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Change to UK pension inflation measure

The UK Government has announced that it intends to change the measure of inflation used for working out statutory minimum increases to pensions from defined benefit occupational pension schemes. Instead of basing these increases on the Retail Prices Index (RPI), in future it will use the Consumer Prices Index (CPI). The change will apply to revaluation in deferment as well as increases to pensions in payment.

In practice, the CPI has tended to show a lower inflation rate than the RPI, though this has not always been the case.

The change will not affect benefits until the next increase is made, which in most cases will be in 2011. However, schemes will want to identify the impact quickly in order to respond to member queries.

Comment

The Government has said that the change is being proposed because the CPI is a better measure of pensioners' cost of living than the RPI. But it seems likely that another purpose is to reduce pension liabilities in both the public and private sectors. For employers, that is a rare piece of good news. Members may well take a different view. Trustees need to assess the extent to which their scheme is impacted by this change. We are happy to look at their rules and advise on what action (if any) is required or permitted.

Employers and trustees will want to estimate the impact of this change on the funding position. Whether by accident or design, the timing of the announcement should minimise disruption to funding discussions, given that the 15-month deadline after most 2009 valuations has just expired.

Impact

The impact on a scheme will depend on its rules:

- Some rules simply link increases to the statutory requirements (e.g. statutory revaluation and pension increase orders), in which case members will be directly affected if the statutory measure changes.
- Other rules "hard code" a link to the RPI measure of inflation. Here, members may not be directly affected (at least if increases are capped at 5% or more, rather than say 3%). If the CPI is ever higher than the RPI, it may apply as an underpin.
- Some schemes have restrictions that will make it impossible to use the scheme's amendment power to change to CPI increases for rights already built up. Changing to the CPI for future increases might involve a worsening of past service rights, which trustees may not think is appropriate. Section 67 of the Pensions Act 1995 would also prevent such an amendment. It is not clear whether there will be an overriding statutory power to make the change.
- Some rules already give the trustees power to change the index they use. Changing to an index that is expected to be less generous may be a difficult decision, especially as it affects past service.
- In many cases the scheme defines the RPI in a way that provides for a different index to apply if the RPI is replaced. RPI is not being abolished so, in our view, it has not been "replaced".

If you would like to discuss any of the issues covered in this bulletin, please speak to your usual Mayer Brown contact or to Helen Parrott.

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