Sackers

Hot topic

September 2022

Rising inflation: considerations for DB and DC schemes

Cost of living increases have reached levels unprecedented in recent history. CPIH rose by 8.8% in the 12 months to July 2022, the highest annual rate since December 1990[1]. High inflation has wide implications for pension schemes and consequently scheme governance, with different considerations for DB and DC schemes.

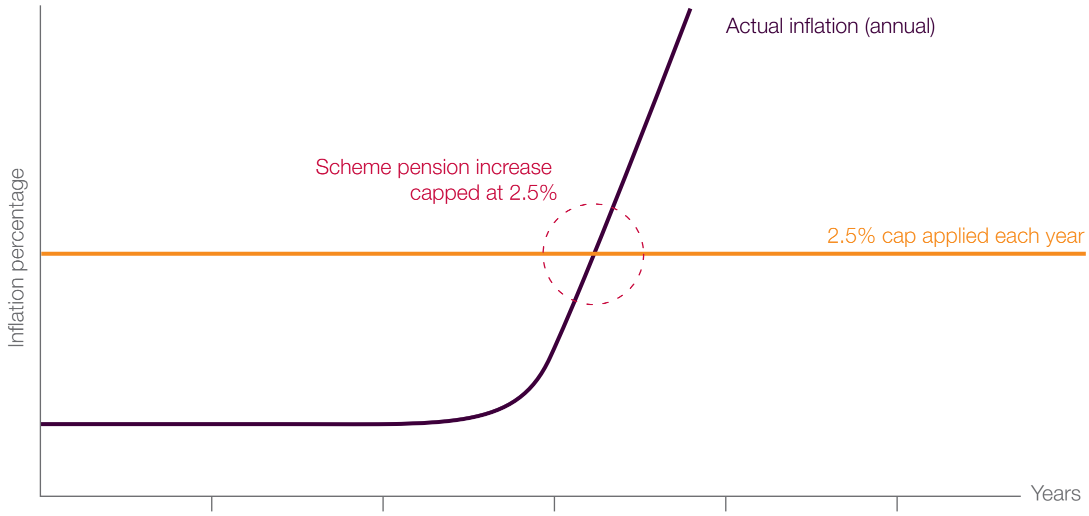
DB considerations

To gauge the impact of inflation on members, trustees will first need to understand what inflation-linked benefits members are entitled to under scheme rules and/or legislation.

Pensioner members

DB pensions will usually increase annually at a level in line with inflation, but the amount of increase is typically capped, and will often vary depending on when the benefit was accrued, and between classes of members. Statutory minimum annual increases for pensions in payment were first introduced on 6 April 1997, and originally limited to inflation capped at 5%. Pensions earned on and after 6 April 2005 currently increase by reference to CPI capped at 2.5%, as shown in the illustrative graph below (not to scale). Pensions in excess of GMP earned before April 1997 do not benefit from any statutory increases, although scheme rules can be more generous.

How increases to pensions in payment are capped



1 Based on constructed historical estimates by the Office for National Statistics

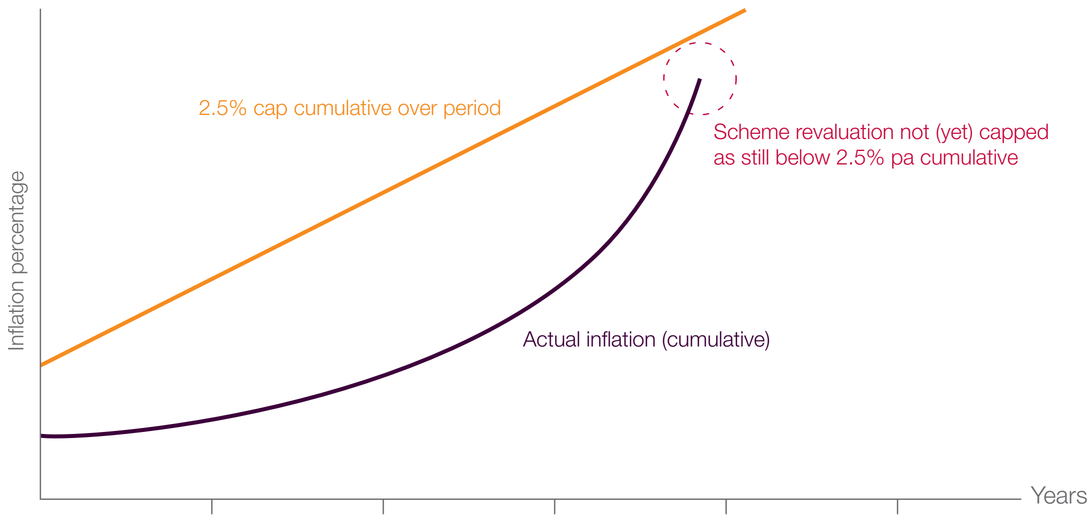
Active members

Active members (and the limited number of deferred members of closed final salary schemes who remain in service and retain a "final salary link") have some inflation protection for their salary-linked benefits through salary increases, provided those increases are pensionable. The level of protection provided depends on the salary increases awarded, which may not track inflation.

Deferred members

As the illustrative graph below shows (not to scale), legislation requires deferred pensions to be revalued during the period of deferment, but like minimum pension increases, statutory minimum revaluation rates vary depending on the period benefits were accrued and the date the member left pensionable service. Since 6 April 2011, the statutory minimum "final salary" revaluation increase is CPI capped at 2.5% per year for pensions earned on and after 6 April 2009, or 5% for pensions in excess of GMP earned before that date.

How revaluation of deferred pensions is capped



In contrast to pension increases, the statutory revaluation cap is not tested against the rate of inflation annually, but over the whole period of deferment (as shown above). Whether or not the cap "bites" therefore depends on the level of the cap and the length of deferment. A member with a relatively long period of deferment spanning a period of low inflation may have built up a significant amount of "headroom" against the cap, so that a one-off year of high inflation can result in a material increase to the member's benefits.

Trustees may feel it important to explain to members the impact inflation could have on the value of deferred benefits and how the timing of retirement can impact the amount of revaluation applied – see below for issues to consider.

Discretionary increases

As shown above, even inflation-linked benefits are unlikely to give most pensioners full protection against the current level of cost of living rises. However, scheme rules will often contain powers to increase or augment benefits in excess of normal pension increases. While the approach taken will vary on a scheme-by-scheme basis, trustees and employers may find there are good reasons to review whether it would be appropriate to use these powers in the current environment. Relevant factors to consider include:

- inflation protection provided under the scheme rules and legislation
- the impact of cost of living rises on the scheme's particular membership
- how the power has been used in the past

Members taking early retirement

Early retirement calculation methods may need to be reviewed more frequently to ensure they remain appropriate in the current high inflation environment, and to ensure that trustees are complying with their legal (preservation) duties in relation to the value of "short service" benefits.

Rising inflation: considerations for DB and DC schemes cont.

- the scope of the relevant powers under the scheme rules, including who holds the power (employer, or trustees, or both?) and any restrictions on its use
- the impact on the scheme's funding position and security of members' benefits as a whole, and
- whether additional contributions would be required to meet the cost of any increases.

Wider impacts

The impact on benefits cannot be considered in isolation, since inflation will have broad impacts on DB schemes. Trustees should engage with their advisers to assess issues such as:

- how has the high inflation environment affected the scheme's journey plan (taking into account the impact on liabilities, investments, employer covenant, and whether funding assumptions remain appropriate)?
- are members changing how they access benefits – eg is there an increase in late retirement requests as members stay in work longer?
- are the options available to members still suitable – eg the terms of any pension increase exchange options?

DC considerations

For DC members, protection against cost of living rises will depend to a large extent on investment returns and decumulation options. Trustees should consider with their advisers:

- what is the impact on the performance of the default fund and any investment pathways offered? Are changes recommended to the range of self-select funds?
- how are members entering decumulation affected by high inflation?
- is there a change in the way members access benefits – are members delaying retirement, or requesting to access benefits more frequently? Do trustees need to adapt member communications accordingly?
- do members understand and make use of the options available to them, and/or can the scheme offer additional support?

Tips for communicating with members about high inflation

- ✓ Trustees should check whether existing communications remain appropriate, eg in relation to member options.
- ✓ It may be helpful to explain to members the impact of inflation on the scheme and member benefits and any actions the trustees are taking (eg in an annual newsletter), particularly if members are raising questions about this.
- ✓ Consider whether a joint approach with the employer would be appropriate so that messaging is consistent.
- ✓ Generally, trustees do have a duty to explain the scheme's benefit structure to members but are not required to warn members about actions which may be to their financial gain or detriment. In fact, recommending particular actions as to the exercise of options could constitute financial advice, so any communications should focus on generic explanations.
- ✓ Consider whether members will expect similar communications in the future. Will the trustees continue to communicate to members about the impact on the scheme in comparable situations, or can this instance be justified as a "one-off"?

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