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Dear Sir or Madam,

Local Government Pension Scheme: Amendments to the statutory underpin

Surrey County Council (Surrey) welcomes the opportunity to respond to the consultation on proposed amendments to the statutory underpin.

Surrey is the Administering Authority for the Surrey Pension Fund (the Fund) as part of the Local Government Pension Scheme (LGPS). The Fund has assets of over £4billion and includes nearly 300 employers.

Surrey is supportive of most of the proposals although it thinks that adjustments are needed in order to completely eliminate age discrimination. We set our response the questions posited in the consultation below:

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

Surrey County Council (the Fund) agrees that the underlying discrimination should be addressed but it believes that the suggested remedy is flawed.

Question 2 - Do you agree that the proposed underpin should end in March 2022?

The original underpin was due to end on 31st March 2022 and the Fund agrees that it is a natural watershed and it cannot see any logical reason for extending it.

Question 3 – Do you agree that the revised regulations should apply retrospectively to 1st April 2014?

The regulations that introduced the discrimination came into force on 1st April 2014 and, therefore, it is logical that the remedy should also take effect from that date.

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

The draft regulations appear to implement the proposed remedy effectively; however, the Fund believes that the remedy is flawed and may itself be age discriminatory.

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

There will be challenges in collating data, identifying resources and communicating with members and employers. Employers are only required to retain payroll data for six years, records are already degrading and there needs to be clear guidance on how to handle cases where the records are incomplete. It is the Fund's view that the remedy does not cover all members equitably and would benefit from considered amendments.

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

The consultation appears to postulate that, for an active member, the provisional underpin date and underpin crystallisation date will always be the date of death. However, this will not be the case if the member is aged 65 or over at the date of death and this is one of several reasons why the Fund thinks that the provisional underpin date should be the earlier of the date of leaving active membership and 31st March 2022.

The Fund accepts that a few ill-health retirements may benefit from an underpin, particularly if they left before state pensionable started to rise; however, this is becoming less likely (longer enhancements in the current scheme). Moreover, the members who are likely to benefit from the 2007 scheme ill-health enhancements are either close to retirement or part-timers who previously worked full-time - and the former group are protected by regulation 12 of the Transitional Regulations if they were aged 45 or over before 1st April 2008 in any case. For these reasons it would be much simpler to exclude ill-health retirements from the underpin arrangements although the Fund accepts that it is a sensitive topic as the most likely losers are part-timers, the majority of whom are women.

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

If the intention is to remove the link to retirement and to introduce a general protection to the 31st March 2022 or the date of leaving active membership, if earlier, then it makes sense to remove the requirement to have an immediate entitlement to retirement benefits.

The old underpin created a dichotomy even within the protected group as those who left with preserved benefits were not covered and the extension of the new underpin to (almost) all age groups risks exacerbating that problem. Offering the underpin to members who leave with preserved benefits addresses the problem, given that younger members are more likely to leave with an entitlement to preserved benefits, but it creates administrative issues. It will be much harder to collate, retrieve or reconstruct data for members who left some time ago.

In the Fund's opinion the remedy is reminiscent of the flaws in the 85-year rule transitional protection. MHCLG focused its attention on the members who narrowly missed out on protection (group B members) in that exercise but, in doing so, it put some of them in a better position than the originally protected group (group A members). This was because members who reached 60 shortly after 2016 suffered miniscule actuarial reductions but their pension was protected until 2020 instead of 2016. It appears that the suggested underpin remedy also has the potential to put younger members in a better position than the original group but, fortunately, this could be addressed with minor changes.

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

The proposed remedy seems to extend the underpin to 31st March 2022 for all members, except those who reach age 65. This limit was a feature of the old underpin set aside by the Court of Appeal and it seems incongruous to include it in the proposed remedy as there was no mandatory scheme retirement age in the 2007 scheme. If a member continued working beyond age 65 they would simply have continued to accrue 60ths and it seems counterintuitive to insert an arbitrary deadline that appears to discriminate against older members.

Persevering with the age 65 deadline will affect some members whose SPA is 66 or later and it seems to complicate matters unnecessarily. The Fund believes it would be both logical and simple to make the test for the provisional underpin the earlier of the date of leaving active membership and 31st March 2022.

Conversely, there is an argument that says it is unfair to restrict the extension of 2007 scheme to members who were active on both 31st March 2012 and 31st March 2014. It would be certainly be simpler to offer the underpin to all members who were active on 31st March 2014 and it would make it much easier to determine eligibility. The two dates requirement is an unnecessary vestige of the defunct underpin but, given that it applies to all members equally and without exception, it does not appear to be inherently age discriminatory.

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

This addresses an anomaly in the existing underpin provisions and it is both logical and consistent with the intention that the underpin should relate to a single employment. Nonetheless, and notwithstanding reopening the aggregation window, there will be potential losers and a thorough impact assessment should be undertaken and digested before the final regulations are drafted

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

Re-opening the aggregation window is necessary if the underpin is to be restricted to a single employment and this resource has been used in similar circumstances before, most recently in

2011. However, unlike previous exercises, the proposed option is not a general reopening of the aggregation window but, rather, a targeted one focused members who might lose out if they can no longer rely on an underpin straddling two employments. This will be very difficult to administer not least because many of the members who might qualify for an underpin in relation to two separate employments may not be aware that they are entitled to one. How will the limited option to aggregate work in practice; will it be restricted to members who potentially benefit from an underpin, regardless of whether they actually qualify or not, or simply to the ones who are already entitled to an underpin – even though many of them may not even know that they are eligible? It is evident that potential cases can only be identified by administrators and software providers and doing this, and presenting the options to eligible members, will require considerable resource.

If a member has a pre-2014 preserved benefit and a post-2014 benefit without a disqualifying break it is also necessary to reopen the election window under regulation 5(5) of the Transitional Regulations 2014, or deem them to have made an election, in order for them to benefit from a final salary underpin.

It should be noted that reopening the aggregation window is not a complete solution for the loss of an underpin straddling two separate employments. This is because members would only be able to retain an existing guarantee by making a committal decision (to aggregate), which may not necessarily be to their advantage. Although the proposed remedy will mitigate the potential detriment, unfortunately, it will not remove it entirely.

It makes sense, although it is unusual, to extend the option to aggregate to deferred beneficiaries although it is not clear how it would work in practice and the same policy concerns that affect active aggregations also apply here. Moreover, how would you treat a member who had suffered a big pay drop and elected to keep their pension benefits separate only to become a deferred beneficiary in the second employment within two years; although they were eligible for an underpin in the original employment they would cease to qualify unless they elected to aggregate? Happily, aggregating would work well for this member because they can elect to have their pension benefits calculated under regulation 8 of 2007 benefit regulations (best of the last three years). However, this provision has the potential to be unfair to employers because members can transfer substantial pension benefits – as long as it is to their advantage - thereby disturbing long-standing funding positions. This is most likely to happen when members opt for preserved benefits following a big pay drop - only for their career to take off again and their final pay to increase significantly allowing for inflation, although this is unlikely to be common in practice.

The option to aggregate benefits is not open to members who opted out after 11th April 2015, which means that some members who may be adversely affected may not have a remedy to hand. It may be worth considering relaxing this restriction for a year for underpin cases in the interests of consistency – although there are contrary arguments.

Turning to members who suffer a major pay cut in a single employment, should we simply alert them to the options of aggregating or keeping their pension benefits separate or should we draw their attention to the possibility of doing nothing and invoking regulation 10 (a three year pay average in the last ten years) which would protect their higher pay - and their underpin – for ten years. This may not seem attractive to members who are more than ten years from retirement which, in turn, begs the question of whether it is ethical to mention that they can invoke regulation 10 and subsequently elect to opt-out up to ten years after the material reduction, thereby cementing their higher final pay/underpin - albeit that this approach is not without risk.

The policy intention appears to be to leave pensions that are already in payment with underpins alone and this is sensible as to reduce them would not only be unfair but technically challenging.

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

Members who chose to keep their pension benefits separate following a substantial reduction in pay and who currently benefit from an underpin, would lose it unless they aggregate their pension benefits under the current proposals. It would seem rational - depending on circumstances - to keep the benefits separate unless the new underpin would produce a better outcome, which may not be clear until the provisional underpin date or, possibly, the underpin crystallisation date. The Public Sector Pensions Act 2013 requires the responsible body proposing the changes to first obtain the consent of the members who are significantly adversely affected - or their representatives - in order to make retrospective changes. Although relatively few members are likely to be significantly adversely affected it is not immediately clear how the responsible authority would obtain their consent without offering concessions and it may be necessary to submit a report and seek affirmation from both Houses of Parliament.

The replacement for the original (flawed) underpin should have been designed from scratch. Unfortunately, in recycling elements of the original mechanism MHCLG appears to have inadvertently introduced direct age discrimination that curtails the final salary membership of older members who could, otherwise, have remained in the 2007 scheme until 31st March 2022. As the original underpin is considered unlawful and the proposed underpin effectively extends the old scheme to 31st March 2022, it is arguable that MHCLG is obliged to obtain older member's consent for this potential diminution of their pension benefits.

Question 12 – do you have any comments on the proposed amendments described in paragraphs 56 to 59?

The proposals are generally progressive, reasonable and consistent with the policy intentions. Although the element of retrospection is logical it will present challenges in collecting/recovering data that may have been eroded or destroyed. It would be helpful if SAB could produce clear and pragmatic guidance on how to address these issues.

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

It is a pragmatic solution to have a provisional underpin date and an underpin crystallisation date. The provisional calculations can be performed when the member leaves employment, and accurate records are available, and the final adjustments can be made at the date they eventually crystallise their pension benefits, which may be many years later.

The two-stage process has the potential to create annual allowance complications which are considered in question 18 below.

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

If a member aged 65 or over without a five-year gap re-joins the LGPS before 31st March 2022 they would not benefit from an underpin and this appears to be overtly age discriminatory. It is a discordant feature of the new underpin that it extends the best of both schemes' protection for all members until 31st March 2022, unless they happen to be older ones.

The fund would like to see more detail about the proposals covering club transfers and how the mechanism would work in practice. It does not object to members being asked to make a committal decision in principle as this was a feature of previous iterations of the club memorandum, which allowed members to elect for a non-club transfer if that would give a better outcome (usually if they had taken a large reduction in pay or they were aged 63 or over).

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

There is one commission that the Fund believes needs to be addressed; the age 65 limit should be removed because it is directly age discriminatory.

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

The Fund believes that annual benefit statements are already too complicated for a lot of members to understand and adding more information simply exacerbates the problem. As the underpin is a guarantee it might be better to omit it from ABS at least until the run up to retirement, if not retirement.

Underpins are likely to be few and (usually) low in value to start with - but they will become increasingly common and grow in value over time. As a rule, the further a member is from retirement on 31st March 2022 the larger any eventual underpin is likely to be and, therefore, it might be better to omit them from standard ABS.

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

If it is a policy decision to include underpin information in ABS a lot will depend upon what the software providers can deliver. It would seem logical that the notional ABS underpin for active members should be based on the assumption that they left active membership on 31st March each year, excluding regulation 8 and regulation 10 protections which are time limited, and deferred member’s provisional underpins could be updated each year automatically.

Question 18 - Do you have any comments on the potential issue identified in paragraph 110?

On balance SCC believes that the underpin should be tested against the annual allowance / lifetime allowance at the underpin crystallisation date. It expects underpins to be modest in the short to medium term and unlikely to generate tax charges unless the member is a high earner or has enhanced their pension benefits significantly. Moreover, there is a possibility that, otherwise, a few members may incur an annual allowance tax charge but not qualify for an underpin when they eventually leave active membership.

Ideally the Fund would prefer a fluid approach with an eye to moving to an annual assessment in the medium to long-term if – as seems likely – the median underpin grows in value over time. This way, the increase would be staggered and be less likely to generate an annual allowance tax charge than assessing it in one fell swoop at the underpin crystallisation date; however, the fund accepts that the Treasury is unlikely to be sympathetic to this idea.

Although the Fund advocates a utilitarian approach, it accepts that it is finely judged decision and there will be winners and losers whichever approach is adopted.

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

The remedy addresses the discrimination identified in the above cases but the Fund thinks that it inadvertently introduces direct age discrimination.

The original underpin was a time-limited protection for older members and it was reasonable to cap it at “normal” retirement age even though there was no formal retirement age in the 2007 scheme and members could continue to accrue 60ths until the day before their 75th birthday.

The old underpin has been swept away and replaced by a guarantee that offers the better of the old and the new scheme for all active members until 31st March 2022 - unless they happen to be older members.

Another way of looking at it is that members who could otherwise have remained in the 2007 scheme until age 75 are being expelled from the best of both schemes lifeboat at age 65 by a measure intended to address age discrimination. The proposed remedy arbitrarily restricts the protection to age 65, regardless of whether the member has reached state pensionable age (pensionable age in the current scheme) or not.

What would or should have been a general guarantee to 31st March 2022 has been undermined by a, perhaps understandable, desire to recycle elements of the existing underpin. The new underpin is an entirely new and separate entity that must be judged on its merits and there does not appear to be any objective justification for imposing an arbitrary age limit on what is, otherwise, a universal protection. This appears to be direct age discrimination and the judgement in *Walker v Innospec* suggests that its proponents cannot take any comfort from the pension regulations exemptions in the Equality Act 2010.

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

The Fund has concerns about the equality impact.

The proposed underpin is predicated on ensuring that members are no worse off than they would have been had they remained in the 2007 scheme until 31st March 2022 and yet it excludes older members who could otherwise have continued in the old scheme until 2022. The remedy removes one form of age discrimination, namely the requirement to be within ten years of retirement, and introduces another because the underpin is extended to 2022 for everyone, except those who reach age 65 in the meantime. The impact of this anomaly is illustrated by a member with a SPA of 66 who reaches age 65 on 31st March 2021, is awarded a provisional underpin but cannot draw their pension benefits without reductions until 31st March 2022.

The underpin is no longer an age-related protection and it is, or should be, a general guarantee. It would be both simple and logical to extend the provisional underpin to the earlier of 31st March 2022 and the date the member left active service. It would be both easier to administer and cost very little as few members benefit from significant pay rises close to retirement and fewer still work beyond age 65.

Few of the original cohort benefited from an underpin but younger members are likely to benefit considerably from the extension of the underpin when they eventually retire. That is happy development for the younger members but the (very) few older members who might benefit from the removal of the arbitrary age 65 limit should not be treated unfairly.

The Fund is aware that some commentators have advanced a counterintuitive argument that the age 65 restriction is intended to favour younger members who have lost access to a final salary pension scheme. In fact, the government has imposed a general deadline on 31st March 2022, it does not favour younger members and neither do they benefit from older members being treated less favourably. The Fund believes that the age 65 limit merely introduces direct age discrimination against older members.

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

No.

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

The Fund's views are set out in questions 9, 19 and 20.

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

The key to engaging with members and employers is a carefully considered programme of communications and the fund touches on this below.

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

All qualifying leavers must be identified and have their pension benefits reviewed as soon as possible in order to determine whether the revised underpin will apply. The scheme employers will have to be contacted promptly in order to optimise the data available and to give them the best chance of recovering / reconstructing incomplete records.

Data collection / cleansing will consume significant additional resources in both employing and administering authorities. It is critical to engage with actuaries and software providers as soon as possible and, although some of the work can be performed electronically, it will require substantial manual intervention and this demands resources.

A structured communication plan is vital and generic material produced by SAB/LGA should be used as much as possible. Targeted messages should be delivered using websites, regular newsletters, brief messages on payslips and annual benefit statements augmented by sending more detailed general letters to members and specific ones to members who have suffered tax charges or are leaving with provisional underpins. In all cases the content should be carefully calibrated for the intended audience (e.g. members, dependants and employers).

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

Members who were active on 31st March 2012, accrued benefits after 1st April 2014 and who have died, retired, transferred out or left must be prioritised. This is because the payroll and the membership records required to calculate final salary benefits are gradually degrading and the six-year requirement to maintain payroll records has already expired for some members. Moreover, some employers will have changed payroll providers, lost experienced payroll managers and suffered other misfortunes that can slowly erode data quality.

This is a real challenge as details of final pay, part-time hours, changes of hours, aggregated concurrent employments etcetera may not have been maintained properly since 2014.

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

The Fund believes that the provisional underpin date should be simplified to the earlier of the date the member leaves active employment and 31st March 2022. This makes it simpler for everyone as it avoids the differential actuarial reductions of members who are capped at 31st March 2022 but are not eligible to retire until age 66 or older. It is also a simpler message to convey to members, employers and administrators and no additional work for software providers as they would have to write new calculation routines anyway.

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

It would be very helpful if SAB could publish a generic guidance on collating/recovering data where records are incomplete. It is important to have carefully considered pragmatic solutions that would help to ensure consistency across the LGPS.

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

The Fund believes that the underpin should be treated as a general guarantee for all eligible members – without exception - until the earlier of 31st March 2022 or the date of leaving active membership.

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

Our actuaries built a generous contingency into the funding model and we expect the proposed remedy to fall within the anticipated cost envelope. They also expect pay increases in the LGPS to fall well below the generic assumptions the Government used for the whole of the public sector because pay increases in local government are expected to be lower. However, the good news is tempered by the costs of identifying cases and implementing the remedy, which are likely to be considerable, and that is why the Fund advocates keeping the remedy as simple as possible. For this reason, we recommend making the provisional underpin the earlier of 31st March 2022 and the date of leaving active membership and that serious consideration is given to extending the underpin to all members who were active on 31st March 2014.

Yours faithfully,



Anna D'Alessandro
Director of Corporate Finance

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