

Pension schemes and the CPI/RPI switch - what does it mean?

April 2012

Pension briefing

HIGHLIGHTS

- The Retail Prices Index (RPI) has been replaced by the Consumer Prices Index (CPI) as the Government's measure of inflation used for determining minimum inflation-proofing for deferred pensions and pensions in payment from occupational pension schemes.
- The last two annual revaluation orders have been calculated by reference to the CPI meaning that, for some schemes, the statutory minimum measure for inflation-proofing has been the CPI since January 2011.
- The Pensions Act 2011, in force from January 2012, amends the legislation governing increases of pensions in payment to extend the CPI statutory minimum to some other schemes.



The effect on pension schemes will generally be scheme specific and will depend on the provisions of the trust deed and rules. For example, in the recent *Danks v QinetiQ Holdings Ltd* case, the High Court held that the trustees had discretion as to the basis for calculating indexation and revaluation. Some schemes will continue to have RPI as the measure used for inflation-proofing, where this is required under their rules.

CPI or RPI – what is the difference?

Both the CPI and RPI are consumer price indices used to measure inflation in the UK. They each measure the average change from month to month in the prices of goods and services purchased by most UK households. Although both indices use the same basic price data, they differ as to what they use to measure inflation. For example, the CPI:

- does not include council tax and a number of housing costs, whilst RPI does;
- includes charges for financial services, whilst RPI does not;
- covers a broader population than RPI;
- adopts a different mathematical formula to calculate price changes; and
- has different classifications for goods and services.

Historically, CPI inflation has been lower than RPI inflation. However this may not always be the case in the future. For example, as RPI includes mortgage repayments, where interest rates fall, RPI will also fall whilst the CPI may not.

The Government believes the CPI "provides a more appropriate measure of pension recipients' inflation experiences and is also consistent with the measure of inflation used by the Bank of England".

BACKGROUND

Inflation protection

To protect the value of accrued pensions against the effect of inflation, a degree of inflation-proofing must be applied to:

- defined benefit pensions in payment accrued since 6 April 1997; and
- deferred pensions in the period before they come into payment.

Inflation-proofing is also required for some defined contribution pensions in payment. For more information on the statutory requirements relating to increases to pensions in payment (indexation) and deferred pensions (revaluation), please refer to the box on page 3.

All change

In the summer of 2010, Pensions Minister Steve Webb confirmed the Government's intention to use the CPI as the measure of price inflation used for determining statutory minimum increases for pensions in payment and deferred benefits from occupational pension schemes. This follows on from an earlier announcement that the change would apply to public sector pensions and reflects the Government's view that the same index should be used in determining increases for both public and private occupational pension schemes. The changes relate to the statutory minimum increase required for deferred pensions and pensions in payment; occupational pension schemes still have the freedom to pay more than the statutory minimum.

Revaluation orders

The statutory minimum increase is announced each year and is given effect in a revaluation order. Traditionally, revaluation orders have used RPI as the measure of inflation, capped at various levels depending on when the benefit accrued.

Last year's revaluation order, effective from 1 January 2011, was based on changes in the CPI in the 12-month period to 30 September 2010. Where schemes already revalue deferred pensions, or increase pensions in payment, by reference to the annual revaluation orders and the rules do not explicitly refer to RPI, the CPI is the measure of inflation to be used from 1 January 2011.

The Pensions Act 2011 and changes to pension legislation

The switch to the CPI as the statutory minimum measure was extended further for pension increases by amendments to primary legislation contained in the Pensions Act 2011. The Act came into force in January 2012. Changes ensure that

other references to price inflation in pension law are consistent with the changes. Therefore, the CPI is the basis used for determining the revaluation of Guaranteed Minimum Pensions accrued between 1988 and 1997 (although not for the indexation of GMPs in payment). Similarly, increases in benefits payable under the Pension Protection Fund and Financial Assistance Scheme are now linked to the CPI.

WHAT WILL THE EFFECT BE ON SCHEME FUNDING?

Historically, CPI increases have been lower than RPI increases, with the difference having averaged around 0.75% per annum over the past ten years. It is expected that this will continue (for more information on the difference between the two measures, please refer to the box on the previous page).

Therefore, for schemes that are affected, the change is likely to result in lower benefits for members and consequently reduce the liabilities both for funding valuations and company accounts, and to reduce transfer values.

However, the extent to which schemes are affected will depend on each scheme's trust deed and rules. As the change is to the statutory minimum, where scheme rules provide for a more generous increase the rules will continue to apply. This is explored in more detail below.

HOW ARE BENEFITS AFFECTED?

For a summary of the effect of the changes on pension increases and revaluation in deferment please see the tables opposite.

Rules do not refer to RPI

To the extent that scheme rules simply state that pensions are to be increased in accordance with relevant legislation, the new statutory minimum applies and increases should be automatically linked to the CPI.

"Hard-coded" provisions of scheme rules

Many scheme rules contain explicit provisions that link to RPI, rather than simply referring to whatever is the legislative default. Therefore, the formula for inflation-proofing is effectively "hard-coded" into the rules and members will remain entitled to RPI-linked increases or revaluation in deferment.

Where scheme rules contain "hard-coded" provisions, if employers wish to adopt the new measure for pension increases, the rules would need to be amended. However, such an amendment to benefits attributable to past service would be prohibited under section 67 of the Pensions Act 1995 (see below).

Furthermore, some schemes' rules contain restrictions within the amendment power preventing an amendment to the rules that would reduce benefits accruing in the future.

It can sometimes be difficult to analyse what has been hard-coded. For example, following the *Danks v QinetiQ* case (see box), it appears that where trustees have an unrestricted discretion to choose RPI or CPI, inflation-proofing is not in fact hard-coded. Other cases will depend on the wording of the particular scheme rule.

Danks v QinetiQ Holdings Ltd

The QinetiQ pension scheme rules provided for the revaluation of deferred pensions and indexation of pensions in payment in line with the annual increase in the "Index", defined as RPI "or any other suitable cost-of-living index selected by the Trustees".

RPI had always been used as the measure of inflation but the Trustees applied to the High Court for directions on whether a switch to CPI would infringe section 67 of the Pensions Act 1995, which (broadly) prevents detrimental changes being made to entitlements or accrued rights.

The Court ruled that the member's right to revaluation or increase at the RPI rate did not arise until it was actually calculated. The Trustees could therefore choose to apply either RPI or CPI at that time (and could select RPI for indexation and CPI for revaluation). The decision has surprised some commentators but it seems that a decision to adopt CPI instead of RPI would not be a detrimental modification of a member's subsisting rights for section 67 purposes.

RPI with CPI underpin?

Concerns had been raised that, where RPI inflation-proofing is written into scheme rules, trustees would have to apply a CPI underpin and increase/revalue pensions by the greater of CPI or RPI. However, the provisions in the Bill were amended and the Act does not require a CPI underpin in such cases, providing certain conditions are met.

Other cases?

Scheme rules may also provide for increases to be at the discretion of the trustees, subject to the statutory minimum. Although allowing a degree of flexibility as to whether the scheme will adopt the new statutory minimum, trustees must bear in mind their fiduciary duties to members, and may wish to take advice before exercising such discretion.

AMENDING SCHEMES - WHAT ARE THE ISSUES?

Regulated modifications - section 67 of the Pensions Act

Section 67 of the Pensions Act 1995 ("PA 95") provides that no modification may be made to a scheme that would or might (amongst other things) reduce any pension in payment without the pensioner's consent. Similarly, no modification may be made that would or might have a detrimental effect on a member's benefits earned up until the date of the change unless the member consents or the scheme actuary provides an actuarial equivalence statement.

As outlined above, the switch to CPI is expected to result in lower increases being applied to both pensions in payment and deferred pensions. Therefore, an amendment to the scheme rules that replaces an entitlement to RPI-linked pension increases with CPI-linked increases for accrued benefits, without satisfying the consent requirements, will be prohibited under section 67.

As a result, schemes that have "hard-coded" a particular level of increase into their rules will be unable to take advantage of the new legal minimum in respect of past service unless legislation is introduced that overrides the restriction contained in section 67 – which the Government has confirmed it does not intend to do. However, as explained above in relation to the *Danks v QinetiQ* case, section 67 will not bite if the level of increase is not in fact hard-coded.

Attempts to reduce members' rights that have already accrued could also have human rights implications.

Statutory amendment powers

Section 68 of the PA 95 provides trustees with the power to modify the scheme by resolution to achieve one of a list of "specific purposes". This has proved useful in cases where

the scheme's own amendment power is particularly restrictive. However, despite representations from the pensions industry, the Government does not intend to add the amendment of scheme rules to link pension increases and revaluation rates in deferment to the CPI to the list of "specific purposes".

Consultation with employees

A switch to CPI for indexation or revaluation constitutes a "listed change" requiring the employer to consult with affected members (active and prospective members), although the duty to consult does not apply to proposals announced to affected members before 6 April 2012.

Indexation and revaluation – statutory requirements prior to the CPI changes

• **Indexation of pensions in payment**

Once a pension is in payment, the law requires that it must be increased by a minimum amount each year to account for inflation.

Before 6 April 1997, there was no legal requirement to increase pensions in payment (except pensions derived from certain contracted-out rights). Whether or not increases were payable depended on the scheme rules.

From 6 April 1997 to 5 April 2005, section 51 of the Pensions Act 1995 required that pensions in payment must be increased by a mechanism known as Limited Price Indexation (LPI), under which increases were at least the lesser of 5% and the increase in RPI over the preceding year (5% LPI). Section 51 only applies to benefits earned after 6 April 1997. Since 6 April 2005, further reforms reduced the statutory minimum in respect of future service to the lesser of 2.5% and RPI (2.5% LPI).

In relation to defined contribution schemes, there is no statutory requirement for pension increases to be provided on benefits which come into payment after 6 April 2005.

• **Revaluation of deferred benefits**

Deferred members of schemes also benefit from statutory protection against inflation. The deferred benefits of members who have left pensionable service with an entitlement to a short service benefit are revalued up to normal pension age by a statutory mechanism to take account of inflation in the intervening period.

Four methods of revaluing deferred pensions are set out for final salary schemes in Schedule 3 to the Pension Schemes Act 1993. The most common method involves increasing a deferred member's benefits by a percentage specified each year by order of the Secretary of State for Work and Pensions. The order shows a percentage that is (prior to 1 January 2011) the lesser of the rise in RPI or 5%, over the whole period of deferment (following reforms introduced by the Pensions Act 2008, the cap was reduced to 2.5% in relation to service after 6 April 2009). The percentage increase to be applied will be related to the number of complete years between leaving pensionable service and normal pension age, as set out in the revaluation order.

The legislative provisions stipulate the minimum levels of revaluation. Schemes have the freedom to offer more generous revaluation rates.

NEXT STEPS - GUIDANCE FROM THE PENSIONS REGULATOR

When the changes were announced in 2010, the Regulator issued guidance on a number of steps trustees and employers should take once the changes were final.

- Review your scheme rules and member communications to ensure that you are clear on both the indexation and revaluation requirements under the rules and what has been communicated on these matters to members.
- **Consider your response.** Any rule amendment to introduce the change to the CPI may need trustee consent. Trustees should take advice on whether they may properly agree to this change. Similarly, both trustees and employers need to consider the impact of any change on members. The Regulator recommends trustees and employers engage in "open and constructive dialogue" on how they might respond.
- **Member communications:** Trustees should plan to communicate with members on the impact of these changes as soon as possible after the details have been finalised, even if the impact is likely to be negligible.

Where the proposed changes result in lower estimated liabilities for a scheme, the Regulator expects that this would "generally lead to shorter recovery plans resulting in greater security for members and greater certainty for employers". Further guidance on this is expected.

If pension schemes have made investments to hedge inflation risks through financial instruments based on RPI, the trustees and employers will want to review them.

As outlined above, the practicalities of implementing the proposed changes are complex. Should you have any questions as to how the proposed changes may affect your scheme, please speak to your usual contact in our pension team.

CPI/RPI switch – revaluation of deferred pensions	
Trust Deed and Rules	Impact
Refers only to statute	CPI
Refers to RPI	RPI applies
Difficult cases?	Depends upon the precise wording in the rule

CPI/RPI switch - increases to pensions in payment	
Trust Deed and Rules	Impact before Pensions Act in force
Refers only to statute (Use Revaluation Orders)	CPI
Refers to "inflation" over a period different to 1 October-30 September	RPI

CPI/RPI switch - increases to pensions in payment		CPI/RPI switch - increases to pensions in payment	
Refers to RPI (Whether use revaluation period of 1 October- 30 September or a different period)	RPI	Refers to "inflation" over a period different to 1 October-30 September	CPI
Difficult cases?	Depends upon the precise wording in the rule	Refers to RPI (Whether use revaluation period of 1 October-30 September or a different period)	RPI
Trust Deed and Rules		Impact from January 2012	
Refers only to statute (Use Revaluation Orders)	CPI	Difficult cases?	Depends upon the precise wording in the rule

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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