PENSIONS POLICY INSTITUTE
PPI

Flexibility of scheme indexation: Revaluation and Increases

Tim Pike, Head of Modelling, Pensions Policy Institute

About this Paper

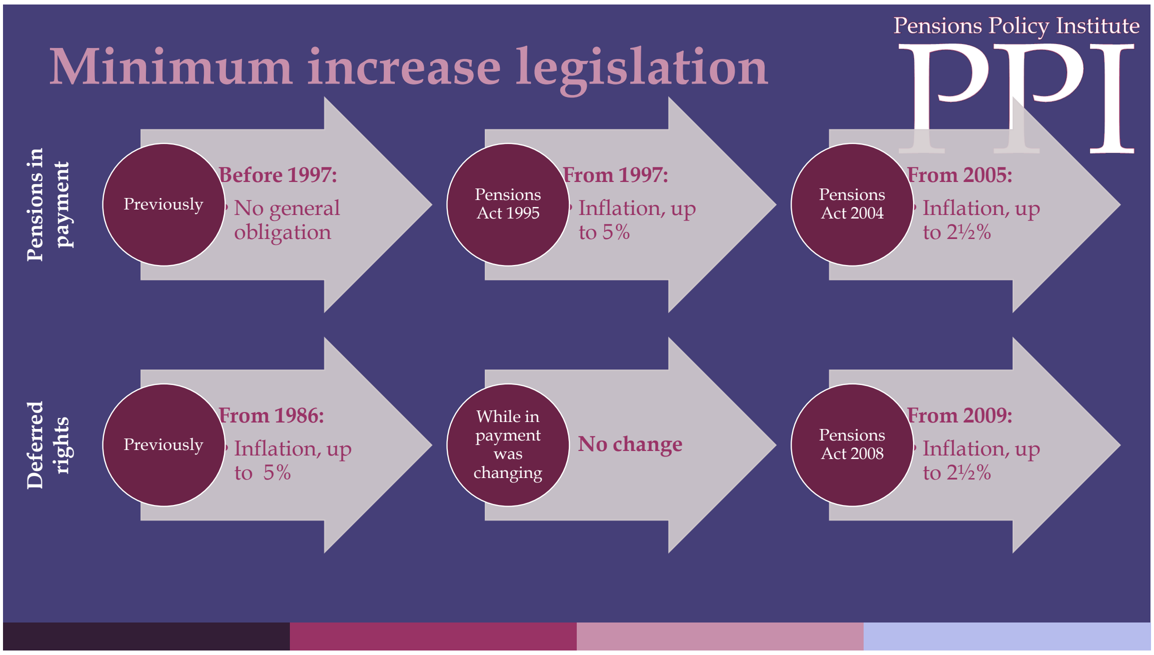
This paper summarises the content of a presentation outlining the current options of discretionary indexation in Defined Benefit (DB) pensions and the evolution of CDC (Collective Defined Contribution) pension schemes in the UK. It considers the trade-offs of the alternative approaches in the context of the UK system alongside international implementations.

The Paper is structured as follows:

- Section 1: Background
- Section 2: Discretionary increases in the current landscape
- Section 3: Collective Defined Contribution schemes

Section 1. Background

1.1. Minimum increase Legislation



This Paper relates to the treatment of non-protected rights[a] benefit accrual.

There are differences in how pensioners in payment are treated compared to deferred members.

Pensions in payment[1,2]

Benefit increases for pensioners are to offer protection from inflation.

- Benefit accrued before April 1997
    - Out of scope of legislation

Pensions Act 1995

- Benefit accrued from April 1997
    - Pensions in payment must be increased for inflation based on Limited Price Indexation (LPI)
    - LPI is equal to inflation capped at 5%

Pensions Act 2004

- Benefit accrued from April 2005
    - The cap on inflation was reduced for increases of pensions in payment
    - Inflation capped at 2.5%

Deferred members[3,4,5]

Benefit increases for deferred members have been needed in some form since 1986. It is designed to remove the detrimental impact of a member leaving the employer and becoming

[a] The portion of benefits that are accrued as a result of contracted-out contributions (protected rights), are inflexibly bound by GMP increases.

a deferred member, rather than an active member. For final salary schemes, where active members would retain a link to their earnings, deferred members benefits had to also be increased:

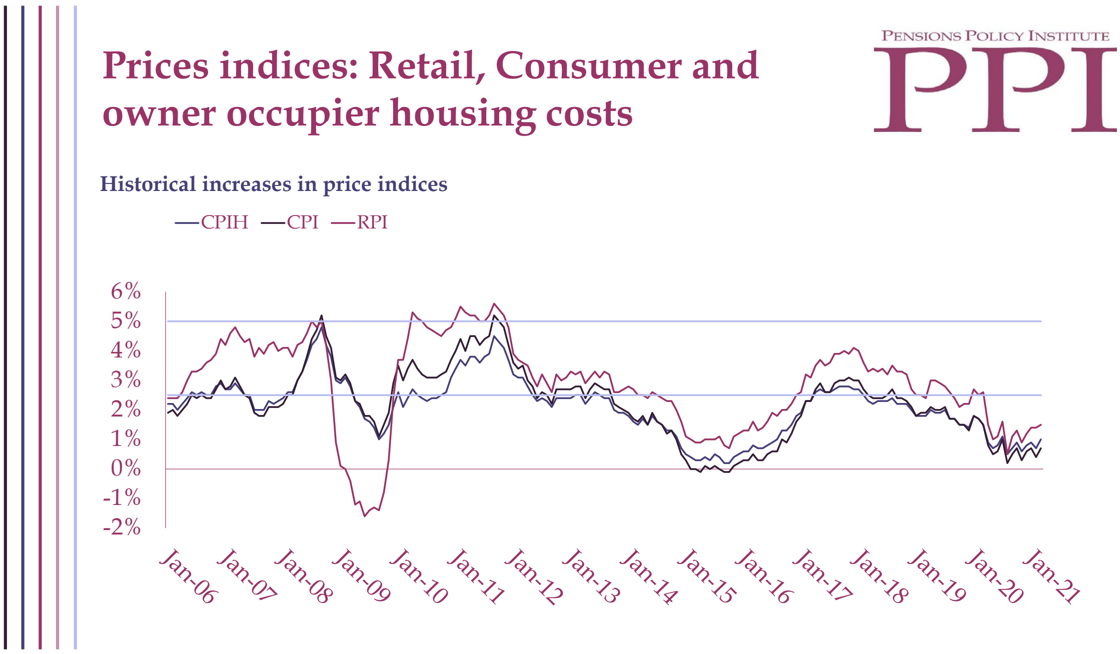
- Accrued before April 2009
    - Inflation capped at 5%
- Pensions Act 2008
    - Accrued after April 2009
    - Inflation capped at 2.5%

For members in **career average schemes**, deferred members must not be treated detrimentally when compared to active members. This may mean a scheme could operate below the minimum increases specified in the qualification criteria for automatic enrolment. As such, the scheme would not meet the employer's obligation to provide a suitable scheme under automatic enrolment legislation.

Automatic enrolment

Minimum increases for a scheme to qualify for automatic enrolment are defined separately, and are currently aligned with final salary schemes for all forms of Defined Benefit schemes.

1.2. Prices indices: Retail, Consumer and owner occupier housing costs



Government switch to CPI[1,6,7,8,9]

Inflation used to mean RPI, as it was the only inflation standard.

- The Pensions Act 1995 refers to the retail prices index and the Pensions Act 2004 did not change it.
- Generally, legislation just says inflation rather than specify a particular index.
- In the 2010 Budget: the Government announced they will adopt CPI for the indexation of benefits, from April 2011.
    - Chart 1.2 shows that CPI is generally lower than RPI.

- July 2010: The then Pensions Minister (Steve Webb) announced that CPI will become the inflation for increasing pensions. This change applies to:
  - Minimum increases,
  - GMP increases, and
  - Pension Protection Fund benefits.
- The Pensions Act 2011 enacted all the necessary legislation including removing references to RPI
  - A scheme is not obliged to reduce increases to this new, lower minimum.
  - The ability to switch will be based upon what is written in the scheme rules.

Occupational pensions switch to CPI[10,11,12,13]

At the time of the minimum change in 2011 less than 1 in 5 schemes applied minimum indexation and revaluation. More recently, by scheme rules:

- ~64% indexation based on RPI
- ~27% based on CPI
- ~34% revaluation based on RPI
- ~56% based on CPI

An override provision was consulted upon and rejected by the Government. The result is that employers were required to consult. Schemes have to work with what they had at their disposal, e.g., in 2018 Barnardo's got as far as the supreme court trying to suggest that:

"General Index of Retail Prices published by the Department of Employment or any replacement adopted by the Trustees without prejudicing Approval"

Their argument was that this would give enough room to enable them to replace RPI indexation with CPI indexation. The court ruled against replacing the indexation until RPI was discontinued and replaced. BT also visited the High Court and Court of Appeal in 2018 to the same effect.

Future changes to RPI[14,15]

RPI is to be phased out in 2030 based on the duration of index-linked gilts, to be replaced with CPIH methodology.

This will result in some schemes using CPI and some using CPIH for indexation and revaluation based upon their scheme rules. These two inflation measures are far more closely aligned than RPI and CPI.

For someone currently retiring, changing increases from RPI to CPIH in 2030 (so reducing increases by ~1% p.a. after that point) could reduce the lifetime value of their pension by 4%-5%, around 12% - 13% if they've still got 10 years to retirement.

Section 2. Discretionary increases in the current landscape

2.1. What is permitted

What is permitted

- Legislated minimums
- Scheme rules
- Trustee and sponsor agreement
- Independent (actuarial) advice
- Subsisting rights

In the current landscape, discretionary increases are for benefit increases beyond minimums laid out in both legislation and scheme rules.

- Indexation and revaluation must be above applicable minimums.
- Discretion is only provided for the uplift of benefits beyond these levels.

Discretion does not apply to reducing benefits.

Indexation written into scheme rules above applicable minimums is not discretionary.

To reduce from the scheme rules towards the minimum would require an amendment to the scheme rules.

Automatic enrolment qualifying scheme minimums[16]

For a Defined Benefit scheme to meet the qualifying criteria for automatic enrolment it must meet certain benchmarked standards, alongside all other legislated standards. For career average earnings pension schemes, the modified test scheme standard is based on benefit accruals of 1/120th of each year's qualifying earnings revalued each year by at least the lower of:

- RPI,
- CPI, or
- 2.5 %.

Permissible schemes can include revaluation below these rates in particular years providing they are expected to outperform the minimum standards over the longer term. This has to be recognised in the schemes funding principles.

For example:

- The funding of the pension scheme must be based on the assumption that accrued benefits would be revalued at or above the minimum rate in the long term, and
- such funding must be provided for in the pension scheme's statement of funding principles required under part 3 of the Pensions Act 2004, or in an equivalent funding statement if the pension scheme is not subject to the part 3 funding requirements of the Pensions Act 2004 (for example a non-UK pension scheme).
    - E.g., revaluation could be linked to earnings which is expected to increase at a higher rate over the long term without concern for the years when earnings increases fall below the minimum.

Schemes which operate discretionary revaluation can also be a qualifying pension scheme, so long as they fund for revaluation at least at the above level and this is reflected in their statement of funding principles.

Trustees vs sponsors

Generally, trustees have discretionary powers around scheme rules and benefits. This may include:

- The ability to amend scheme rules
    - For practical administration purposes to keep the scheme rules doing what they are meant to; or
    - To modify the intention of the scheme.
- Increase / augment benefits
    - Distributing a surplus to members.

Generally, changes to scheme rules require agreement from the sponsor and / or need to take independent advice (e.g., from actuaries) to use powers in certain ways.

Scheme wording

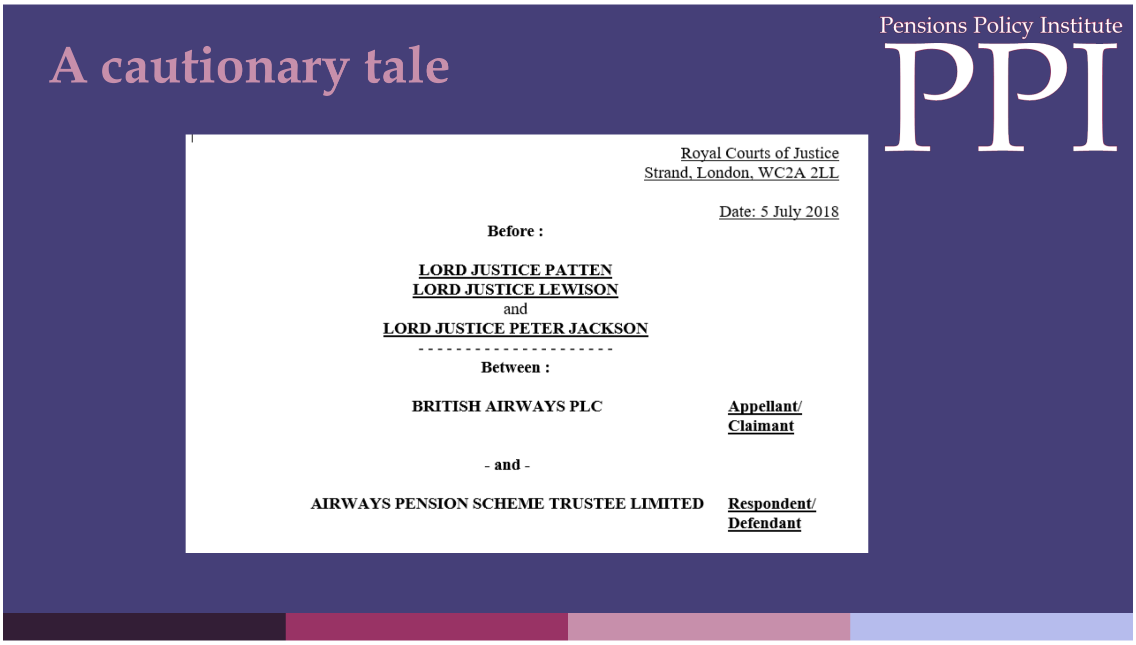
Scheme wording matters and these are hard rules, which if misapplied can result in legal action. Typically, there are words in scheme rules to allow for an increase in benefit above those specified in the scheme rules.

Subsisting rights[17]

There is protection of benefits (and their indexation) which have already been accrued (so does not apply to future accruals). These have been protected in Section 67 of the pensions act 1995. Subsisting rights are benefits which members (and their survivors) have already built up under a pension scheme's rules.

- A protected modification is a change that would result in a members' or survivors' subsisting rights being replaced by money purchase benefits, or would reduce pensions being paid. This needs member consent.
- A detrimental modification is a change which would adversely affect members' or survivors' pension subsisting rights. This can only be done without consent if there is actuarial advice stating value of benefits already earned will be the same or greater.

2.2. Misapplied discretion in practice



Two case studies of applying discretion in practice from recent years (one challenged, and one implemented in line with scheme rules):

British Airways[18]

The RPI to CPI change applied across the BA pension scheme when implemented. This came directly from the government's 2010 announcement (the scheme came about before privitisation so public sector rules reign).

Trustees in 2011 implemented their unilateral power of amendment to the scheme's rules to give power to grant discretionary increases.

In 2013 the trustees made a discretionary increase to halfway between CPI & RPI. An additional 0.2%.

BA challenged this on two grounds:

1. The payments were "benevolent or compassionate" (against the scheme rules)
2. The amendment to the scheme's rules was improper

The first point did not stick, but the amendment to the scheme rules did, as the change to the rules was not for administrative purposes as the amendment powers were purposed.

The discretionary increase was therefore not tested to destruction as it was blocked for other reasons.

2.3. Other scheme designs in the current landscape

Pensions Policy Institute
PPI

Other scheme designs in the current landscape

Other scheme designs

- **Defined Benefit lump sum schemes**
- **Underpin schemes**
- **Self-annuitising money purchase schemes**

These can transfer both upside and downside risk to the member

Alternative scheme designs can offer benefits linked to investment returns over a life-course while retaining some features associated with DB schemes.

Final Salary Lump Sum schemes[16]

In these schemes, a member accrues a DB benefit which is a lump sum at retirement, there is no regular pension paid out. Automatic enrolment (AE) qualification for the scheme is based on an accrual rate for the lump sum of at least 16% of qualifying earnings per year with the benefit revalued until retirement. Essentially, the scheme makes no promise of increases in retirement and a member could choose decumulation options which are impacted by investment returns.

Underpin schemes

These schemes provide a benefit equal to the higher of notional DC and DB benefits accrued. For example, DB can guarantee the "underpin" while the DC calculation could offer a higher benefit if returns are higher.

Self-annuitising hybrid schemes / self-annuitising money purchase schemes[16]

Members make DC pension contributions to acquire a DC benefit which is subsequently used to purchase a DB annuity funded by the scheme. Such schemes must meet DC qualification standards for Automatic enrolment.

Case Study Church of England Pension Builder Classic[19]

This is a hybrid scheme and, technically, a with profits deferred annuity.

Members make DC contributions which are converted to a deferred annuity benefit (based on age dependent conversion factors).

The aim is to keep your pension increasing every year in line with inflation.

- If the security level is between 105% and 110%: add an increase of 1%.

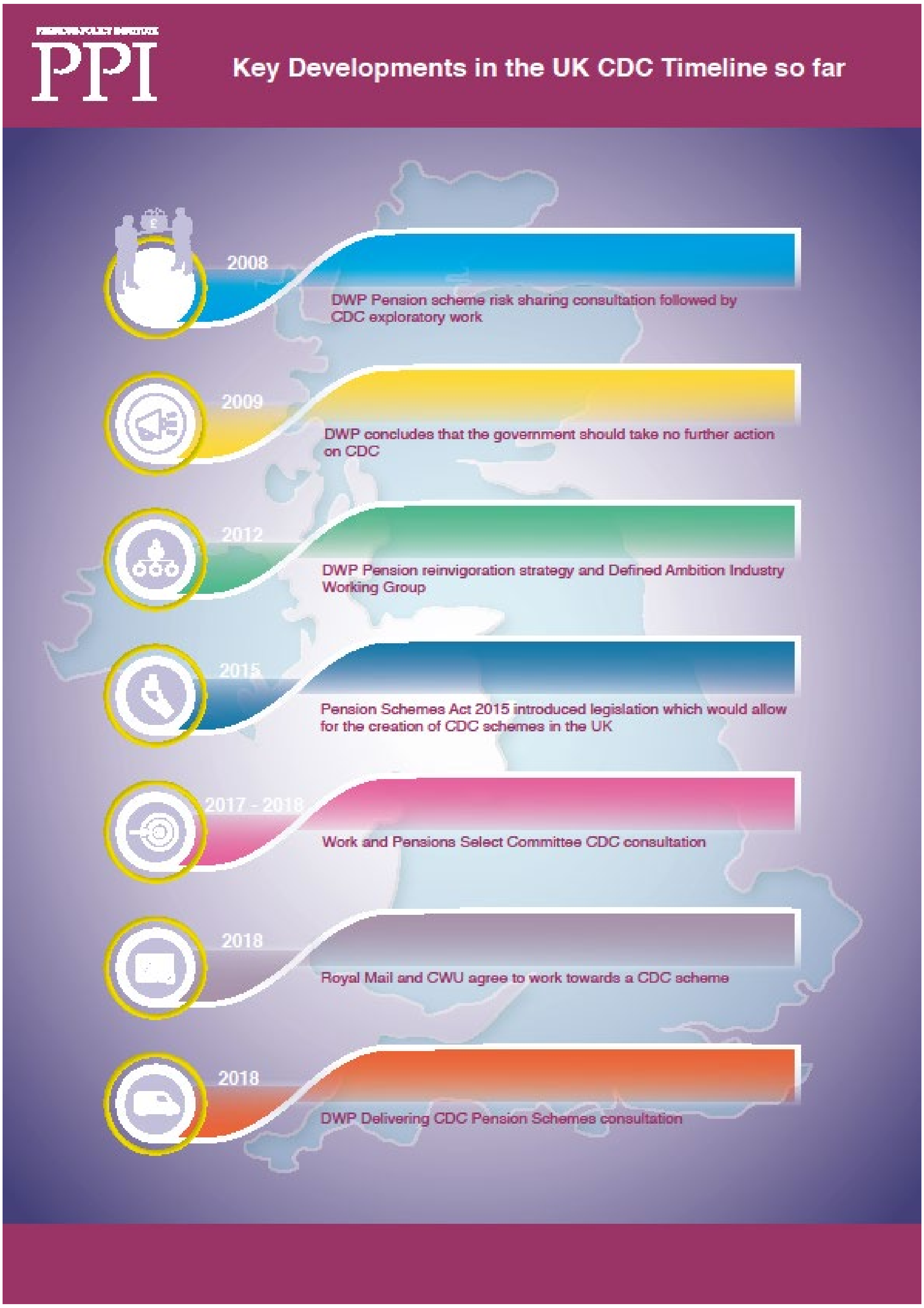
- If the security level is above 110%: match RPI, up to a cap.

This is therefore dependent upon an actuarial valuation and judgment.

Transfer values are based upon contributions, bonuses declared and an actuary.

Section 3. Section 3: Collective defined contributions

3.1. Key developments in the UK CDC timeline[20]



PENSIONS POLICY INSTITUTE

The UK still only has two forms of pension schemes, DB & DC. However, the introduction of Collective Defined Contributions (CDC) as a third alternative is on its way.

2015 Act[21]

Primary legislation enabling CDC style schemes was implemented in the 2015 Pensions Act which allowed for:

1. **Defined Ambition**

This was designed as a "tier" below DB and was to allow a step down for employers who wished to reduce their commitment from a DB scheme.

2. **Defined Contribution Collective Benefits**

This was designed as a "tier" above DC and was targeted at employers who wished to implement a more paternalistic scheme than a pure DC one.

However, implementation of secondary legislation was still necessary to enable CDC in the UK.

2018, Royal Mail[22]

In November 2018 agreement between Royal Mail and Communication Worker's Union was reached to establish a CDC scheme specifically for this organisation. The main features were:

- Contributions of 19.6% (6% employee and 13.6% employer);
- Guaranteed Lump Sum (DB); and
- A CDC retirement income.

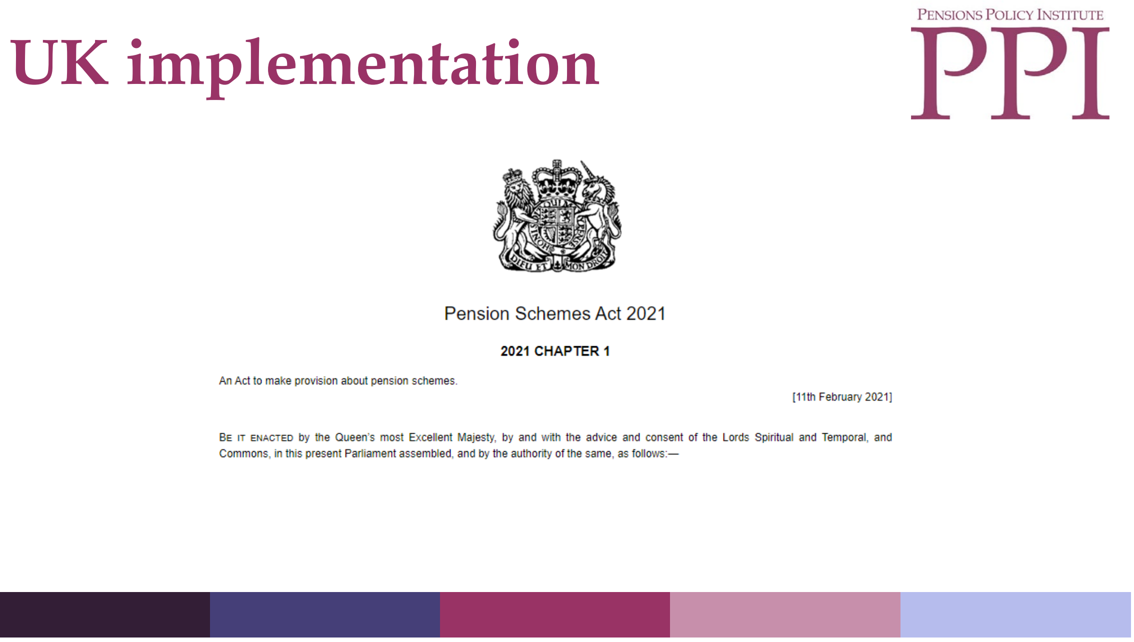
The CDC part providing a retirement income has been designed as a money purchase arrangement – the funding position could not be adjusted by altering future contribution rates.

The valuation of the CDC part is based upon a best estimate basis (with no allowance for prudence margins), and adjustments to benefits are calculated from this starting point.

2018 Consultation[23]

The Government consulted before publishing its response in March 2019.

3.2. UK Implementation of CDC schemes



UK implementation

PENSIONS POLICY INSTITUTE

PPI

Pension Schemes Act 2021

2021 CHAPTER 1

An Act to make provision about pension schemes.

[11th February 2021]

BE IT ENACTED by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

The UK implementation of CDC pensions has been built upon the debate to date in the UK alongside learnings from abroad to protect members.

International Imports to UK CDC[20]

From the Netherlands:

There have been concerns expressed about intergenerational fairness in their implementation, that it allows contributing members to subsidise pensioner members. This is linked to their use of capital buffers and contribution rate responses to funding.

In response UK implementation is to have no buffers and be an entirely money purchase arrangement. This means a scheme cannot set up a reserve in case of future economic downturn, as setting this up is a cost to contributing members. Further, there is no provision for either an employer or members to make up any funding shortfall out of future contributions in the manner of a DB scheme. This leads to less predictable outcomes, and should improve transparency while not placing a burden on members who have to build up or maintain this buffer. (The proposed Royal Mail scheme design does not include buffers.)

Canada

Canadian CDC schemes can be set up as a conversion from a DB pension scheme. Converting accrued DB benefits into retained CDC rights. This transfers a risk to members which is complex to communicate and understand.

In response, UK recommendation is that DB scheme benefits are not to be unilaterally converted to CDC retained rights. For benefits to be changed from DB to CDC requires affirmative consent from members.

Pension Schemes Act 2021[24,25]

On 11 February 2021 the Pensions Schemes Act 2021 received Royal Assent, providing primary legislation for the implementation of CDC schemes in the UK. The technical name is "Collective Money Purchase Schemes".

Qualifying schemes

- Trust based
- Single or group of connected employers (not a master trust)
- Not a public service pension scheme

Qualifying benefits

- Scheme rules must allow for periodic adjustment to balance between available assets and projected costs
  - Any arguments around valuations will still be present
- Amendment to other legislation to make this a subset of 'money purchase benefits'

Other matters

- Intergenerational fairness
  - Lords introduced an amendment for trustees to assess whether the scheme operated fairly between groups of members
  - Commons removed this and said it would "use regulations to set out clear principles and processes to ensure that different types of members are treated the same where justified."

Regulation[26]

The schemes are to be authorised by the Pensions Regulator, building upon the master trust authorisation criteria with additions to address the specific challenges of CDC.

Authorisation criteria

- Key individuals must satisfy fit and proper persons test
- Scheme's design is sound
- Trustees must produce an actuarially certified viability report
- Scheme must meet financial sustainability requirement regarding costs
- Adequate communication with members
- Systems and process requirements (from IT to trustee appointment)
- Continuity strategy in the case of a triggering event

All such schemes will need to be sustainable without a sponsor, as they will not have recourse to the Pensions Protection Fund (PPF) (or have to pay a PPF levy).

3.3. Scope for scheme design in the UK

Automatic enrolment[23]

A scheme would need to meet criteria for automatic enrolment:

- Charge cap of 0.75% (or equivalent, calculated at scheme level)
- Either DC contribution minimums or DB minimum benefit level test

Scheme design[23]

Where a scheme could meet the conditions for being both DB and CDC schemes it will be classed as a DB scheme (not a CDC scheme). This is to prevent DB schemes operating under the CDC regulatory regime.

You cannot convert DB benefits to CDC benefits without member consent.

Each type of qualifying benefits has to be kept separate (e.g., so no cross subsidies between benefit types, so if say accrual rates alter, they are different schemes to all intents and purposes)

Benefit design[24]

Benefit adjustment is to be defined in the scheme rules.

Scheme actuary

Trustees will be obliged to take advice from the scheme actuary to value benefits – and consequently this will impact any benefit adjustment stemming from funding levels.

Smoothing

Limits around smoothing and spreading of adjustments and the circumstances.

Discretion

Trustees will have to explain to the Pensions Regulator when they make a benefit adjustment that is not in line with the scheme rules and latest valuation.

Future development

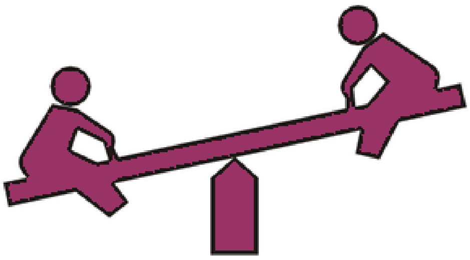
Clause 47 of the act to allow multi-employer schemes or providers to offer CDC master trusts. But this would require consultation before debate and approval by both Houses of Parliament.

Section 4. Comparisons between CDC and discretionary increases in DB schemes

4.1. CDC vs Discretionary increases

CDC vs
Discretionary Increases

PENSIONS POLICY INSTITUTE
PPI



Pensions professionals think CDC will be more beneficial than detrimental (PMI 2018).

Actuaries will need to validate the scheme design for CDC.

There will always be a dependency upon scheme valuations. As a result, scheme valuations will be as contentious as ever. This will impact:

- CDC benefit adjustments
- Any surplus available for a discretionary increase.

Trustees will not have discretion in a CDC scheme.

AE qualification rules will mean CDC charges must meet the DC charge cap.

Communication may make them less desirable to set up, it is part of the prerequisites but in a world of AE and defaults, engagement may be inadequate.

PENSIONS POLICY INSTITUTE
PPI

References

1. Pensions Act 1995, s. 51. Available at: https://www.legislation.gov.uk/ukpga/1995/26/contents (Accessed: 19 May 2021).
2. Pensions Act 2004, s. 278 - 279. Available at: https://www.legislation.gov.uk/ukpga/2004/35/contents (Accessed: 19 May 2021).
3. Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March, p12; Pension Schemes Act 1993, Part IV
4. Pensions Act 2008, s. 278 - 279. Available at: https://www.legislation.gov.uk/ukpga/2008/30/contents (Accessed: 19 May 2021).
5. Pensions Schemes Act 1993, s. 84. Available at: https://www.legislation.gov.uk/ukpga/1993/48/contents (Accessed: 19 May 2021).
6. HM Treasury, Budget 2010, HC 61, June 2010
7. HC Deb, 8 July 2010, c14-16 WS
8. HC Deb, 19 July 2010, c4
9. Pensions Act 2011, s. 20. Available at: https://www.legislation.gov.uk/ukpga/2011/19/contents (Accessed: 19 May 2021).
10. PLSA (2017) *Annual Survey*
11. DWP, Government response to consultation, June 2011, para 18 and 34
12. The Supreme Court (2018) Judgment, Barnardo's (Appellant) v Buckinghamshire and others (Respondents)
13. Approved Judgment Between: British Telecommunications PLC (Appellant) - and - (1) BT Pension Scheme Trustees Limited Respondents (2) Linda Bruce-Watt (Representative Beneficiary) (2018) Court of Appeal, Civil Division, Case Nos: A3/2018/0353 and A3/2018/0389. Available at: https://www.judiciary.uk/wp-content/uploads/2018/12/bt-v-bt-pension-scheme-trustees-ltd-anr-approved.pdf (Accessed: 19 May 2021).
14. HM Treasury and UK Statistics Authority (2020) *A Response to the Consultation on the Reform to Retail Prices Index (RPI) Methodology*
15. Silcock, D (Pensions Policy Institute) (2020) *How could changes to price indices affect Defined Benefit schemes?*
16. DWP (2014) *Automatic enrolment: Guidance for employers on certifying defined benefit and hybrid pension schemes*
17. Pensions Act 1995, s. 67. Available at: https://www.legislation.gov.uk/ukpga/1995/26/contents (Accessed: 19 May 2021).
18. Approved Judgment Between: British Airways PLC (Appellant) - and – Airways Pension Scheme Trustee Limited (Respondent) (2018) Court of Appeal, Civil Division, Case No: A3/2017/1684. Available at: https://www.bailii.org/cgi-bin/format.cgi?doc=/ew/cases/EWCA/Civ/2018/1533.html (Accessed: 19 May 2021).
19. Church Workers Pension Fund (2021) *Pension Builder Classic Members' Guide*

20. Wilkinson, L (Pensions Policy Institute) (2018) *What is CDC and how might it work in the UK?*
21. Pensions Schemes Act 2015, Part 1. Available at: https://www.legislation.gov.uk/ukpga/2015/8/contents (Accessed: 19 May 2021).
22. Royal Mail Group and CWU (2020) *Pension Schemes Bill 2019-21: Collective Defined Contribution (CDC) Schemes October 2020*
23. Department for Work and Pensions (2018) *Government response: Delivering collective defined contribution pension schemes*
24. Pensions Schemes Act 2021, Part 1 and 2. Available at: https://www.legislation.gov.uk/ukpga/2021/1/contents (Accessed: 19 May 2021).
25. PBC Deb 3 November 2020 c12 and 22
26. Djuna Thurley, James Mirza Davies (2020) *Briefing paper. Number CBP 8674, 2 July 2020, Collective Defined Contribution Schemes*