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Dear Paul

Annual allowance and Fixed Protection
Changes to deferment revaluation on deferred annuity purchase

I refer to our letter of 1 November to Jo Barlow, and to the December PISF meeting, in which we noted that certain reasonable actions by trustees could result in the scheme's deferred pensioners losing (or indeed already having lost) the "deferred member carve-out". I am writing in relation to agenda item 18 of the PISF meeting.

1. Relevant background

Relevant background context to this letter is that one of the points has effectively been closed off. We requested special treatment in relation to the following: " In relation to the Government's changes to increase rules in particular for deferred pension revaluation, from being by reference to RPI increases to by reference to CPI increases, if a scheme changes its rules after October 2010 to reinstate the pre-change position, or vice versa to take advantage of the new level of statutory minimum increases." You indicated that "the original policy intention

was to allow increases of CPI. We therefore don't propose to recommend any changes to this at present".

2. Details of the issue from agenda item 18

With the above context partly in mind, this letter deals with Agenda Item 18 of the PISF meeting. HMRC described this as: *"Fixed protection - Where a DB scheme is winding up and the trustees buy out benefits for deferred members, if the trustees buy deferred annuities subject to revaluation with a RPI index element then this would normally result in benefit accrual and the loss of FP."*

The issue in question was identified by ACA particularly in the context of a scheme that would otherwise be due to provide benefits revaluing with a CPI-based index; but where the Trustees instead buy (in connection with a potential winding up) deferred annuities subject to revaluation with a RPI index base, and grant this benefit to the member. Typically this would be because of the limited or zero availability of CPI-based deferred annuities; or because a CPI-based deferred annuity costs nearly the same as an RPI-linked one (despite the fact that CPI is expected be materially lower than RPI over the long-term) and so is not viewed as good value for money.

The concern is not just in relation to Fixed Protection but also in connection with unwarranted and unexpected amounts of Annual Allowance Pension Input Amount.

The situation would appear to arise either where the scheme had an explicit "specified rate" in its rules based on CPI (either directly, or indirectly via a reference to the statutory minimum leaver revaluation requirements) – but loses it by virtue of granting the RPI link; or where it had no "specified rate" in the first place (although one might argue that the existence of the overriding statutory requirement as an underpin creates a specified rate).

The test for FP benefit accrual in either case would be against the specific CPI allowance in Finance Act 2011 Sched 18 para 14 (13)(b); and for AA would be under 234 (5B) with definition (b) of "relevant percentage" in (5C) or indeed without 234 (5B) applying at all. And since both these fall-backs refer to CPI not RPI a member with FP would likely lose FP and all members would have some AA PIA that would otherwise be nil.

2.3 Schemes in wind-up

We believe that schemes that enter wind-up could potentially be affected in different ways. The legal situation will be different for a scheme that is winding up with an insolvent sponsoring employer from one that is winding up in a planned and orderly way with a solvent sponsoring employer.

> **Insolvent wind-up**
>
> In an insolvent wind-up, the scheme will have insufficient assets to secure benefits in full for all members with an insurer. The benefit due to the member under rules in wind-up could be different from their expectations as an on-going member: their actual deferred pension level may be lower, and what revaluation applies could be different under each scheme. For example, some scheme rules may require only a CPI-based revaluation for part of the benefit (the PPF compensation level) even if the on-going scheme would have provided RPI; and others may provide for complete flexibility in the form of benefits purchased by the trustees. Overall, the trustees will need to consider what the monies available can best buy, having allocated the appropriate amount available for each member.
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> In these circumstances we wonder whether there may be a fine legal point to understand what the "specified rate" was in October/December 2010 and whether it has changed. Alternatively, in view of the requirement under section 73 of the Pensions Act 1995 to allocate each member a certain "pot" of the available scheme assets, we wonder if the benefit might be said to have changed to DC for AA purposes – thus removing the issue in question entirely?
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> **Solvent wind-up**
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> In a scheme winding up fully solvent, the member by definition should get the same benefit as if the scheme had not wound up, so it will be clearer if there has been a move from a "specified rate". Particularly in relation to solvent wind-up, our view is that for your considerations for change in the tax law, "in connection with wind up" should include schemes in the run up to eventual wind up, as we explain further in the Appendix.

We therefore note a basic uncertainty as to how the legislation works, but leave you to check this point with the Association of Pension Lawyers as you see fit.

3. Potential impact

You asked us to give further background, example numbers and impact, so that you can consider this issue further, so I am duly writing.

In terms of impact:

- It is likely that all schemes currently going into wind-up will seek to buy RPI-based deferred pensions where legally permissible; and this will continue while insurers can price only on the basis of RPI indexation because only assets linked to the RPI (eg UK index-linked gilts) are readily available to back the annuities.
- In the long term, nearly all UK private-sector defined benefit pension schemes will eventually wind up. Potentially, very many of these will be affected by the issue in question when they come to wind up,

particularly where this takes place under the solvent route. If it would be useful, we can provide details (anonymously) of some recent cases where it is clear that the scheme rules "required" CPI but RPI was purchased (we may need our clients' permission).

If the issue is not addressed, then there are clear impacts for members, pensions administrators and Trustees:

- Some members of the scheme may have fixed protection: the grant of RPI instead of CPI based revaluation would mean potentially losing access to fixed protection.
    - It is not possible to identify how many members in a scheme might want fixed protection, particularly deferred pensioners: while it may be obvious that some members have deferred pensions high enough to suggest FP is of interest, another deferred member might have £100 pa in the scheme in question and £2,000,000 fund value in another scheme: an RPI increase to the £100 pa pension could lose the member £75,000 of pensions tax relief.
- Many members of the scheme will find that their deferred pension now creates Pension Input Amounts:
    - This will seem anomalous from a benefit that they deemed fully accrued some time past and will make new savings planning difficult (and probably lead to errors)
    - The amount of PIA may not simply reflect "RPI less CPI" each year. Our separate letter dated 5 February 2012 on the technical detail of deferred pensioner revaluation as interpreted by the Finance Act 2004 Valuation Assumptions indicated that, where the structure of revaluation follows along the lines of the statutory revaluation, the figures that emerge are likely to be complex to calculate and unintuitive.
    - I refer you to our "quantum of AA" separate letter of today's date (copy attached) concerning the materiality of the figures and the impact for administration.
- For the pensions administrator (which may be an insurer) it creates unwarranted complexity of administration.
- For Trustees considering such a deferred annuity purchase in future
    - It creates extra complexity and the need for legal advice. For example, they might feel the need to exclude certain members from the rule change if it would compromise their Fixed Protection, but without knowing exactly which members; and with the on-going special treatment that might need.
    - Given that it was only relatively recently that HMRC issued its Fixed Protection Newsletter which mentioned the RPI/CPI issue, it may be that some Trustees were not aware of the point and have already granted benefits which mean (at worst) that some individuals will not be able to use Fixed Protection for the scheme concerned nor for any other scheme benefits they have.
    - The Annual Allowance is unlikely to affect their decision as to who gets the change (a benefit net of AA charge is usually – though not always – more than no benefit at all), but there may be cost implications they have to take into account
- We have discussed with you the likely possibility that an individual who became a deferred member of a scheme before 6 April 2006 and has since not changed that status (ie has had no benefit accrual in the scheme) does not have a PIP and hence no PIA. This does mean that –so long as it is recognised that a switch from CPI to RPI is simply changed revaluation and not "benefit accrual" – the AA problems described above would remain only for those who left pensionable service since April 2006 and those who leave pensionable service in the future. However, of course this "easement" does not extend to FP. And there has been an escalation of members leaving pensionable service since 2006 as a result of schemes closing to accrual.

We make a few further points in the Appendix to this letter.

2.2 Our proposed solution

As a reminder, the main solution we asked you to consider was:

- for Annual Allowance purposes, to accept the new revaluation as part of the relevant percentage when assessing whether the value of the relevant rights of the increase during the pension input period is more than the relevant percentage (eg under S234 (5B) of FA04); and

- for Fixed Protection purposes, to accept the new revaluation as part of the specified rate in the relevant percentage under S14 (12)(a) Schedule 18 of Finance Act 2011.

- We would be happy to work with you identify an appropriate way to minimise potential abuse.

We understand that changes to Fixed Protection require primary legislation change which takes substantial time. A change in future that applies retrospectively (for schemes preparing or proceeding to wind up now, potentially via a buy-in), would be very welcome and certainly serve a purpose; but unless with an early ministerial statement of intent, would give members very uncertain positions.

Yours sincerely

Karen Goldschmidt FIA
Chair of the ACA Pensions Taxation Committee

Appendix

Some further points

Schemes "de-risking" with wind-up in mind ("buy-ins")

Many DB schemes have closed to new entrants, and many have closed to new accrual. In such circumstances, the Trustees inevitably have to consider what the future of the scheme might be, and are likely to be advised [some sort of quote from regulator etc] that they should be planning around an end-game of wind-up in the short or medium term.

In such circumstances Trustees will often be aiming at retaining some performance achievement by way of equity investment; but securing elements of benefits as they become affordable – security being measured as "how closely the value of scheme assets moves in line with the ultimate cost of purchasing an insurance company annuity or deferred annuity on wind-up". A first step might be to purchase investments that more closely follow the prices of these products; but the quickest route to security will be the actual purchase of the annuity/deferred annuity in tranches (as an investment of the scheme) – when the market is best favourable – potentially well ahead of actual wind up. This is referred to as a "buy-in" and is becoming more and more common practice.

We believe that these schemes too should be considered for special treatment.

It is true that the Trustees could buy such assets, and collect the RPI-based benefit as an asset but pass on only the CPI-based payments, the balance being retained by the scheme as a "profit". The scheme can generally manage this mismatched asset whilst it is ongoing. But ultimately wind-up will occur and the position needs to be crystallised with the members' benefits being aligned with the insurance policy purchased (or vice versa at some cost).

We would note that we are aware of [at least one – PS you mentioned you had another?] scheme(s) that secured deferred pensioners with a buy-in asset before October 2010, buying an RPI-based revaluation because that is what statutory revaluation meant at the time and therefore that was thought to match the requirements of the scheme's rules. In that case, the scheme's rules are now being changed to re-align the benefit payable to the members with what was purchased under the insurance policy. It seems particularly unfair that the action of changing the scheme's rules should cause the consequences we have described here. We are also aware of at least one £60m buy-in of deferred pensioners in this situation. (We note that if pre 6 April 2006 deferred pensioners are carved out from AA, the numbers affected in respect of AA for this particular case would fall to a trivial level – but of course we cannot tell which members might seek Fixed Protection.)

Why are Trustees buying deferred annuities with RPI-based revaluation? What products are available for buy-outs carried out now? When is this likely to change?

Insurers are required to purchase assets to closely match the benefit promises they make under the insurance policies they provide. Where there are no closely matching assets available in the market, insurers are required to hold significant additional assets as reserves against the mismatching risk that they are exposed to. This makes it uneconomic for insurers to provide benefits for which they are not able to purchase matching assets.

The pensions industry has lobbied for the Debt Management Office (DMO) to issue index-linked gilts linked to CPI but so far the DMO has decided not to issue any such gilts.

Therefore, at the current time, purchasing CPI-linked benefits from an insurer is expensive and is a very inefficient use of pension scheme funds. Generally the cost for purchasing CPI-linked benefits is similar to the cost for RPI-linked benefits, notwithstanding that RPI is expected to be materially higher than CPI over the long term.

We do not foresee this situation changing materially until the DMO issues CPI-linked gilts. Even then it may be many years before a liquid market exists allowing CPI-linked benefits to be provided by insurers at a reasonable market price.