First Briefing, October 2022
The impact of high inflation on pension schemes

The Consumer Prices Index (CPI) rose by 10.1% in the 12 months to September 2022, up from 9.9% in August. The September 2022 figures for the Retail Prices Index (RPI) and the CPIH were 12.6% and 8.8% respectively.

The September inflation figures are of particular relevance to Defined Benefit pension schemes as these are typically used to increase a number of benefits (such as statutory deferred pension revaluation).

More generally, with inflation at its highest level for at least 40 years, trustees should consider the impact of high inflation on actual member benefits and scheme financing.

Considerations around member benefits:

- Early retirement terms and the deferred pension revaluation due in 2023
- Possible review of transfer values and other actuarial factors
- Capped increases on pensions already in payment and whether discretionary increases should be considered.

Considerations around scheme financing:

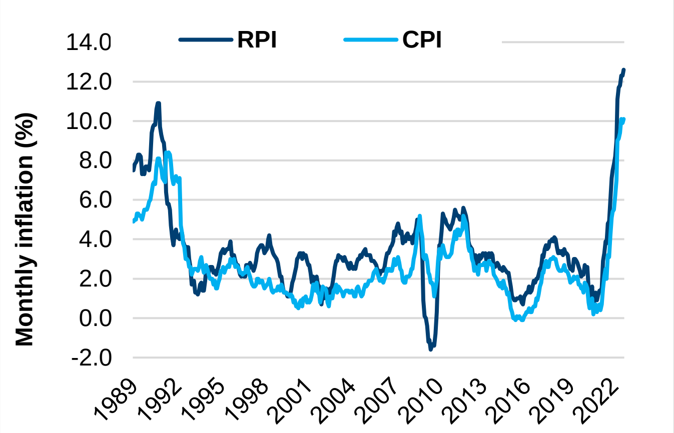
- The increase in liabilities from the current inflation spike
- Investment performance – particularly the effectiveness of any liability hedging in place
- The potential impact on the covenant of the sponsoring employer – particularly due to increased energy costs.

This briefing sets out more detail and suggests next steps for trustees as part of scheme governance good practice.

Background

In the UK, inflation has been relatively subdued since the early 1990s. Many trustees have never had undue cause for concern about the impact of high inflation on scheme assets or liabilities.

However, it's been hard to miss the headlines on inflation in recent months. A number of events have given rise to what is currently expected to be a short-term period of very high inflation. Inflation is currently at its highest for 40 years.



Future projections

In its August 2022 Monetary Policy Report, the Bank of England said it expected higher energy prices to push CPI inflation to around 13% in the following months. Projections from the Bank of England and the Office for Budget Responsibility (OBR) indicate that the current high level of inflation is expected to be short-lived (but persisting into 2023), falling below the Government's inflation target by the middle of 2024.

Looking into the longer term, the gilt market has priced in inflation (RPI and CPIH) at an average of around 3.3% pa over the next 20 years.

How does inflation affect members' benefits?

When members retire, they can expect at least part of their pension to increase in line with inflation (either linked to RPI or CPI). This will typically be capped at 5% or 2.5%. This cap is applied on a year-on-year basis and is relatively easy to understand. Given that inflation this year has been above 5% each month, most pensioners are likely to receive an increase in line with the relevant cap on any inflation-linked tranches of pension.

The minimum increases deferred members receive before they retire (i.e. between the date they leave pensionable service and their retirement age) work on a slightly different basis. Statutory increases dictate that all deferred members have a 5% pa cap applied to their revaluation. (A lower cap of 2.5% pa might apply to post 2009 service.) However, this cap applies over the whole of the deferment period.

This means that some members will have headroom in the revaluation. For many members, inflation has been well below 5% pa since they left service. Some deferred members could therefore receive a full inflation-linked uplift of over 10% once the new revaluation rate comes into force on 1 January 2023.

The way inflation impacts members' benefits gives trustees a number of issues to think about.

Members taking early retirement

One area that might need trustees' immediate attention is those members taking early retirement – and in particular, the early retirement factors (ERF) that scheme administrators use. This issue is fairly technical, but in simple terms most ERFs use a long-term estimate of deferred pension revaluation. This is driven by an assumption about future inflation. However, the period over which they apply this is much shorter – generally less than 10 years and possibly as short as a year or a few months.

During periods when inflation is expected to be fairly constant over the short and longer term, this becomes less of an issue since small differences get lost in the rounding. However, ERFs are unlikely to capture the current scenario where inflation is high but longer-term inflation estimates are much lower. They will also have been set against a backdrop of much lower expected returns from gilt holdings.

A member retiring one year early at the moment might miss out on a revaluation increase of around 10%, which we expect they might otherwise have received the following year. Even allowing for the additional cost of paying the pension one year early, this could still mean the pension should actually be increased rather than reduced for early payment this year.

The legal requirement on trustees to be 'reasonably satisfied' that the value of a member's early retirement benefit is at least equal to the actuarial value of the pension at normal retirement age makes it difficult to ignore this issue.

Here are some options trustees to consider:

- Wait for the next early retirement request before deciding what to do. This might be appropriate for small schemes where the frequency of early retirement requests tends to be very low
- Ask your Scheme Actuary to look at early retirement quotes on a case-by-case basis in order to calculate a bespoke adjustment
- Update the factors used for members who want to retire less than two years early or before 1 January 2023 (when revalued pensions will have allowed for the circa 10% increase)
- Carry out a full review of early retirement factors.

Transfer values and other actuarial factors

Similar to ERFs, transfer values too are based on a set of assumptions – the key ones being future investment returns, life expectancy and of course inflation.

Trustees will need advice from their Scheme Actuary as to whether transfer values should be adjusted to reflect anticipated short-term high inflation (and the recent rise in gilt yields). For members who are close to their retirement age, higher inflation will mean higher revaluation of deferred pensions and hence a bigger transfer value. However, for members who are some years from retirement age, future years where inflation is below that assumed in their transfer values may offset a short period of high inflation.

Other actuarial factors should also be considered (e.g. cash commutation, late retirement), but as increases in payment are generally capped (typically 2.5%, 3% or 5%), the impact of one or two years of high inflation is less significant.

Current pensions in payment

Scheme members are likely to be aware of high inflation, due to its impact on day-to-day life. There is no shortage of public commentary stating that pensioners with capped (or even nil) annual pension increases will lose purchasing power. As a result, administrators may get more queries than usual.

Trustees may wish to consider discretionary pension increases where there is an appetite (and of course funds to do so). It's relatively common for schemes to have the power to provide additional (discretionary) pension increases but employer consent is usually needed. Trustees may want to review their rules to check whether there is a discretionary increase provision. If there is, trustees can consider whether or not to exercise this provision and, if so, to what extent.

A decision from the trustees to offer discretionary increases may be constrained by one or more of these issues:

- Augmentation or discretionary powers in the rules often need employer agreement
- The scheme may have a deficit (on the technical provisions and/or the long-term funding target)
- Even if the scheme is well funded, the trustees may have de-risked the asset portfolio. So any costs associated with a discretionary increase will need to be supported by the employer rather than through investment returns
- Fairness to all members – for example, some members may receive no increase on their pension.

Scheme financing

Covenant

The current environment of rising interest rates and high inflation can affect employers in different ways. There will be those who have natural hedges, being able to pass inflationary costs to customers. Others who may not be able to do this – and perhaps also have high levels of debt or are impacted by high energy costs – are likely to be struggling.

As part of an integrated risk management framework, trustees should be aware of any changes to the covenant, and if necessary, make appropriate decisions in relation to their investment and funding strategy. For example, a weakened covenant might mean trustees increase the margins for prudence in the assumptions they use for the actuarial valuation. Alternatively, they may consider whether the level of investment risk is appropriate.

Liabilities

In general, anything that increases benefits paid, such as high inflation, increases the value placed on the liabilities.

Many trustees receive regular funding updates from their actuary. Trustees should discuss with their actuary whether any adjustments should be made to the liabilities for short-term high inflation.

Alternatively, as scheme funding is a longer-term issue, trustees may decide to make no adjustments and allow actual experience to come through at the next triennial actuarial valuation.

It's worth remembering that although deferred revaluation can be impacted by high inflation, those pensions already in payment and inflation-linked are in most cases subject to a cap. If inflation continues to rise, it's unlikely that current pensioner liabilities will increase significantly as these caps will bite.

While high inflation increases liabilities, it's also worth bearing in mind that rising interest rates could mean higher discount rates (assuming the discount rate is linked to gilt yields). This in turn would lower the value placed on the liabilities. Most trustees are likely to want a funding update from their actuary to assess how the funding of their scheme has been impacted by these events.

Investment

Most trustee boards will use assets like index-linked gilts or Liability Driven Investments (LDI) to hedge against increases in inflation and interest rates. These assets are expected to rise or fall in value to match the change in liabilities.

Once the current gilt market volatility has calmed down, trustees will be revisiting hedging strategies to ensure they remain appropriate. Long-term inflation will be one of factors to consider in these reviews.

Issues for employers

Companies preparing accounting disclosures over the coming months should discuss with their actuary how they capture the impact of high inflation in their liability calculations (including the new deferred pension revaluation rate in force from 1 January 2023). Allowing for actual inflation is now standard annual practice with auditors, and adjusting for the very latest published inflation figures is becoming increasingly common. Combined with the rise in corporate bond yields, the next set of pension cost accounting disclosures could look very different from the previous year.

Get in touch with our experts

Short-term high inflation raises plenty of scheme-specific issues for trustees and employers to think about.

We recommend you contact your usual First Actuarial consultant to discuss these.