Technical Briefing No. 30

Revaluation Requirements

Introduction

Since 1986 it has been a requirement that when a member leaves a defined benefit pension scheme the preserved pension is broadly preserved in real terms. This has been achieved by a requirement to revalue the pension at the date of leaving in line with inflation (the Retail Prices Index, hence RPI not CPI) for each complete year up to retirement. Since the introduction of this requirement there has been a cap on the level of revaluations of 5% p.a.

The Pensions Act 2008 amends this requirement so that the minimum level of revaluation will be revaluation in line with RPI capped at 2.5% p.a. for service accrued after 6 April 2009 only.

This development will have no impact on members who have already left service or retired, it will only potentially impact on members who are currently active scheme members but who withdraw from service before retiring from their scheme, and then only in respect of service after a future change date.

Existing scheme rules

The rules of a scheme will refer to the revaluation of pension benefits in one of two ways:

1. The scheme rules may refer to the revaluation of benefits at the prevailing legislative rate. In this case when the legislative rate changes from 6 April the level of revaluation for that scheme will automatically change to the lower cap of 2.5%.
2. The scheme rules may refer to the revaluation of benefits at the current level of RPI with a cap of 5%. In this case the legislative change will not make an immediate change to the rules of the scheme and the current level of revaluations will prevail.

Where there is any doubt on this point the trustees and scheme sponsor should consult their legal adviser.

Changing the scheme rules

Where the employer would prefer to implement an alternate strategy, to that implied by the existing scheme rules, consideration must be given to the nature of the change.

Where the existing scheme rules refer to the legislative minimum level of revaluations only:

- If the employer, in consultation with the trustees, wishes to maintain the existing 5% p.a. cap then the scheme rules should be amended and the members notified.
- If the employer wishes to take advantage of the new legislation then as a consequence of the format of the existing scheme rules no immediate action need be taken.

Where the existing scheme rules specifically refer to revaluation as RPI capped at 5%:

- If the employer wishes to maintain the existing 5% p.a. cap then no action need be taken.
- If the employer wishes to take advantage of the new legislation and reduce the cap on revaluations to 2.5% then the scheme rules would need to be amended and the members informed. This is likely to require the employer to consult with the scheme membership and the trustees on the change. (There is some debate as to whether the consultation requirements extend to legislative changes such as this.

It is perhaps safest to assume that they do and consult in any event.)

Future service only

Any changes to the level of revaluations will only impact on future service. Any service up to 6 April 2009, or any later date of changing scheme rules, will on the withdrawal of a member from active service, increase up to retirement at RPI capped at 5% p.a. Only service built up after a change would, on the withdrawal of a member, increase at RPI capped at 2.5% p.a.

As an example consider a scheme whose rules state that on withdrawal pension is revalued up to retirement at the prevailing legislative rate. Further, consider a member who has built up 8 years service before 6 April 2009 and then builds up a further 2 years after that date and then leaves service before retiring in a further 10 years time.

- The pension from the 8 years that accrued before 6 April 2009 will increase over the 10 years to retirement in line with increases in RPI capped at 5% p.a.
- The pension from the 2 years that accrued after 6 April 2009 will increase over the 10 years to retirement in line with increases in RPI capped at 2.5% p.a.

Cost savings

There is likely to be a saving in the cost of benefits on switching to a lower rate of revaluation on pension benefits. However any cost saving is likely to be modest but also difficult to predict as:

- Only a limited number of scheme members will be affected by this change. It will have no affect on deferred and pensioner members and will only impact on currently active scheme members who withdraw from service before retiring from the scheme.
- Any cost saving can only be in respect of future service.
- Costs will also be driven by the actual level of prospective inflation, from the date of withdrawal of affected members to their dates of retirement. If actual inflation averages 2.5% or less then these two levels of revaluation will be identical. The more actual inflation exceeds 2.5% the greater the potential saving a scheme might make.
- Any savings may be partly offset by potential additional costs arising from further administration complexity.

Commentary

Employers and trustees should consider the details of what their scheme rules say to determine how this change will affect them. The employer should consider whether any automatic changes (or the lack of such) are consistent with their requirements and where that is not the case consult with the trustees, and potentially the members too, on changes.

The cost implications of any change are likely to be modest and, as no changes will be made to benefits already accrued, will only emerge over time. Any potential savings will be offset by the expenses of making changes to scheme rules and meeting additional administration costs.

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