

Increasing pensions in payment – simplification or complication?

Back in July 2002, the Pickering report¹ put forward a radical rethink of compulsory increases on pensions in payment because of concerns that they were “disproportionately expensive”. With the Government keen to maintain some degree of mandatory indexation, new relaxations are being introduced under the Pensions Act 2004 (PA 2004) on 6 April 2005. Here we highlight some of the issues, including the possible need to amend scheme rules.

Pension increases

Some history

- Before 1997, there was no statutory requirement to increase pensions in payment except in respect of contracted-out benefits (or where an employer took a refund of surplus).
- The Pensions Act 1995 introduced compulsory increases for both final salary (DB) and money purchase (DC) pensions attributable to pensionable service from 6 April 1997.
- Historically, the level of such increases has been in line with the increase in prices capped at 5% (LPI).

DB Benefits

Reducing statutory LPI

- For DB benefits, the statutory cap on increases reduces to 2.5% for pensionable service accrued from 6 April 2005.
- But the statutory 5% LPI requirement still remains for pension accrued between April 1997 and April 2005.
- It is vital to check scheme rules to see whether this change is automatic or not (see box on rule amendments).

DC benefits

Removing statutory LPI

- Acknowledging that DC members lose out on flexibility and bear the LPI cost, the LPI requirement for DC benefits accrued since April 1997 will disappear.
- The requirement for statutory increases on protected rights (DC contracted-out benefits) built up before 6 April 1997 will also go.
- The upshot is that a DC pension coming into payment on or after 6 April 2005 will not need to be increased annually.
- Schemes will have to meet new information requirements to help members choose between the types of annuity on offer (e.g. flat-rate or with increases)².

¹ “A simpler way to better pensions – An independent report by Alan Pickering”

² A leaflet is to be made available by the Pensions Regulator for use by trustees

Hybrid Schemes

DB / DC

- The Government's stated intention is that LPI will no longer apply to DC benefits – including DC benefits in hybrid schemes.
- There have been concerns that the legislation is not as clear as it might be in respect of hybrid schemes.
- The Government has confirmed that the uncertainty will be clarified by regulations (confirming its original intention).

Rule amendments?

A possible complication

- Depending on the drafting, the statutory LPI relaxation may not override the pension increase provision in scheme rules.
- For example, DB scheme rules which identify a specific rate of pension increases (say, 5%) will probably require amendment to take advantage of the reduced statutory cap.
- Proposed changes should be considered in the light of all scheme documents (including contractual promises).

DB benefits

Administration complications?

- As the statutory cap is only being reduced for future pension accrual, DB schemes need to keep track of increases attributable to different tranches of pensionable service.
- Scheme administrators should be approached to ensure that their systems are ready for this.

Conclusion

Seek advice

- Through the LPI changes, the Government is hoping to reduce the financial burden on schemes with DB benefits "flowing from the current 5% limit" and imposed by the new Pension Protection Fund levy.
- But for many schemes the statutory changes may not be as straightforward as they seem.
- Employers and trustees would do well to seek advice on this potentially complicated simplification.

This edition of Sackers Extra news is part of a series focusing specifically on pensions reform. Our Pensions Reform Team will continue to keep you abreast of the key issues throughout this period of pensions simplification. If you would like further information please contact our Pensions Reform Team.

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