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RPI OR CPI: TIME TO REVISIT PENSION INCREASES?

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Most pension schemes will have previously taken advice on whether the switch from RPI to CPI for pension increases applied to their scheme, but it may be worth sponsoring employers revisiting this advice and seeking an updated legal opinion.

Background

Since 6 April 1997, defined benefit (DB) occupational pension schemes have been required to increase pensions in payment by a minimum amount each year to protect against the effects of inflation. Up until 31 December 2010 inflation for these purposes was measured by the change in the Retail Prices Index (RPI), but from 1 January 2011 this switched to the Consumer Prices Index (CPI). Whether or not the switch to CPI flowed through to the increases on pensions payable from a particular DB scheme depends on the specific wording of the scheme rules.

Essentially DB schemes fall into one of three categories:

Category 1

Pension increase rule refers to the statutory minimums

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The switch to CPI was automatic and will have occurred,

Category 2

Pension increase rule refers to RPI only

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RPI “hardwired”. Changing to CPI only possible for future service via an amendment to rules,

Category 3

Pension increase rule refers to RPI but also has a discretion to be able to switch to an alternative index.

↓

Switching to RPI may be possible and worth revisiting

Most DB schemes took advice in 2010/2011 to understand which category they fell into. Surveys published indicate around 75% of schemes fell in categories 2 or 3. At that time, where a scheme fell into category 3 most legal advisers adopted a narrow interpretation as to if and when the discretion could be exercised and therefore advised that the effect was that the switch to CPI couldn’t be made using the discretion.

What's changed?

Since then there have been a number of cases on this issue. These cases have shown: (i) the courts have taken a wider view as to the operation of the discretion for schemes falling into category 3 than many legal advisers thought to be the case; and (ii) confirmed that switching to CPI for past service is permissible. ***This means there may be more scope for schemes to switch to CPI-based increases than previously thought.***

As a sponsoring employer it is therefore worthwhile revisiting any advice previously obtained on this in light of the subsequent case law, as the position may have changed.

Why bother?

A switch to CPI-based increases could significantly reduce your scheme liabilities (by 5-10% on a Technical Provisions basis according to estimates from the Pensions Regulator). Therefore it is worth understanding whether you have any flexibility as regards increases, particularly if you are:

About to commence valuation discussions with your trustees.	Looking for ways to off-set a "black-hole" that may have arisen in the scheme due to an unexpected issue e.g. an error or legacy equalisation issue that has not been resolved.	Looking at ways to manage your pension liabilities generally on a path to de-risking your scheme.

Understanding if there is flexibility to switch to CPI does not necessarily mean you have to make the switch, but it may provide useful leverage in negotiations.

Other Considerations

There are other considerations that mean a switch may not be straightforward:

1. It may still require trustee agreement (depending on your rules) and some trustees may be reluctant to agree to the change because it would in all likelihood represent a reduction in members' benefits. However, there are a number of ways to position this with trustees and reasons why trustees may be willing to agree to a change.

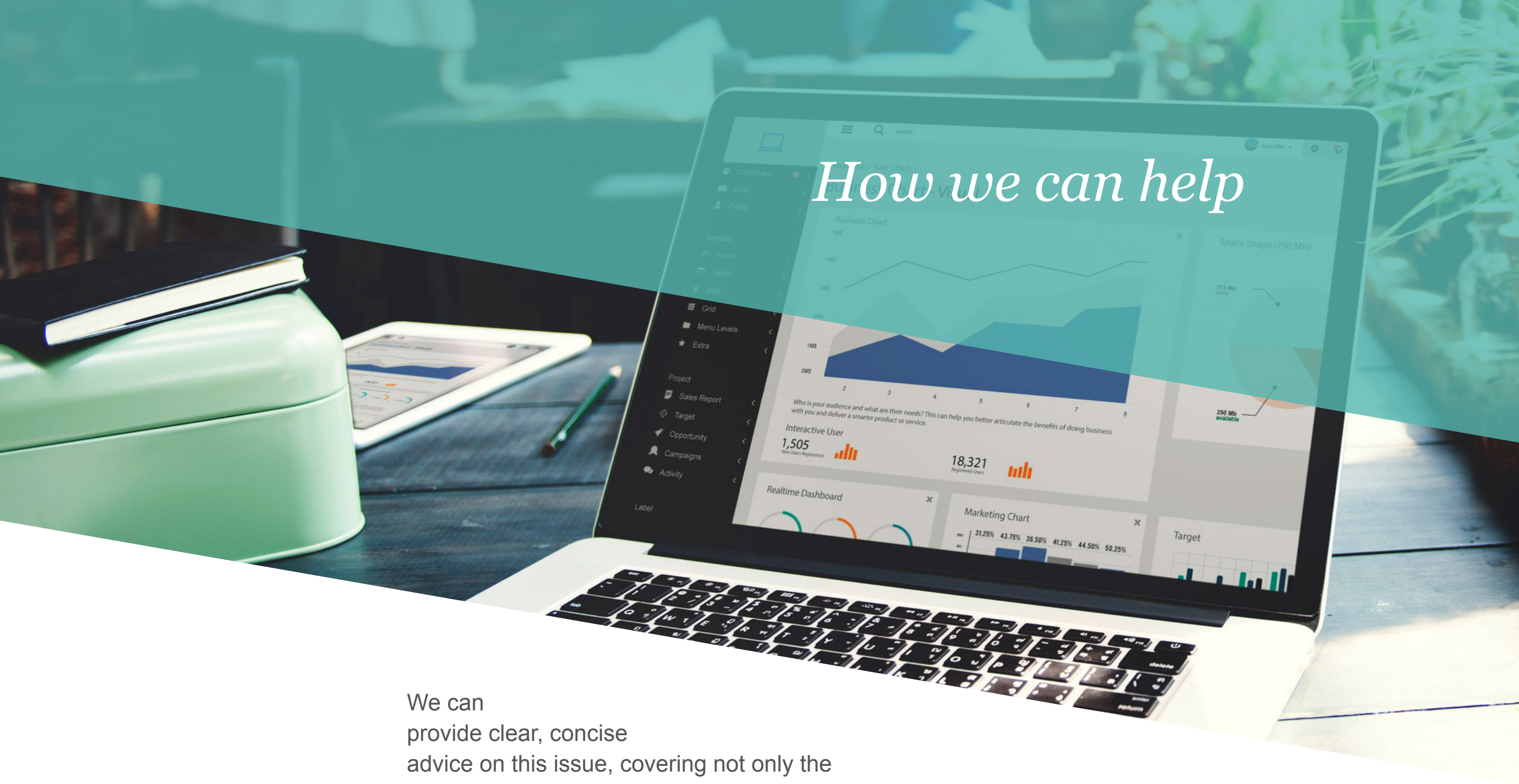
2. Whenever a switch is proposed it will require a prior (60 day) consultation with affected active and prospective members (if any) before it can be implemented, but this does not require members to consent.

3. There can be additional complexities if the increases rule and/or definition of index in the scheme rules has changed over time and that will need to be considered.

4. Previous communications to members that reference pension increases may also need to be reviewed and this may include any communications issued as part of any pension increase exchange exercises previously carried out.

5. The same issues also arise for schemes in relation to revaluation i.e. the inflation protection given to pensions for the period between leaving the scheme and normal pension age. So it is also worth revisiting that issue at the same time and checking whether the previous advice on switching to CPI for revaluation holds good. However, it was more common for schemes rules to reference statutory minimums for revaluation and so for the switch to CPI to have occurred automatically.

How we can help



We can
provide clear, concise
advice on this issue, covering not only the
technical analysis so you understand what is permitted under
your scheme rules and any risks or key issues to be aware of, but also
strategic advice on what options this may give you when managing
your scheme going forward.

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