Technical Briefing

No. 35

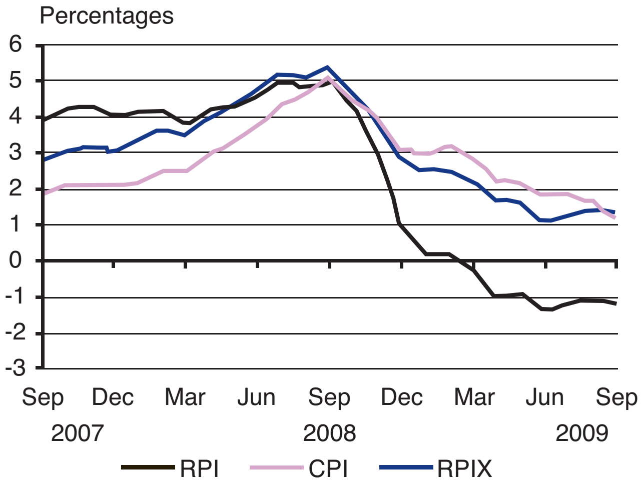
cprm
actuaries and consultants

Deflationary Consequences

Introduction

The Bank of England's monetary policy to combat the current recession caused by the "credit crunch" has resulted in the UK experiencing an unprecedented modern period of economic deflation (negative inflation) as measured by the Retail Prices Index (RPI).

Progression of UK Inflation
(Office for National Statistics)



For defined benefit pension schemes changes in the RPI index will be the driver for many pension increases in deferment and in payment. This Technical Briefing will consider how these pension increases for defined benefit schemes may be affected by a sustained period of economic deflation.

Impact on Deferred Members

Once a member has left active employment their pension benefits may be revalued up to retirement in line with the change in RPI. This applies automatically for all members leaving employment after 1986 and follows UK pension legislation.

Hence the question is, where there is a period of deflation, can the revaluation of pension benefits result in a reduction in the level of a member's pension.

The reality is that the majority of such members will have an extended period between the date they left employment and the date they will retire. Over the majority of this period RPI inflation will be positive (to date this is true for almost any period before February 2009) and a short period of deflation will still mean that their overall pension at retirement will be positively increased.

For the limited number of individuals with a very short period from the date they left employment up to retirement, and where that falls fully in a deflationary period, the question is more complex. The primary legislation that provides for such revaluations only ever foresaw increases to pensions, and for such members it is likely that pensions will be frozen, and not reduced. However, putting this another way, such members may get an increase to their pension in excess of RPI inflation which is something that was never intended.

The government publishes statutory revaluation factors at the end of each year and Trustees will wait with interest to see this year's publication.

Impact on Pensioner Members

UK final salary schemes have a variety of approaches to providing increases to pensions when they are in payment. Some increases are fixed in nature and in those cases a period of deflation is not relevant. However many schemes follow the legislative requirements from 1997 and 2005 that pensions when in payment must increase

No. 35

in line with annual rate of RPI (normally with a cap of 5.0% or 2.5% p.a.).

Hence the question is that for pension increases related to RPI, during a period of deflation, can pensions in payment be reduced.

The clear view of the pensions industry is that, when in payment pensions cannot be reduced, only increased. Hence where there is a period of deflation the pension increase will be floored at zero and the pension will not be reduced.

A further consideration might be whether it is possible to offset such an effect of deflation against future inflationary increases. This is not viewed as possible and as such the effects of deflation are likely to result in increases to pensions in payment in excess of inflation for many members of pension schemes. Particularly those with pension scheme service after 1997 when statutory increases related to RPI were introduced for the first time.

The only way for this position to rebalance itself would be for the UK to experience a period of higher inflation (above the 5.0% and 2.5% cap) and effectively reduce the level of benefits in real terms.

Insured Pensions in Payment

Some Trustees may have made an investment decision to insure pensions in payment to remove the investment and longevity risk associated with these liabilities. If these pensions are still under the Trust of the pension scheme then the responsibility to pay these pensions still rests with the Trustees.

Under deflationary conditions, the precise wording of the insurance contract may not match the benefits described under the scheme rules. In such conditions, the Trustees would be responsible for ensuring that the benefits paid to pensioners correspond to those under the scheme rules rather than the conditions secured with an insurance company. This could result in Trustees making top-up payments to pensioners if the insurance contract allowed them to reduce pensions in payment whilst the scheme rules did not.

Scheme Rules

The Trustees of pension schemes should initially consult the scheme rules and announcements to determine whether the benefits paid are affected by a period of economic deflation. In particular, they should examine whether the specific wording in the scheme rules refer to increases or changes in the RPI index. A further detail will be to consider whether the scheme rules simply rely on the overriding legislation for benefit increases.

Summary

Although we are observing a period of economic deflation (in RPI terms), it is widely expected that this will not last for an extended period and therefore it would have a relatively small impact on the revaluation of pensions in deferment.

Pensions in payment with ‘increases’ related to the RPI index will be protected by legislation which will avoid the possibility of reductions to pensions in payment as they have a zero floor. Such pensions will remain flat over deflationary periods.

The Trustees should examine the scheme rules to determine whether or not they permit pensions in payment to be reduced in an economic deflationary environment or even allow for the off-setting of deflationary periods against inflationary periods.

Even if the scheme rules do allow Trustees to reduce pensions in payment, many Trustees would be reluctant to reduce pensioner’s income on paternalistic grounds especially since the actual inflation experienced by pensioners will typically be much higher than the recorded RPI. Indeed the government’s preferred measure of inflation is the Consumer Prices Index (CPI) which has remained positive over the recent period where RPI has been negative.