STEPHENSON HARWOOD

pensions law group

Pension schemes and inflation

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Background

In the 12 months to August 2022, RPI has increased by 12.3% and CPI 9.9%. With this recent significant rise in inflation, employers and trustees have been asking what the impact of this is upon their defined benefit pension schemes. Members are also concerned that, against high inflation and a 'cost of living crisis, their pensions will maintain their value in real terms.

Impact on benefits

Defined benefit schemes

The rapid rise in inflation means that members of defined benefit pension schemes are likely to see their benefits reduce in real terms:

- For those schemes which are still open to accrual, the pay rises of employees which feed into their pension calculations are unlikely to be keeping up with the recent levels of inflation.
- For closed schemes, deferred pensions are revalued in order to help protect them from the effects of inflation, although the level of revaluation is unlikely to be close to the levels of inflation.
- Pensioners also benefit from increases to pensions in payment, again as a protection from inflationary erosion. These increases have not, however, kept pace with recent inflation.

The levels of revaluation and increases that a scheme provides is subject to a statutory minimum and will be set out in the scheme rules. In the current climate this statutory minimum is not currently keeping pace with inflation. Most rules typically provide a maximum revaluation or increase of either 2.5% or 5% per annum (dependent upon various factors, including periods of service). Whist such a scheme cap will limit the effects of inflation on the cost of benefits for employers, it also means that members' benefits are reducing in real terms.

As a result, we have seen trustees question whether their fiduciary obligations require them to consider if they have discretionary powers to increase the amount of deferred pension revaluation or pension increases. Any such discretion would be subject to the rules of the scheme. Trustees would also need to consider the wider funding position of the scheme as well as their fiduciary obligations.

Employers and trustees may wish to consider the discretionary increase powers within their rules and whether it would be appropriate to exercise that discretion against the backdrop of scheme funding levels and employer covenant. The Stephenson Harwood pensions team can assist with any review and negotiations on this point.

Defined contribution schemes

Members with defined contribution pensions will also be impacted. Those nearing retirement may be concerned that their 'pot' is being reduced in real terms and may turn to more risky investments in order to offset this. Members may also look to enter drawdown and withdraw more of their benefits in the shorter term in order to try and maintain their current standard of living.

Early retirement and transfer values

Early retirement factors and statutory transfer values require certain assumptions to be made regarding inflation. These factors and assumptions should be reviewed regularly in any event, but even more so in the current climate. Trustees should consider the factors and assumptions in place are appropriate before granting a statutory transfer or early retirement.

Member communications

With inflation rises continuing to make the headlines, it is likely that trustees will receive increased questions and concerns from members over the impact of inflation on their pension benefits. Trustees should therefore carefully consider how they will communication with members regarding this and should be prepared for an increase in queries on this topic.

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