HYMANS ROBERTSON

DISCRETIONARY INCREASES

Checklist of issues for DB pension schemes to consider

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With inflation running at 10%, is it time to look again at your discretionary pension increase policy?

As calls for discretionary increases look set to increase, there are advantages in taking early steps to review powers, principles and historic practices. These may not have been considered for many years and in many cases, there will not be a well-articulated policy in place.

Even if not something the trustees and/or sponsoring employer want to grant, being able to respond to members' questions quickly and clearly should help to reduce the risk of further queries or challenge.

Read on for our brief guide to the issues to think about.

1 Who has the power?

Check what the scheme rules say about discretionary increases. Ultimately the question of who has the power to exercise any discretion will be really key. Is it a trustee, sponsor, or joint power?

Although less common, some schemes may have an obligation to actively consider discretionary pension increases. Whilst the rules may also specify particular conditions or procedures. If no provision exists, it may be possible to give a discretionary increase under the broader augmentation rule.

Take advice from your legal adviser if you have any doubts or concerns.

2 What is the sponsoring employer's view?

Where employer agreement is required, this may make for an easy (and quick!) decision. Certainly, there is unlikely to be any obligation on the employer to agree. However, trustees could still be criticised for not asking the question.

Even if the trustees have a unilateral power, reaching a consensus will usually be desirable and employer views important. For example, employers will also be thinking about what salary increases they can afford to pay.

The Company accounting impact of a discretionary pension increase may also need to be considered as it could be treated as an augmentation cost which has to be charged to the Company's profits.

Nevertheless, whilst it's appropriate to consider the employer's interests, they shouldn't automatically override those of the members.

3 What impact is inflation having?

How benefits are linked to inflation will vary between schemes. Most schemes have pension increases that are subject to annual 'caps' (usually 5% or 2.5%). For members with elements of pension that receive no guaranteed increases – for example, those with only discretionary increases on pre-1997 accrued benefits – the impact of inflation eroding the benefit will be even more significant.

- Do some member categories have benefits which are less well protected from inflation?
- Will pensions have increased above inflation in the past? For example, where inflation linking is subject to a minimum increase or linked to RPI rather than CPI.
- In practice, the extent to which prices continue to rise may well be a key factor in determining how hard pensioners might push and how compelled trustees and sponsors might be to act. Provided any period of high inflation is relatively short lived this is likely to have a more modest impact than high inflation for an extended period.

4 What do members expect?

It may be important for the trustees to review what members have been told in past member communications.

If discretionary increases have been awarded historically, it would be reasonable to assume that member expectations may be higher. These may also be skewed by increases to the state pension, which are not capped.

Addressing in upcoming communications could help with managing member expectations.

5 Is it affordable?

Awarding discretionary increases will add to liabilities. What uplift could the scheme afford? Is the employer able to bear any extra funding needed? What if funding deteriorates? You may need to think beyond what it will cost this year but also future years if repeated.

Requests may be easier to decline in schemes with a funding deficit but there may be growing pressure on schemes in surplus. Indeed, with inflation driving interest rates up and liabilities down, scheme funding and affordability may have improved. Trustees and sponsors should be factoring in up-to-date funding and covenant assessments to their thinking.

6 Would it have implications for long-term plans?

Inevitably there's a balance between ongoing funding surpluses being used to support further de-risking / long-term funding plans versus granting discretionary pension increases.

Those with buy-out targets may be less inclined to add to liabilities at this stage.

For those at buy-out with a surplus, the high inflation environment may be giving food for thought about whether to insure a discretionary increase to members' pensions. Any discretionary benefits that the trustee and company want to insure will need to be codified and these will then become guaranteed.

7 Is it fair?

The impact on those who do not benefit from a decision to award discretionary increases (e.g. ongoing security) is a relevant consideration. However, there is nothing ruling out a decision that benefits one group of members over another. Indeed, the fact that deferred pensions receive increases capped over the whole period of deferment – which may mean full CPI – is an example of where inequity may already exist.

Employers may also be mindful of wage growth for employees as well as impacts for those in any DC arrangement.

Indeed, a discretionary award may not be welcomed by some members. It could, for example, cause the loss of valuable lifetime allowance fixed protections (plus potential fines if the person fails to inform HMRC in time). Others may have their appreciation for the increase tempered by unexpected tax bills, such as annual allowance charges for those who cease to be covered by the 'deferred member carve out'.

8 Will it set a precedent?

Trustees and employers are likely to be relatively cautious about granting discretionary increases that would increase a scheme's liabilities and potentially set future expectations. As a minimum, member communications should make it clear that future increases are not guaranteed.

Please contact your usual Hymans Robertson consultant if you would like any further information or to understand the position of your scheme before making any decision

Documenting decisions
As with exercising any discretion, process and a good audit trail are key. Trustees will want to be able to show they have taken account of all relevant factors.

A robust policy would cover aspects such as:

- Who has the power
- When it would be used
- The process that should be followed
- How any conflicts will be managed