

# Your pension liabilities reduced?



**The Minister for Pensions has announced that statutory increases in private sector pension schemes should, in future, be linked to the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) that is currently used. This followed the Chancellor's announcement in the June Budget that public sector pensions would be increased in this way.**

This could deliver a significant reduction in pension liabilities for many schemes. However, it should be noted that any reduction will be at the expense of members, who will receive lower pensions.

## Why it's significant

It is estimated that, solely due to the different mathematical methods used to calculate the indices, the annual increase in the CPI will be around 0.5% pa lower than RPI, e.g. if RPI were 3.5% pa in the longer term, CPI would be around 3.0% pa. For a 65-year old retiree, a pension increasing by 0.5% pa less than it otherwise would have done means that the overall value of the pension is around 6% lower.

Another important difference is that the CPI excludes the cost of mortgages. With base rates being so low at the moment, RPI is likely to materially outstrip CPI over the next few years. To see what effect that might have, we can look at forecasts produced by the Office for Budget Responsibility (OBR) at the time of the June Budget:

Year	2010	2011	2012	2013	2014	2015
RPI	3.7%	3.2%	3.2%	3.3%	3.4%	3.5%
CPI	2.7%	2.4%	1.9%	2.0%	2.0%	2.0%
Cumulative difference	1.0%	1.8%	3.1%	4.4%	5.8%	7.4%

So, on top of a systematic ongoing reduction of around 0.5% pa, there is a materially higher advantage to employers by the Government implementing this proposed change at this time.

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## Will all schemes be affected?

The actual effect on a scheme is likely to depend on the scheme rules.

### Increases in deferment

Most schemes' rules state that pensions in deferment will be increased in line with statutory revaluation. So if the published statutory revaluation is lower, then those schemes automatically adopt the lower increase. For clarification, the intention is that increases from a member's date of leaving to 2010 remain linked to RPI. CPI increases are to apply from 2011 onwards.

If a deferred pensioner member is 20 years away from retirement, we estimate that the overall reduction in the resulting pension could be around 15%. The increases in deferment on some types of pensions would not be affected, e.g. Guaranteed Minimum Pensions.

### Increases in payment

The Government will use the one-year revaluation order as the basis for the statutory minimum increase for pensions in payment related to service from 6 April 1997.

It is clear that a pension scheme will be able to take advantage of this in respect of benefits building up in the future although a rule change is likely to be required.

Pension increases on any Guaranteed Minimum Pension (GMP) earned between 6 April 1988 and 5 April 1997 will increase in line with the CPI, with the annual cap at 3%.

It is not clear at this stage if many schemes will be able to take advantage of this in relation to non-GMP pensions built up in

the past. Unlike a generic reference to statutory revaluation of deferred pensions, the rules relating to increases in payment for most pension schemes will have specific references to RPI. Unless there is overriding legislation brought in, the RPI will need to be retained on pensions that have already accrued. Moreover, as the CPI is the new statutory minimum, CPI will have to be provided if CPI is higher than RPI.

## Changing the Rules

To take advantage of the proposed CPI-linkage, a rule change may be required, especially if pension increases in payment are to change. In respect of benefits accrued in the future, this will typically be straightforward.

If the rules make specific reference to RPI linkage for increases in deferment and payment, then adopting CPI linkage for past service will diminish the value of the benefits. This may not be allowed under the amendment powers of a scheme's trust deed & rules.

If the rules specify that statutory revaluation in deferment and statutory increases in payment are to be provided, a rule change will not be necessary.

There are calls from some quarters for schemes to be put on an equal footing, i.e. that schemes that refer to RPI-linkage would be able to adopt CPI. Overriding legislation could make this either the default position or an option available by making a rule change.

If the Trustees' agreement is required to change the rules, Trustees will need to ensure that it's in the best interests of members to do so and this may prove difficult in respect of pensions already accrued. Perhaps the only situation where this might be possible is where the employer is in a poor state and a change might be the difference between entering the Pension Protection Fund (PPF) or not.

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## The practical effects of a change

Where a defined benefit pension scheme has the opportunity to use CPI rather than RPI for revaluation and/or increases on pensions in payment, many aspects of managing it will be affected.

### Scheme funding valuations

Employers that are currently discussing the assumptions underlying the Technical Provisions with Trustees may wish to press for a lower allowance for revaluation or pension increases. Until the situation becomes clearer, this is only likely to be accepted in relation to increases in deferment.

### FRS 17 and IAS 19 valuations

There will be a beneficial effect on the employer's balance sheet and for many schemes the amount will be significant.

### PPF levy

Pensions in the PPF that are now RPI-linked will in future be CPI-linked. Section 179 valuation assumptions will need to be adjusted to reflect this. As the benefits in the PPF will be lower, this will result in lower PPF levies than they otherwise would be under RPI linkage.

### Closing to future accrual

The financial benefit to the employer of closing to future accrual and linking pensions to statutory revaluation is now greater than ever.

### Transfer values

Trustees should obtain actuarial advice and review their assumptions. Trustees should also ensure that any transfer quotations in the pipeline are managed appropriately so that they are not paying too much unnecessarily.

### Transfers-in

Many pension schemes offered pensions increasing in line with, or linked to, RPI. Trustees will need to consider the terms on which transfers were offered.

### Actuarial factors

The actuarial factors used in a pension scheme will need to be reviewed. This will include commutation factors, early and late retirement factors and conversion of AVC funds to pension.

If pension increases in payment are to be CPI-linked in respect of past service, be careful with any pensions derived from AVCs. Trustees will need to look carefully at the terms offered to the AVC payer at the time of conversion to pension.

### Schemes in wind-up

Schemes that are in wind-up but not yet bought out will need to consider CPI-linking. Any schemes going through the final stages of wind-up that have received a buy-out quote should contact the insurance company to amend the prices if statutory revaluation is bought out. Otherwise the windfall will be given to the insurance company rather than the members and/or employer.

### CARE schemes

Career Average schemes where the revaluation each year is revalued in line with RPI, with or without a cap, should consider the revaluation basis from 2011 onwards. A change to the CPI basis may be preferred.



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### The Pensions Regulator's view

The Regulator has issued a statement to help Trustees and employers in managing the impact of the proposed changes. Whilst accepting that any impact will be scheme specific and dependent on the details of the legislation, the Regulator is recommending Trustees prepare by reviewing their rules and any expectations arising from previous member communications. He is also recommending that Trustees communicate with members on the impact as soon as possible, even where the impact is likely to be negligible.

Until legislative changes are made, he is reminding Trustees to continue to take decisions based on current law, that the current scheme funding regime will continue and, in particular, existing payment schedules should remain in force.

If changes do result in lower liabilities in the future, as always, the Regulator expects this to be reflected in a shorter recovery plan, not lower current contributions.



If you haven't produced a deed of amendment relating to the A-Day tax regime change, you should consider doing it as soon as possible. After 5 April 2011 it might be too late.

Rule changes may be needed to maintain an Earnings Cap, for members to take the maximum 25% lump sum on retirement, to allow trustees to deduct tax from members' benefits and to prevent certain unauthorised payments being made.

## Time running out on Section 251

Lawyers have recently got interested in the apparent poor drafting of Section 251 of the Pensions Act 2004.

Most schemes already had the power to return surplus to the employer. Section 251 temporarily gave this power to those schemes that previously did not have it. A strict reading of Section 251 removes this power for all schemes on 6 April 2011, even if they previously had this power, unless the Trustees pass a resolution by this date. To be safe, members and the employers will have to be notified of the resolution three months before it is passed. Therefore action is needed by the end of this year.

The Trustees will need to be sure that a rule change would be in the members' interests. This is probably demonstrable in most cases where there is a deficit on a buy-out valuation. If an employer can never

have surplus returned, then the employer will be keen to keep contributions low. If the surplus can be returned, the employer is more likely to find higher contributions more agreeable and so the security of accrued rights would be greater.

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## About Hughes Price Walker (HPW)

HPW are pensions specialists, working with clients to efficiently and accurately manage their pension schemes.

Three directors, who all have over twenty years' experience in occupational pensions, own the company. There are no outside shareholders, bank loans or other financial commitments, allowing us to make decisions in the interests of our clients rather than third parties.

One of the directors has direct involvement in providing our services to each client, with a very personal interest in ensuring that the quality of our advice and our service standards are second to none.

To date, most new business has come from referrals by other pensions professionals or by word of mouth.

**We benchmark our fees to be 60-70% of the major consultancies.**

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## HPW News

We have enjoyed a very successful 2010 so far with the following new business wins:

Consultancy, actuarial and administration services for a manufacturing and services company based in Gloucestershire.

Advice to the employer on closing a scheme to future accrual for an organisation in London.

Consultancy, actuarial and administration services for an engineering company in South Wales.

Consultancy and actuarial services to a shipping company in North Yorkshire.

The information and opinions contained in this document are not intended to be a comprehensive study, nor to provide advice, and should not be relied on or treated as a substitute for specific advice concerning individual situations.

## Win a luxury hamper! Or a donation to charity

This issue's competition!

In order to be in with a chance of winning a luxury hamper (or if you would prefer a donation to your favourite charity or community organisation) simply answer the following question:

What will be the value of the FTSE 100 Index as at the close of business on Friday 1 October 2010?

Entries must be submitted by email to [competitions@hughespricewalker.co.uk](mailto:competitions@hughespricewalker.co.uk) by 5pm on 17 September 2010.

As well as your guess, please state your name and the company or pension scheme you're connected with.

The competition is open to directors, managers or trustees associated with a trust-based occupational pension scheme. Only one entry per person.

Congratulations to the winner of our last competition - Wyn Davies of TDK-Lambda UK.