Equalising for the effects of GMPs

Briefing for pension schemes following the Lloyds Bank case

November 2018 | Pension briefing

HIGHLIGHTS

In a landmark decision which will impact most defined benefit (DB) pension schemes in the UK, the High Court held on 26 October 2018 that pension schemes must equalise for the effect of guaranteed minimum pensions (GMPs) providing different benefits for men and women. For the many employers still struggling to make good funding deficits, the judgment will not be welcome.

The judgment includes the following key rulings of wide significance to pension schemes.

- Trustees are obliged to amend their schemes to equalise for the effect of GMPs between men and women.
- There is more than one possible method of equalising GMPs (please see the explanations below). Trustees may not choose a more expensive permissible method in preference to a less costly method, unless the sponsoring employer agrees.
- Only GMPs earned between 17 May 1990 (the date of the *Barber* decision) and 1997 (when GMP accrual ceased) need to be equalised.
- Arrears of underpaid pension must be made good, with simple interest at 1% over base rate.
- Scheme rules may limit back-payments to those falling due within the previous six years. Where there is no such provision in the scheme rules, there is no backstop on the arrears which must be paid.

Members should not expect significant windfalls as, for most, the change will be less than 2% of the benefit that was earned between 1990 and 1997. The work involved in calculating and administering equalised GMPs will be significant. Fees paid to administrators and actuaries could well dwarf increases to individual members' pensions.

This note sets out our 8-point GMP Equalisation Plan for schemes affected by the judgment, followed by an explanation of the case and discussion of its longer-term implications.

For background information on GMPs, please see the Appendix to this note.

PART I

8-POINT GMP EQUALISATION PLAN: WHAT PENSION SCHEMES SHOULD DO NOW

1. Reconcile GMPs

Schemes need to finalise the reconciliation of their GMPs with HMRC before they can start equalising for the effect of GMPs. Most schemes are nearing completion of this project but, so far, few have adjusted members' benefits. We recommend that trustees complete the reconciliation of their GMP records but hold off rectifying any mismatches in benefits, pending finalisation of both their reconciliation and equalisation projects.

2. Stop the clock

Check whether your scheme rules contain an express six year limitation rule (so that benefits which fell due more than six years previously may not be payable) and whether this limitation is mandatory or discretionary. Where there is an express limitation provision, trustees should consider agreeing with their sponsoring employer to "stop the clock" now so that members will not be disadvantaged by any delay in implementing GMP equalisation.

3. Communicate with members

Your members may have seen reports in the press of pension "windfalls" arising from the High Court decision. In reality, most adjustments to benefits will be very small (although the implementation costs may be significant). Consider a short communication to members reporting that you are reviewing the implications of the decision for your scheme but that any increases to benefits are likely to be very modest.

4. Payment of transfers

Ask your actuary to assess whether cash equivalent transfer values (CETVs) should be adjusted to reflect the obligation to equalise GMPs, or whether the current factors have sufficient flexibility in them. You may want to consider suspending payment of CETVs for a limited period (although you can't suspend past the statutory deadlines).

5. Accounting implications

Sponsoring employers may be required by their auditors to include provision for GMP equalisation in their accounts. Likewise, trustees currently undergoing triennial valuations should consider including a provision to reflect the need to equalise GMPs.

6. Offset ("frank") benefits where possible

A principal cause of GMP inequality is the complex "anti-franking" legislation, designed to protect deferred members' rights to benefits in excess of the GMP. Some franking is permitted – but administrators do not always frank revaluation of GMPs against pension increases to the maximum extent allowed. Check your administrator's practice against the anti-franking rules, as maximum use of franking could go a long way to reducing the cost of equalising GMPs.

7. Prepare your data

Historic data will be needed for a GMP equalisation process. For many schemes, this data may no longer be available and approximations will be needed. Trustees should work with their administrator to identify where there are gaps and to work out how these can be filled.

8. Wait

The Department for Work and Pensions (DWP) is expected to reconvene the pension industry GMP working group (in which Hogan Lovells has participated) and to produce guidance on how GMP conversion legislation could be used to equalise benefits on a “once and for all” basis. Equalising GMPs through conversion would avoid the ongoing administration cost of running dual pension payroll records which other equalisation methods would involve. Additionally, it is possible that some/all of the judgment may be appealed, and there may be another court hearing to deal with some of the ancillary issues which were not asked in the main hearing.

PART II

BACKGROUND TO THE CASE

THE LLOYDS BANK CASE

In July 2018, the High Court heard an application brought by the trustee of some of Lloyds Bank's pension schemes seeking directions as to whether and, if so, how the schemes should adjust benefits to compensate for the inequalities of GMPs.

The judge was presented with the unenviable task of deciding whether there is a correct way to adjust benefits, or whether several different methods would be acceptable. He was also asked to consider what needed to be done regarding back-payments where members had been underpaid (including for those who had transferred out of the scheme).

Judgment was handed down on 26 October 2018.

EQUALISATION METHODS

In the *Lloyds Bank* case, four main methods of equalising GMPs (most with their own sub-variants) were presented to the Court. Methods A, B and C are based on the amount (quantum) of benefit paid. Method D, which is the method favoured by the DWP, looks at the actuarial value of male and female benefits.

Method A

Method A broadly speaking involved equalising different parts of the benefits. Method A3 involved equalising each "part" of the pension (GMP plus the pension which was the "excess over GMP") and levelling up each part. This would result in both male and female members receiving more in each year of payment than either would have had without equalisation. Method A is therefore a particularly expensive means of equalisation.

Method A was favoured by the representative beneficiaries.

Method B

Under Method B, each payment of pension (GMP combined with excess over GMP) is equalised, with the member receiving the higher of the benefit each year paid to a male or a female member in otherwise identical circumstances.

Under this method, in the early years of pension payment the female's pension would be higher – so the male pension would be topped up. After the "cross-over" point (please see the Appendix), the male pension would exceed the female, so a female pensioner would receive a top up.

Under Method B, both male and female pensioners would receive greater amounts over the course of their expected retirement than if the benefits had not been equalised.

In *Lloyds Bank*, no one argued that Method B was the right one to adopt.

Method C

Under Method C1, the male pension would be increased to the level of the female pension in the early years of payment but the increase would be treated (for the male) as a credit for early payment. After the "cross-over" point, the male pension would remain at the level of the female pension (by then lower than the male pension) until the accumulated credit had been used up – the second cross over point.

After the second cross-over point, both male and female pensioners would receive the amount of pension payable to a male.

Under a variation of Method C (Method "C2"), interest would be added to the credit for early payment, resulting in lower overall payments being made than under method C1.

Method C was favoured by the sponsoring employer.

Method D

Method D looks at the actuarial value of the projected income stream (of GMP and excess over GMP) for male and female members and would seek to equalise for the difference in treatment on a "once and for all" basis.

The DWP favoured a variation: Method "D2". Under this method, GMPs would be converted (please see the box on GMP conversion below) and the converted amounts then equalised. The converted benefit would all be treated as non-GMP, with the result (in many cases) that the starting amounts of pension would be lower than before conversion. After a "cross-over "point, pension payments would be higher than pre-equalisation for both men and women.

Equalisation methods: what did the judge say?

When assessing the various suggested methods, the judge relied on the principle of "minimum interference" with parties' rights. He concluded as follows.

- Methods A3, B, C1 and C2 were all permissible means of achieving equal treatment.
- The sponsoring employer could require the trustees to adopt method C2 as the method which would involve least cost (and therefore the minimum interference with the employer's rights). Similarly, method C2 is the

method trustees could use without the employer's agreement to any other method.

- Method D1 was not permissible as it would infringe the rights of the beneficiaries (while other methods would not). The judge suggested that equalising using method C2, followed by conversion of GMPs (please see the box below), would be acceptable.
- Trustees must make back-payments to make good arrears of underpaid pension, including interest at 1% over base rate.
- Scheme rules may limit back-payments to those falling due within the previous six years. Where the rules do not contain such a provision, there is no limitation on how far back arrears must be paid.

GMP conversion

Trustees have a statutory power to convert GMPs to regular scheme benefits which are not subject to the special GMP rules. Several safeguards apply, including that:

- GMPs must be replaced with actuarially equivalent benefits;
- conversion of GMPs to money purchase benefits is not allowed;
- pensions in payment may not be reduced;
- the employer must consent to the conversion; and
- the affected members must be consulted.

Some commentators had doubted that the legislation permitted the conversion of survivors' benefits in payment at the conversion date. Helpfully, the judge ruled that the legislation is not defective in this way and that it allows survivors' benefits to be converted.

DIFFICULT ISSUES

The *Lloyds Bank* case left various questions unanswered as to how equalisation should be achieved in practice. The following areas in particular will need further consideration.

Members who have died

- Trustees will need to consider how to approach equalisation where members have died without leaving a spouse or partner entitled to a survivor's pension.
- In practice, it can be very difficult to pay small amounts of money to an individual's estate a long time after the individual's death.

Historic transfers: who's responsible?

- Where a member transferred a GMP to a new scheme, does liability for equalising the GMP ultimately lie with the receiving or the transferring scheme trustees?
- In the *Lloyds Bank* case, it was accepted that receiving trustees take on responsibility for the liability to pay a GMP. However, it has been common for schemes only to accept a transfer in of a GMP where the transferring trustees provided an indemnity for any liabilities associated with GMP equalisation.
- Where there is an indemnity, trustees will need to assess how practical it would be to make a claim, especially in respect of a transfer which occurred many years previously.

Buy-ins and buyouts

- Historically, bulk buy-in policies have dealt with GMPs in one of two ways:
    - the trustees have retained the liability (if any) to equalise the GMPs of members covered by the buy-in policy; or
    - the trustees have paid an additional premium for the bulk annuity provider to accept responsibility for GMP equalisation.
- Before buying-out benefits, some annuity providers have insisted that members' GMPs be equalised and then converted to non-GMP benefits prior to the bulk annuity purchase. Under some older bulk annuity policies, the insurer has assumed responsibility for equalising GMPs (if required) in return for an additional premium.
- Trustees (and annuity providers) may wish to revisit their historic documentation to assess where liability lies.

Corporate transactions

- Documentation giving effect to corporate transactions completed many years previously may include warranties or indemnities in relation to GMPs. Employers may find themselves responsible for liabilities they forgot about many years ago, unless those warranties/indemnities are now time-barred.
- Equally, some companies with the benefit of a historic GMP warranty or indemnity may find that the company which gave the warranty or indemnity no longer exists.

NEXT STEPS

Seminar – 5 December 2018

Our pension team is holding a seminar on from 5 December, to explain the implications of the *Lloyds Bank* case and to explore practical means of compliance.

All who are impacted by the Court decision are welcome to attend. For an invitation, please click here or email events@hoganlovells.com.

Contact us

We would be pleased to speak to any employers or trustees who are concerned about the impact of the judgment. For further information, please contact one of the pension partners below.

APPENDIX: WHAT IS A GMP?

Defined benefit (DB) pension schemes that were contracted-out of the State Additional Pension (SERPS) in the period from April 1978 to April 1997 are required to provide members with a minimum level of pension (known as the Guaranteed Minimum Pension – GMP). The GMP replaces part or all of a member's SERPS entitlement.

GMPs, like SERPS at the time, were calculated differently between men and women in that:

- the age at which GMP becomes payable (GMP Age) is 60 for women but 65 for men ; and
- women earned GMP at a faster rate than men.

Women's state pension age started to be equalised upwards from 1997. However, no changes were made to GMP Age, meaning that the inequalities between men and women entitled to GMPs remain hard-coded in legislation.

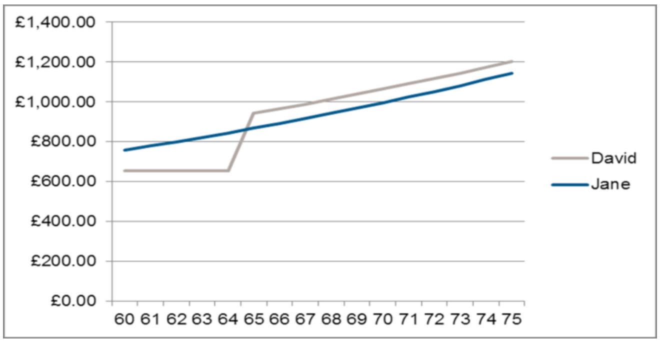
The *Barber* judgment

Following the European Court's May 1990 decision in the *Barber* case, most schemes took steps to equalise normal retirement ages (NRAs) between male and female members. Commonly, this meant increasing women's NRA to 65, to match the male NRA. This usually meant that overall benefits at the date of retirement, or leaving pensionable service, were equal for men and women (typically, a pension of 1/60th of final salary for each year of pensionable service, payable from age 65).

Unequal benefits and the "cross-over" point

The statutory GMP requirements, combined with the effect of the particular scheme's rules on any benefit in excess of the GMP, mean that a male is unlikely to receive exactly the same pension in payment as a female comparator.

The chart below illustrates how benefits can differ between comparable male and female members – with the female receiving higher benefits between 60 and 65 and then being overtaken by the male at some point after he reaches GMP Age.



Differences can arise because:

- a man who leaves pensionable service before GMP Age will have his GMP revalued for a longer period of deferment than an equivalent woman who leaves pensionable service at the same age;
- a woman's GMP will be subject to statutory increases from age 60, while the GMP of her male comparator will only be increased from age 65;
- the notoriously complex "anti-franking" requirements of legislation (please see the box below), can result in differing treatment of male and female benefits.

The level and severity of the difference in treatment between men and women varies from scheme to scheme, depending on a number of factors – the most important being:

- how a scheme's rules increase pensions in payment;
- whether there is a period of deferment before the pension comes into payment (and, if so, what revaluation is applied in deferment); and
- the scheme's administration policy on anti-franking (please see the box below).

Anti-franking and GMPs

A member whose accrued right to pension is greater than the level of his/her GMP, will have rights to both the GMP and to the "excess over GMP". If the member leaves pensionable service before reaching GMP Age, the GMP must be revalued (protected against inflation) in line with statutory requirements.

"Anti-franking" legislation protects the member's deferred benefits – by ensuring that the growth in the GMP cannot simply be offset by making a corresponding reduction to the member's excess over GMP.

The anti-franking provisions are highly complex.

WHAT HAVE SCHEMES PREVIOUSLY DONE TO EQUALISE GMPS?

In practice, schemes have usually only sought to equalise for the effect of GMPs if the scheme was in winding up or was entering the Pension Protection Fund (PPF).

Otherwise, very few "ongoing" schemes have attempted to deal with inequalities caused by GMPs – most are aware of the issues but have been waiting for answers as to how to achieve equality (recognising that GMPs themselves cannot be equalised unless the legislation changes).

Schemes winding up needed to consider how to adjust benefits (both past and future) to reflect unequal GMPs and those that made any adjustment tended to adopt a rough and ready approach adjusting only future benefits. This was seen as a pragmatic approach to an insolvable problem.

Where schemes of insolvent employers enter the PPF, adjustments are made to compensation according to the PPF's methodology and adjustments are made to correct past underpayments resulting from GMP inequality.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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