Current Issues in Redress Summer 2020

GMP Equalisation

The guidance issued by HMRC on the tax treatment of GMP equalisation earlier this year has enabled many private sector occupational pension schemes to progress implementation. However, most schemes are still at an early stage in the process.

Although the cost of equalisation can be substantial when measured at a scheme level, the impact per member is typically small. However, the increase to an individual's pension depends on their gender, service history, actual or assumed retirement age, and the benefit structure of their pension scheme as well as the GMP equalisation methodology adopted by the scheme. As such, there are some individuals who could see a noticeable uplift in benefits.

Similarly, making allowance for GMP equalisation in redress calculations will not materially affect outcomes in most cases. However, where GMP is substantial as a portion of the investors benefits it may be appropriate to consider whether GMP equalisation should be factored into redress calculations.

It is worth noting that GMP equalisation is expected to have a relatively small impact on public sector pension schemes compared to private sector schemes. This is partly a consequence of their interim solution, now extended to those who reach State Pension Age on or before 5 April 2021. Nevertheless, consideration should be given as to whether allowance should be made for GMP equalisation in public sector redress calculations, particularly for those reaching State Pension Age after 5 April 2021.

Potential unwinding of 2015 public sector pension scheme changes (McCloud and Sargeant cases)

In December 2018 the Court of Appeal ruled that the transitional protection offered to those "close to retirement" during the reform of the judges' and firefighters' pension schemes in 2015 was discriminatory. In July 2019 a ministerial statement was issued confirming that this discrimination would be addressed for all public sector pension schemes.

The Government is now considering how this will be achieved. One proposed approach would allow members to choose whether their accrual over the relevant period should be in the legacy (Final Salary) or reformed (Career Average) arrangements. A public consultation on the changes to address the discrimination is expected later in the year. Legislation will then need to be passed before the agreed changes can be implemented.

From a redress perspective, the main implications of the judgment are for opt out / non joiner cases where the investor would not have been eligible for full transitional protection. For these cases there is uncertainty over the form of benefits that the Investor has lost, and it may be appropriate to put cases on hold. Alternatively, redress could be based on existing benefits and revisited once the Government has effected the relevant legislation.

An additional consequence of the proposed approach to rectification is that where investors had enhanced protection from the lifetime allowance charge in the legacy arrangements and lost this on joining the reformed arrangement, it may be possible to reinstate this protection. Although this will affect a relatively small number of investors, the impact on those cases could be significant.

Implications of the COVID -19 pandemic on redress calculations

- Market volatility – redress calculations are required to reflect market conditions at the most recent quarter end. The market volatility associated with the pandemic may lead to substantial movements in redress valuations when measured from one quarter to the next, due to both variability in the value of defined contribution assets, and movements in market conditions. This is particularly important to note where redress is being calculated for indicative purposes with no expectation of imminent settlement.
- Data gathering – The Pensions Regulator has urged pension scheme trustees to focus on the key risks to pensions savers. This includes ensuring that benefits are paid and that the risk of scams is minimised. Given these priorities, and the resourcing and practical implications of the pandemic on administration teams, we anticipate that timescales for obtaining information from pension schemes will be longer than usual. This may mean that redress calculations are delayed. A similar issue exists in relation to obtaining state pension breakdowns from the DWP, which are required in order to assess the SERPS aspects of redress.

RPI and CPI assumptions

Redress calculations generally reflect inflation assumptions derived in accordance FG17/19- namely market implied RPI and an RPI-CPI gap of 1% pa. However, in the wider pensions world there has been debate over how inflation assumptions should be set since the government's announcement in September 2019 that it would consult on harmonising RPI with CPIH between 2025 and 2030.

One particular concern is the extent to which market indicators remain a reliable measure of long term RPI. To the extent that the potential changes to RPI are not yet priced into markets, as further clarity emerges over the change (perhaps at the end of the consultation period in August 2020) market implied RPI may fall leading to a reduction in redress valuations.

Another point of discussion is whether the RPI CPI differential should be revised downwards. Again whilst this is not directly relevant for redress calculations at present given the prescribed 1% RPI-CPI gap, it is reasonable to expect that at some point the gap may be reviewed downwards leading to a step increase in the valuation of longer dated CPI linked liabilities which are particularly common in the public sector.

Salary increase assumptions

Where an investor is still in service as assumption is needed about their future salary growth. This assumption can materially affect the redress valuation if the Investor is some way from retirement.

A future earnings growth assumption of RPI +2% pa was required in the FSAVC Model Guidance issued by the FSA in May 2000. This has historically been adopted by most clients. However, the Guidance did allow that "Firms may use alternative assumptions for salary increases if they have demonstrable evidence that the above assumption is inappropriate." As such, if RPI +2% pa is considered unrealistic there is scope to use an alternative assumption.

Indeed, in the FCA Handbook COBS 13 the required earnings growth assumption is RPI + 0.5% pa for both pension illustrations and for the Transfer Value Comparator, the latter aligning reasonably closely with the redress situation. This gives an indication that FCA may be willing to accept that in current financial conditions salary growth of RPI+0.5% is a reasonable future assumption.

We note that salary growth has been low over the past decade, particularly in the public sector where redress cases are concentrated. Looking retrospectively over that period an annual growth rate of RPI + 0.5% pa may in general have been a reasonable assumption.

Whilst we have not undertaken economics research to form a view about whether the lower growth rate of RPI+0.5% pa is "demonstrably reasonable" for the future, it is worth bearing in mind that low public sector salary growth in the recent past reflects austerity measures applied over that period. As such, future salary growth could be higher in relation to price inflation than in the past decade. Having said this, salary growth is likely to be constrained by the economic aftermath of the Covid-19 pandemic such that RPI + 2% pa appears high.

Ultimately the choice of future salary increase assumption is subjective and a range of assumptions could reasonably be adopted. Therefore, we recommend that the choice of assumption is given due consideration by clients.

Other issues to watch out for:

- Definition of pensionable pay in the firefighters' pensions schemes – In light of the High Court judgement in Booth v Mid and West Wales, historic pensionable salaries may be increased for firefighters so that they reflect all "permanent" earnings.
- Removal of state pension triple lock – There is ongoing speculation as to whether the triple lock will be replaced with a "double lock" in a post Covid – 19 environment. Limiting increases on the state pension to the higher of inflation and earnings (with no 2.5% cap) would not affect the outcome of redress calculations as future earnings increases are expected to be above 2.5% pa. However, it could impact on future actual loss calculations if actual increases on the state pension are lower than they otherwise would have been.

For more information

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