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Briefing note

High inflation and the consequences for DB pensions

High inflation is particularly bad news for those on fixed pensions, and whilst pensioners whose income increases in line with inflation may be better placed than many to handle this, most inflation protection is limited. Here we look more closely at the current inflationary landscape and consider what this means for benefits in defined benefit (DB) pension schemes.

With rising prices set to significantly push up the cost of living in 2022, should trustees and sponsors brace themselves for calls to revive discretionary pension increases?

Current inflation

Recently released figures show the Consumer Prices Index (CPI) rose by 5.5% in the 12 months to January 2022, whilst the corresponding annual change in the Retail Prices Index (RPI) was 7.8%. The last time inflation hit such heights by any measure was March 1992.

The effects of the COVID-19 lockdowns in 2020 are a key influence. Inflation was always expected to rise in 2021 as economies emerged from lockdowns, but recent inflation prints have surpassed expectations. Supply-side problems are seeing input cost and output price growth running at, or near, record highs alongside a steep rise in energy prices. Strong fiscal stimulus, latent demand from the lock-down period and the shift in demand from services to goods are all demand-pull pressures.

Will this surge in inflation continue?

In the short term this seems likely, with predictions that CPI could reach 7% or more during 2022/23.

Although most forecasters and central bankers expected the most intense inflationary pressures to ease towards the end of 2022 / early 2023, Russia's invasion of Ukraine seems likely to exacerbate existing inflationary pressures in the short term. Downwards revisions to global growth forecasts for 2022 and 2023, and upwards revisions to inflation forecasts, are expected for most advanced economies in the coming weeks as new price surges driven by the escalating conflict look set to kick in. More extreme scenarios could see oil and energy costs continuing to climb and stay at higher levels into early 2023.

As we emerged from COVID-19, the Bank of England has raised interest rates twice already in the past three months to help dampen price spikes. A third hike was widely expected in March. However, already wary of raising rates too quickly amid fears that this could undermine the nascent recovery, the recent developments have cast further doubt on how quickly central banks will feel able to tighten monetary policy.

Therefore, even if persistently high inflation is not the base case, it seems like it may yet prove to be more than a temporary spike. There has been a distinct shift from the tail risk being one of deflation to one of high inflation.

2 March 2022

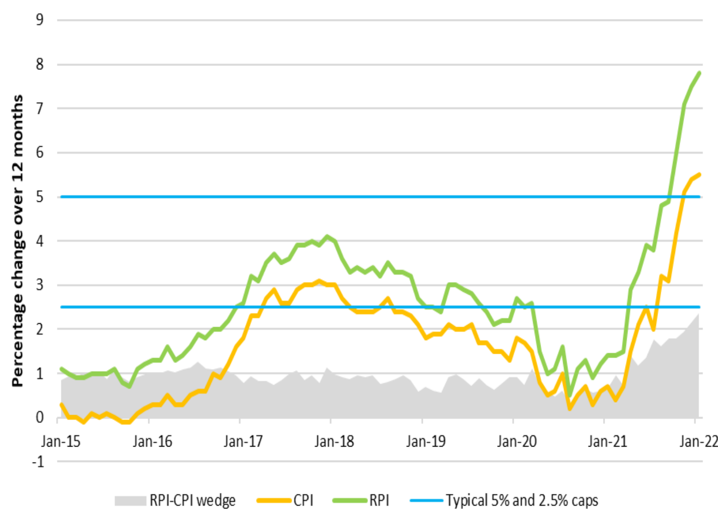
How does inflation impact pensions?

Most DB schemes are required by law to increase pensions in payment by a minimum amount and to revalue deferred members' benefits each year in order to provide a degree of – but not total – protection against the impact of inflation.

Different schemes will have different rules regarding the index to be used, any (maximum) caps and (minimum) floors and the inflation reference month. Most schemes will also have benefits that increase at different rates as a result of changing legislation. However, reflecting statutory requirements:

- Pensions accrued after 1997 typically increase in payment in line with RPI or CPI, but subject to a maximum of 5% or 2.5% p.a. typically for post 2005 service.
- In around 50%[1] of schemes benefits accrued before 1997 (in addition to GMP) do not come with inflation protection.
- Pension increases for deferred members before they retire depend on total inflation between when they leave and when they start to receive their benefits so there are no caps or floors in a given year (i.e. a 5% p.a. cap means members' benefits cannot increase by more than 5% p.a. over the period as a whole but they could increase by more than 5% for a particular year or more). Note this term based cap does not typically apply in CARE schemes where inflation is capped and floored on an annual basis.

With inflation at current levels, and the expectation that inflation will stay high during 2022, it is therefore likely that the increases members receive on their pensions in 2022 and 2023 will be below inflation by more than before (due to any caps being more likely to bite and/or the lag in inflation). The state pension is due to rise by 3.1% in April, in line with CPI inflation in the year to September 2021.



Provided any period of high inflation is relatively short this is likely to have a more minimal (and less immediate) effect on deferred benefits. However, the longer the high inflationary period lasts the more members could retire with a 'below inflation' increase to their benefits.

Why high inflation isn't good news for those on fixed pensions

Those on fixed pensions will feel the squeeze most. High inflation for an extended period would lead to an erosion in the purchasing power of pensions. A relatively small increase in the rate of inflation for an extended period can have a material effect. For example, an inflation rate of 2% per year reduces the purchasing power of a fixed pension by 9% over 5 years. By contrast, if the inflation rate is 5% per year, the reduction in purchasing power over 5 years increases to 22%. Therefore, a period of high inflation is bad news for a pensioner on a fixed DB pension.

RPI vs. CPI

The current wedge between the RPI and CPI is also much bigger than normal – 2.3% vs. the longer term average of around 1% p.a. That means that even though RPI is due to converge with CPI including owner occupiers' housing costs from 2030, if no caps apply, the inflation index schemes use could make a meaningful difference to pension increases in the meantime. It may also drive a disparity between pension increases and wage inflation.

[1] Source: Purple Book

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Actions to consider

Given the current inflationary outlook trustees of DB schemes should think about:

- Reviewing scheme rules to understand the impact on members and whether any inflation caps will bite.
- Consider communications to members and prepare for queries. It may also be a timely reminder to review the actuarial factors and communications around member options such as pension increase exchange – where members can opt to give up inflation-linking for a higher, fixed pension at retirement to maximise their initial benefits – to ensure that members are fully aware of the impact of their choices at retirement and the uplift provided captures current long-term inflation expectations.
- With prices expected to climb faster than wages, consider whether this may also be likely to prompt more requests for early or flexible retirements and manage the associated liquidity impact. Can members draw pensions whilst continuing to work?
- Review discretionary powers, policies, and historic practices, bearing in mind that trustees and sponsors might face growing pressure to revive these. This may not have been considered for many years and in most cases there will not be a well-articulated policy in place.

Discretionary increases

Whether and how trustees and sponsors are prepared to use any flexibility they have to award additional increases could make a meaningful difference to individuals. However, the decision needs considered carefully and will depend on a range of scheme specific factors including:

- How scheme benefits are linked to inflation. Do some categories of member have benefits which are less well protected from inflation than others due to the history of the scheme or bulk transfers?
- Historical practices and concerns about creating a precedent
- What your rules say about who has the power to exercise the discretion. Is it a trustee, sponsor, or joint power?
- Scheme funding and affordability, including considering the balance between de-risking and the award of discretionary pension increases.
- Attitudes of the sponsor and expected wage growth
- Inter-generational fairness between current and future pensioners
- Administrative practicalities

As with exercising any discretion, process is key. You should take appropriate advice from your professional advisors.

Other considerations

High inflation also presents some funding and investment considerations beyond the impact on member benefits. However, the most important aspect for pension scheme finances is not the reported annual level of inflation, but the long-term expectations for future inflation, interest rates and central banks' response to the inflation coming through in markets. The overall impact for a scheme will be determined by a combination of factors including how benefits are linked to inflation, the extent of hedging in place and the performance of other assets. Trustees should understand implications for assets, liabilities and ultimately scheme funding and take appropriate action. For example, revising hedging benchmarks if the sensitivity of liabilities to further changes in future inflation expectations has materially changed.

To discuss the circumstances specific to your scheme, please contact your usual Hymans Robertson consultant. We'd be delighted to help.

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