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Price Inflation – Increases to Pensions in Payment/ Revaluation of Deferred Pension – CPI or RPI?

It has been proposed by the Government that private sector (as well as public sector) pension schemes should be allowed to use the Consumer Prices Index (CPI) as opposed to the Retail Prices Index (RPI) as the measure of price inflation when applying increases to pensions in payment and when revaluing deferred benefits. The Government has stated that it believes this change will make pension benefits more affordable for employers.

Many commentators have pointed out that CPI is generally likely to be lower than RPI – for September 2010 the annual CPI rate was 3.1%, whereas RPI was 4.6%.

However, what these changes will mean for individual pension schemes will depend on how these proposals are ultimately translated into law. This uncertainty has largely been caused by the fact that different pension scheme rules will have reflected the requirement to apply increases or revaluation in different ways. Indeed, in Reed Smith's experience, no two pension schemes will have provisions worded in precisely the same way.

Pension scheme rules

Example A:

Some scheme rules when dealing with price inflation will contain specific wording referring to RPI to reflect the current minimum requirements. This is normally capped at a set figure (2.5% or 5%):

"A pension in payment from the Scheme shall be increased by the lesser of 2.5% and the percentage increase in the Retail Prices Index published by the Office for National Statistics"

Example B:

Alternatively, scheme rules may refer to the requirements of relevant legislation and not specifically to RPI. That legislation then specifies the percentage to be used for increases/revaluation, and that percentage is based on RPI:

"A pension in payment from the Scheme shall be increased as required by the provisions of section 51 of the Pensions Act 1995 "

There are many other ways in which pension scheme rules might deal with price inflation, but we will use these two examples to highlight the complications.

Why does this cause a problem?

The Government appears originally to have intended to introduce this change simply by switching from using a RPI based figures to a CPI based figure when publishing percentages for pension increases or deferred revaluation under the legislation.

Under Example B, this might have meant, in simplified terms, that the pension scheme would start basing pension increases on CPI rather than RPI.

However, if the Government made the change in that way, the pension scheme in Example A would continue to use RPI. This is because it explicitly states that RPI should be used.

The problem here is that, at present, the pension schemes in Example A and Example B would both use RPI. However, making the change to CPI in the way proposed would mean that only the Example B pension scheme would automatically use CPI. This is despite the fact that there might be no reason why the rules in Example A and Example B were drafted differently, other than the preference of the individual who drafted them.

If the pension scheme in Example A wanted to use CPI, an amendment might need to be made to the rules. However, trying to do this could raise significant issues in relation, for example, to whether such an amendment might impact on a member's accrued rights.

There is also concern that, in a pension scheme with a provision like Example A, members would continue to receive increases/revaluation based on RPI but, if CPI ever exceeds RPI, then

members would receive benefits based on the higher of the two. This would increase pension liabilities rather than, in line with Government's aim in introducing this change, reduce them.

So what is happening now?

Many commentators have pointed out the unfairness of this approach given it will unintentionally impact upon different pension schemes in different ways. This would also go against the Government's stated intention of allowing all pension schemes to use CPI.

The latest suggestion is therefore that the Government will introduce new overriding legislation which will apply to all pension schemes, irrespective of how their rules on pension increases and deferred revaluation are drafted. However, any detail on this is yet to be published and there are still many unanswered questions.

What do we do while we wait for clarity?

Given the uncertainty highlighted above, it is not recommended that any action be taken in relation to the potential RPI/CPI change at this stage.

Whilst the Pensions Regulator has said that "trustees should plan to communicate with members on the impact, as soon as possible, once known, even if the impact is likely to be negligible" and that trustees could even consider an interim communication, tPR also acknowledges that 'until any legislative changes are made, trustees should ensure that they continue to take decisions relative to the current state of the law."

You may be sending out member communications before the CPI/RPI change is finalised but which mention the basis for pension increases or deferred revaluation. In that case, we would recommend that consideration is given to including a note stating that changes are expected in this area and further details will follow.

Section 251 of the Pensions Act 2004: Resolution Re Payment To Employer

*****STOP PRESS**: The paragraphs below set out the issue for pension schemes as the legislation currently stands. However, the Department for Work and Pensions has just announced that, given the confusion in this area, it is going to put back the deadline for action to 5th April 2016. On the basis of the DWP announcement, pension schemes could therefore hold off any planned action until late 2015. However, given that action will still be required under current proposals, other schemes may prefer to deal with this now.***

What do we need to do?

If you want to take action now, the first stage is to review your scheme's rules to check if section 251 could apply to the scheme.

If the scheme's rules do allow a payment to be made to an employer (as will often be the case in respect of, for example, any surplus under the pension scheme), one interpretation of section 251 is that, for trustees then to be able to make such a payment on or after 6th April 2011 (or 2016 as now proposed), they must have passed a resolution before that date stating that the power can still be exercisable.

In terms of funding, the preservation of a surplus refund power can be seen as important as otherwise an employer may become more concerned with funding assumptions/contributions that it believes may lead to future overfunding that will become 'trapped' in the scheme. To avoid this issue, trustees can properly agree to maintain a surplus refund power.

Section 251 also allows trustees to specify circumstances and add conditions to any surplus payment power in the resolution they pass. However, in most cases, given the restrictions normally contained in scheme rules as well as in overriding legislation, trustees would not need to seek to use this opportunity to do anything other than maintain the status quo.

Do we need to inform members about this?

Section 251 requires three months' notice of the proposal to pass such a resolution to be given to the employers and the members of the pension scheme. The notice must be in writing, inform employers/members that the trustees have decided to exercise their power under section 251 to pass such a resolution and specify the date from which the trustees' proposed exercise of the power is to take effect.

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Given the three month notice requirement, the absolute deadline for sending out such a notice is therefore 5th January 2011 (or in 2016 as is now proposed), although it would be advisable to send any notice earlier than this.

Summary of Action Required to Pass a Resolution under Section 251

- **Step 1: Check pension scheme rules** – Confirm if there are provisions under the scheme rules which would allow payments to be made to an employer under the scheme and to confirm if section 251 applies.
- **Step 2: Trustee formally decides that it intends to pass a resolution** – The resolution that the trustees decide to pass can state either that the surplus payment power continues to be exercisable in accordance with the terms of the rules of the pension scheme as they stand, or that the power is exercisable only in such circumstances and subject to such conditions as the trustees may specify.
- **Step 3: Notice to employer and members** – Under section 251(6), 3 months' notice of the proposal to exercise the power to pass the resolution must have been given to the employer and to all the members of the scheme. The absolute deadline for this stage is therefore 5th January 2011 (or in 2016 as is now proposed). It may be felt preferable to give the notice at the same time as a more general scheme update to members if timing allows for this.
- **Step 4: Pass resolution** – The resolution can then be passed on the expiry of three months after the notice was given to the employer and members. This must be on or before 5th April 2011 (or in 2016 as is now proposed).

Restricting Tax Relief on Pensions – 14th October 2010 statement

The new Government had previously indicated that it was going to depart from the Labour Government's plans in respect of 'high earners'. The new Government's plans have now been published.

What had the Labour Government planned to do?

Gordon Brown had introduced measures to restrict tax relief for 'high earners' from April 2011. Those measures centred on the restriction of tax relief for those earning an income of above £130,000 (with that limit possibly moving down to £100,000). At the same time, the lifetime allowance and annual allowance were to be frozen at their current level for the next five years.

What is now going to happen instead?

Having consulted on its plans, the Government announced on 14th October 2010 that it would be reducing the annual allowance from £255,000 to £50,000 with effect from April 2011. The 'annual allowance' is the amount by which a member's benefits are allowed to grow in a pension scheme (through, for example, contributions or investment growth) each year without them being subject to a tax charge. The figures allowed before the tax charge would apply will therefore be significantly reduced, and the change applies to all members, not just 'high earners'. However, the Government has stated that the reduced annual allowance will affect around 100,000 pension savers, 80% of whom have incomes of over £100,000.

The lifetime allowance (which is the limit on the total amount an individual can save as pension benefits without incurring tax charges) was set to be fixed at £1.8 million for five years. That figure will now be reduced to £1.5 million. The announcement made by the Government is not explicit as to whether this lower figure is also to be fixed for five years, but that seems to be the intention as a minimum.

The Government has also stated that, to protect individuals who exceed the annual allowance due to a one-off "spike" in accrual, offsetting against unused annual allowance from previous years will be allowed. There will also soon be a consultation on options to enable people to meet tax charges out of their pensions. However, no further detail is given on these changes.

A further suggested reform had been to remove the current exemptions from the annual allowance test, most notably the exemption that means that no test is applied in the year that a member's benefits come into payment. However, there is no further detail on this contained in the announcement.

One of the problems that had been identified with the Government's change to the annual allowance relates to the way that DB benefit accrual is valued and tested against the annual allowance figure. Given the significant reduction in the annual allowance, normal continued accrual could lead to a breach of the annual allowance even for modestly paid members. This is because, as well as the decreased annual allowance, the Government have suggested a technical amendment which would mean that the factor used to establish the value of a member's benefits at the start and end of the annual allowance period is to be raised from 10 to 16.

The Government has estimated that implementing these changes will save around £4 billion, but much of the detail around how these changes will be introduced is yet to be published.

Equality Act 2010

The main provisions of the Equality Act 2010 ("the Act") came into force on 1st October 2010.

The Government Equalities Office describes the Act as a "new cross-cutting legislative framework to protect the rights of individuals and advance equality of opportunity for all; to update, simplify and strengthen the previous legislation; and to deliver a simple, modern and accessible framework of discrimination law which protects individuals from unfair treatment and promotes a fair and more equal society".

Essentially, the Act consolidates various previous provisions relating to sex discrimination, race discrimination, age discrimination, disability discrimination and other discriminatory practices into one place.

One of the key parts of the Act for pension schemes is the prohibition on age discrimination. However, the same exemptions as applied under the previous legislation (which came into force on 1st December 2006) have been replicated in the Act and the law in this area therefore effectively stays the same.

DC Flexibility – Finance (No. 2) Act 2010

This Act has introduced some thinking time for the Government in terms of its plans to remove the age 75 deadline for compulsory annuitisation. The Act does this by increasing the compulsory annuitisation age to 77 for two years, thus giving the Government two years to come up with their final plans, and giving individuals who are reaching 75 years time to defer their decision until the Government's plans are finalised. In the meantime, a consultation on how to implement this has taken place, and draft legislation is expected within the next six months.

6th April 2011 – Transitional Protections Expire

The Finance Act 2004, and associated regulations, included transitional protections to give pension schemes time to adjust to the new regime and put updated documentation in place. Most pension schemes also passed a deed of amendment on or shortly after 6th April 2006 to ensure that the benefit of those protections was incorporated into their schemes at that date.

Many pension schemes have, since 6th April 2006, conducted a full review and update of their trust deed and rules and, for those schemes, no further action is required. However, for pension schemes who have not taken such action, it should be noted that the protections are due to expire, under the terms of the Finance Act 2004, on 6th April 2011.

At that time, a pension scheme's trust deed and rules should still be compliant with the legislation. However, the key risk is that pension schemes relying on the transitional protections will lose any of the old Inland Revenue limits on which they currently rely. That could lead to, for example, a removal of the effect of the earnings cap which would most likely result in an immediate increase in a pension scheme's liabilities.

For these schemes, a short deed of amendment should as a minimum be prepared and executed before 6th April 2011 which would retain explicitly the old Inland Revenue limits past 6th April 2011.

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