and post 31st March 2014, without a five-year break in membership.

6. The underpin applies between 1st April 2014 and the earlier of; the date the member ceases active membership, dies, reaches age 65 or 31st March 2022.

7. The final salary benefit underpin will be calculated at the point the member ceases active membership, dies or reaches age 65.

8. The underpin will be expanded to cover deferred beneficiaries and dependants' benefits but will no longer cover unaggregated deferred benefits, thereby correcting an anomaly.

9. If a member qualifies for an underpin in respect of a separate deferred benefit under the existing regulations they will be given one year from the date the amended regulations come into force to elect to aggregate that deferred benefit.

10. The consultation suggests offering both club transfers-in and out the choice of purchasing final salary or care benefits. Non-club transfers-out will be based on assumptions related to the underpin date; however, non-club transfers-in will not attract an underpin.

11. The changes are retrospective and apply to members who left, transferred-out, trivially commuted, retired or died and meet the new criteria.

12. The calculation will be a two stage process; the first part is performed at the calculation date, which is the earlier of the date of leaving and age 65, and the second at the underpin crystallisation date, which is the date the member actually draws their pension benefits with any Pensions Increase and late retirement increases.

Who is likely to benefit

13. Members who have substantial final salary pension benefits and either; enjoy significant salary increases close to retirement, are some way from retirement and consistently benefit from above-inflation pay increases or who retire early with actuarial reductions (final salary scheme reductions tend to be lower).

Other considerations

14. The revised underpin could generate an annual allowance (tax) charge in some cases, although MHCLG thinks that this would only happen at the underpin crystallisation date.

The cost cap

15. The cost control mechanism has been restarted and the potential costs generated by the McCloud remedy will be factored into the calculations

16. The draft solution is likely to significantly erode the benefit improvements proposed after the 2019 valuation.

Employer costs and funding

17. Hymans Robertson expect the cost to be (about) 0.6% of active liabilities and 0.2% of total liabilities, which equates to a total cost of £0.5 billion across the LGPS in England and Wales.

18. This will have a marginal impact on employer contribution rates and represents a better outcome than the Government's generic estimates predicted, possibly because salary increases in the LGPS tend to be lower (CPI + 0.7%).

Logistics and resources

19. The Administration Team must Identify the work streams, resource and budget required. Plan and manage the project.

20. It is important to identify cases within scope and collate the information as swiftly as possible, particularly for those who have left since 1st April 2014.

21. The Administration Team should prepare considered plain English McCloud specific and generic communications.

The Exit cap

22. The minister has signed (made) the legislation and the exit cap will come into force on 4th November 2020.

23. Only exits exceeding £95K will be affected and standard strain factors should be used until the LGPS regulations are amended/statutory guidance is issued. It is likely that we will have (at least) statutory guidance in place by the date of the meeting.

24. The exit cap was introduced in the Small Business, Enterprise and Employment Act 2015, which was amended by schedule 6 of the Enterprise Act 2016. Most of the legislation was already in place and it only needed to be activated.

25. The exit cap is intended to protect tax payers from excessive termination packages for high earners and the £95K aggregate includes early payment of pension (strain) costs as well as other exit payments. The employer has limited flexibility as statutory redundancy payments under the Employment Rights Act 1996 must be paid.

26. Many respondents to the two consultations felt that the £95K cap was too low, the inclusion of strain costs meant that members earning less than £24K could be affected and it was potentially counter-productive because it would make it more difficult to restructure organisations consensually.

The Government's response

27. The Government has responded to the (second) consultation issued in April 2019 but it has not been swayed by the replies and it has offered few concessions.

28. The £95K figure has been persevered with and, although it was originally proposed in 2015, the response only incudes a nebulous aspiration to increase it at some point.

29. The same exit payments (termination payments and strain costs) are within scope and the cap applies to two or more public sector exits by the same individual within 28 days.

30. The original two-stage implementation has been discarded and all the bodies within scope will be affected immediately.

31. The existing mandatory waiver will be extended to cover health and safety related compensation and unfair dismissal claims.

32. The response is silent about existing exemptions and new ones being "considered" (for firefighters).

33. The Government intends to implement legislation designed to claw-back exit payments if the recipient re-enters the public sector within a year.

34. The government mentions producing legislation and guidance, without mentioning a timescale. Draft amendments of the LGPS are expected shortly so it is possible that the cap could be introduced towards the end of the year.

Key proposals for the LGPS

35. Maximum pay for redundancy payments limited to £80,000.

36. Redundancy payments limited to 3 weeks' pay per year but must not exceed 66 weeks' / 15 months' pay (please note that the £95K cap would bite if the member earned over £76K).

37. Cannot pay discretionary compensation if a strain cost is paid, unless the discretionary payment exceeds the strain cost - in which case the excess can be paid.

38. Strain costs must be reduced by the value of any statutory redundancy payment, even if the total exit payments do not exceed £95K.

39. If the strain cost exceeds £95K the cap would be applied and proportionate reductions would be made to the pension.

40. There is a suggestion that the member may be able to top-up the strain cost in order to draw an unreduced pension – but there is no detail about how it would work in practice. This may be more complicated if the member was dismissed by reason of redundancy as the employer is required to pay a statutory redundancy payment under the Employment Rights Act 1996.

Considerations for employers;

41. Although it is possible for the full council to approve discretionary waivers, this resource is time consuming and it may require approval from MHCLG and, possibly, the Treasury.

42. Employers may consider accelerating the planned departure of senior employees to avoid these measures.

43. It may be possible to flexibly retire employees (ideally a year) before their actual retirement date in order to mitigate the effects of the exit cap – provided the employer's policy allows it. A lot will depend on the final legislation / guidance - so extreme caution is advised.

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Sources/background papers:

Annexes:

Annex 1 - The McCloud Impact Assessment.

Annex 2 - Exit Cap emergency decision

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