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High Inflation and Members' Benefits

The rapid rise in inflation in recent months has focused attention on the cost of living. This includes the impact on pension savings and retirement incomes. This has consequences for defined benefit (DB) pension schemes both for the pensions members receive and for the funding of those schemes. This Update sets out some of the issues which Trustees and Employers should consider.

Increases to Pensions in Payment

Legislation prescribes a minimum rate of increase, and often schemes will provide a higher rate of increase, specified in their rules. Most commonly, these are linked to inflation up to a stated maximum, typically 5%. Of course, inflation is now at a much higher level.

Often scheme rules also contain a power to provide additional discretionary increases. This power could be exercisable by the Trustees and/or the Employer; the scheme rules will prescribe the process and basis upon which these discretionary increases might apply. Commonly, this power is only exercisable with the consent of the Employer.

Trustees may therefore wish to check whether their scheme rules contain such a power, and if so, consider in conjunction with the Employer whether it may now be appropriate for it to be exercised, given the current inflationary environment.

One of the factors to take into account will be the scheme's current funding position. Although short-term inflation is high, longer-term market expectations for future inflation have changed little. Since the start of the year significant increases in bond yields have resulted in many schemes seeing their funding positions improve, although this will have been offset by more recent falls in equity markets. The level of interest rate and inflation hedging will also have an impact. Trustees may wish to seek an update from their Scheme Actuary.

Even if the decision is not to grant any discretionary increases, it is important that the position is reviewed, debated and documented, so that it can be shown that this issue has been considered properly.

Increases to Pensions in Deferment

Legislation also prescribes a minimum rate of increases to members' deferred pensions. This is based on inflation (CPI), with a cap of 5% p.a. (2½% p.a. for service after 5 April 2009). However, this cap is not applied year-on-year (as for annual increases to pensions in payment), but over the whole period of deferment. In recent years, inflation has been relatively low, much lower than the caps. As a result, in many cases, members' deferred pensions will increase by the full amount of this year's inflationary increase, as the overall increase since the member left service will still be below the cap.

Formally, the inflationary increase is based on the rate of increase in the CPI in September 2022, and takes effect from 1 January 2023. The latest CPI increase (May 2022) is 9.1%, and most commentators anticipate a similar level in September. It is therefore likely that deferred pensions will be increasing by more than will have been assumed in previous actuarial valuations. The impact on a scheme's funding position will depend on the level of inflation hedging in place. Trustees may wish to seek advice from their Scheme Actuary on the overall impact on scheme funding, and Employers may wish to discuss with their auditors whether this should be taken into account in their year-end accounting disclosures.

Early Retirement Pensions

Early retirement calculations undertaken after 1 January 2023 will automatically allow for this year's higher inflation. However, Trustees may wish to review the basis used currently for early retirement calculations undertaken this year in respect of members whose normal retirement date falls after 1 January 2023.

Standard early retirement procedures will typically assume a future rate of inflation of 2 – 3% p.a., but as noted above it is expected that on 1 January 2023 members' deferred pensions will actually increase by a much greater amount. There is therefore the possibility that such early retirement calculations may result in a level of early retirement pension which does not fully reflect the value of the members' benefits. Legislation on the calculation of early retirement pensions requires Trustees to be reasonably satisfied that such pensions are at least equal in value to the deferred pension which would otherwise be payable from the member's normal retirement date.

Trustees may therefore wish to consider whether to review the basis to be used for the remainder of 2022 to calculate early retirement pensions for members whose normal retirement date falls after 1 January 2023.

Cash Equivalent Transfer Value (CETV) Calculations

The same issue on allowing for this year's higher inflation may also apply to the calculation of members' CETVs, and Trustees may also wish to discuss with their Scheme Actuary whether it would be appropriate to review the CETV basis to be used for the remainder of 2022 to take this into account.

But short-term higher inflation is not the most significant factor currently influencing the level of CETVs. The substantial rise in bond yields since the start of the year means that, even if some allowance is made for higher short-term inflation, currently the levels of members' CETVs are lower (in some cases significantly lower) than they were at the start of the year.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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Mill Pool House
Mill Lane
Godalming
Surrey GU7 1EY

T: 01483 860201

E: enquiries@cartwright.co.uk

250 Fowler Avenue
Farnborough Business Park
Farnborough
Hampshire GU14 7JP

T: 01252 894883

E: enquiries@cartwright.co.uk

Marlborough House
Victoria Road South
Chelmsford
Essex CM1 1LN

T: 01245 293300

E: enquiries@cartwright.co.uk