Insights

How does inflation affect pension schemes and their members?

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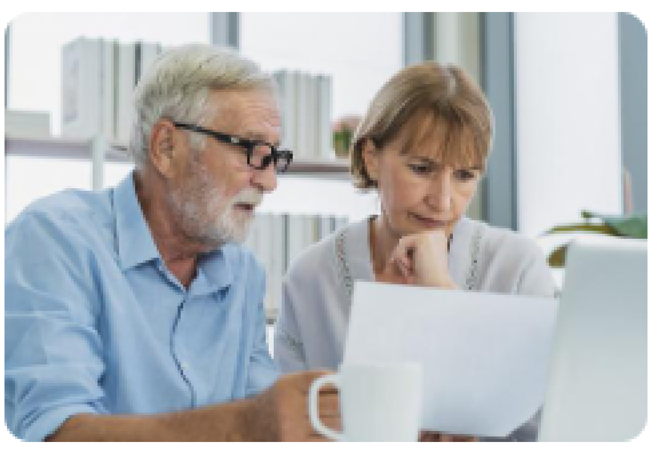

UK inflation has passed its recent peak but is still well above target. What does this mean for pension schemes and their members?

The return of high inflation – its intensity and duration – took many by surprise and fuelled a rise in the cost of living we are still feeling. And UK inflation appears to be stickier, or more persistent, than in other major economies.

After climbing above 11% to a 41-year high in October 2022, the Consumer Prices Index (CPI) dipped below the Bank of England's 2% target for one month in September 2024. But inflation has crept up steadily since, and today's official figures show it unchanged at an annual rate of 3.8%.

That was slightly below expectations, but still almost double the Bank's target and the actual 2% rate in the eurozone. The International Monetary Fund has increased its forecast for UK inflation and predicts Britain will have the highest inflation in the G7 group of leading economies this year and next.

High inflation has prompted members of some schemes to question the value of their pensions, sometimes with political support. In this article I'll look at the debate and suggest some ways trustees might respond.

Inflation poses questions for trustees

Defined benefit (DB) schemes are complicated, and high inflation can have several consequences for trustees to consider. As an administrator, we're focused on the impact on members, especially those members whose pension is already in payment and may well be their main source of income.

One effect of sticky inflation is the sharp drop in transfer values for members of DB schemes. Responding to inflation expectations, bond markets have pushed up gilt yields, reducing the value of transfer values.

We are aware of at least one large scheme where members are asking trustees why their transfer value is so much lower than members received a few years ago. This is the result of more members being able to access their transfer values in real time – it's a great capability to have, but it shows how new options can lead to more questions.

Some pensions aren't protected from inflation

A little inflation is good for the wider economy compared with the vicious circle of deflation – a general fall in prices. That's why the Bank's target is 2% and not zero.

But even moderate inflation is damaging for a large group of members, estimated to be about 750,000, who are drawing pensions with no protection from rising prices. Campaigners have pointed this out for many years, and in the current climate it's not surprising that the discussion has widened and intensified.

Usually, a member's pension will be broken down into slices or tranches, and different tranches will have different increase rules. These rules will reflect changes in legislation over time, changes in the individual scheme's rules, and whether the scheme was contracted out of the various versions of the state second pension.

There may also be some interaction between these: many scheme rules pay increases more than the statutory minimums, but if they don't these statutory minimums will bite.

DB pension savings made after April 1997 have some protection from inflation in law because they rise in line with a measure of prices – typically CPI or the Retail Price Index. However, there are usually caps on this protection, and even members whose pensions are indexed may have suffered a reduction in value when inflation peaked and exceeded these caps.

But the value of pension savings built up before April 1997 will have been eroded much further unless scheme rules allowed for higher increases or the trustees made discretionary payments. That is because there is no statutory requirement to increase this part of people's pension, unless it related to any guarantees related to contracting out of the second state pension.

That means some older pensioners are getting no increase on a significant chunk of their pension in payment, and over time that can make a big difference. As an indicator, the Bank of England's inflation calculator shows that the value of £100 in 1997 has halved to £50.29 in today's money.

How far does trustees' fiduciary duty extend?

Campaign groups have spent many years calling for indexation to apply to these pensioners, often focusing on members of the Financial Assistance Scheme and the Pension Protection Fund. And now members of large company pension schemes are lobbying MPs for their pensions to be indexed.

In a recent article, Maggie Rodger and John Flynn, co-chairs of the Association of Member-Nominated Trustees, put the case for indexing pre-1997 private sector DB pensions as part of trustees' fiduciary duty.

They argued that fiduciary responsibility reaches beyond statutory compliance to include a duty to consider members' best interests and fair retirement outcomes. Many schemes can afford to do this because they are in a stronger funding position than a few years ago, they added. Sponsoring employers of these usually closed pension schemes will argue this is due to company funding, including deficit recovery contributions, over the past 25 years and more.

The point about retirement outcomes is topical. The government has relaunched the Pensions Commission to find ways to avert a retirement crisis for millions of people who aren't saving enough. And the Pensions Regulator has called retirement adequacy "the challenge of our lifetime".

If pensions adequacy is an urgent matter looking forward (and it is), then why, an observer might ask, are we allowing many people's pensions to dwindle so that they are increasingly impoverished?

In setting out the debate, we're not arguing for trustees to make discretionary payments. This is a complex subject and in almost all cases trustees will be very cautious about doing so, often because they don't want to set a precedent or a potentially confusing expectation for members.

There are other considerations such as the cost of any discretionary increases, how they would be funded, who would fund them, and the views of sponsoring employers, particularly as the cost may fall to them and, with many schemes now closed, a discretionary increase often has a limited effect on workforce reward and retention.

How should trustees respond?

What does this mean for trustees of these schemes? I think there are a couple of things all trustees should consider:

- Make sure you know your pension increase rules. And does your scheme pay increases above the statutory minimums?
- What do your rules allow you to do? Are there any powers to provide discretionary increases to pensioners, and if so, how do those powers work?

The debate about indexing pre-1997 pensions raises legal questions as well as diving into areas of risk and fairness across the generations. It's complex, but the debate isn't likely to go away soon.

So for trustees, if your scheme pays no increases to some tranches of benefits, make sure you have an answer ready for when your members raise queries. If a member asks about the trustee's powers to make discretionary increases, do you know how you would answer that question, and are the role, duties and views of the employer properly understood?

In a more volatile world, perhaps we should be prepared for recurring bouts of higher inflation that cause further financial problems for your members. So be prepared if they get in touch with questions. As ever, communication is vital.