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Briefing

Lloyds: High Court rules on GMP Equalisation

The High Court has published its judgement in the case of Lloyds Banking Group Pension Trustees Limited vs Lloyds Bank plc (and others). The case was concerned primarily with the requirement to equalise pension benefits for the effects of unequal Guaranteed Minimum Pensions (GMPs) – referred to colloquially (and in this update) as "GMP equalisation", even though the GMPs themselves are not generally to be made equal.

The key conclusion of the case is to confirm that formerly contracted-out schemes are required to equalise GMPs, and whilst there are several methods for doing this the Court has identified which it considers legally robust.

It may take some considerable time yet to conclude this matter - including awaiting further guidance from the Department for Work and Pensions (DWP) – nevertheless, there are some immediate actions for trustees and employers to consider, including whether to:

- communicate with members about the judgment – in particular where members are retiring or transferring out, whether to flag that an allowance has or hasn't been made for GMP equalisation.
- having discussed with their auditors, include a reserve for the costs of equalisation in companies' accounts
- review the approach to transfers values, both for business as usual and for any bulk exercises
- review the terms of buy-outs / buy-ins or trivial commutation exercises underway.

Help is at hand...

Listen to our webinar hosted by Head of GMP Equalisation **John Cormell FIA** who will guide you through all the implications

LISTEN TO THE WEBINAR

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The 'effect of GMP' issue

Between April 1978 and April 2016, occupational pension schemes could "contract-out" of the second tier of the state pension (the State Earnings-Related Pension Scheme (SERPS) and later the State Second Pension (S2P)). In return for a reduction in, or rebate of, National Insurance (NI) contributions, contracted-out schemes promised to pay certain minimum benefits to members.

Between April 1978 and April 1997 the minimum benefit payable was known as GMP and was broadly intended to replicate the SERPS pension given up. Legislation specified how the GMP part of a member's pension was to be calculated and when it would become payable.

The issue however is that the SERPS benefit being (broadly) replicated by GMPs is not equal for men and women (for instance SERPS benefits become payable at different ages – 65 for men and 60 for women – and hence also the rate at which the benefit is "accrued" is different). The Government has said it is under no obligation to retrospectively equalise the state pension and so the way in which GMPs are calculated is to remain unequal.

Nevertheless, European Courts have long concluded that pension benefits represent a form of deferred pay and therefore employers / schemes are legally obliged to equalise for the differences between men and women - for example the cases Barber vs Guardian Royal Exchange (GRE) in May 1990 and the subsequent clarification afforded by the Coloroll Pension Trustees case in 1992. The requirement to equalise has since been enshrined in UK Equal Treatment law.

The Department for Work and Pensions has long maintained that equalising for the effects of GMP is required by law, even though European legislation exempts state pensions from historic equality rules.

In brief one: the background

- This issue affects schemes contracted-out on salary-related basis between 1990 and 1997.
- GMPs broadly replicate unequal SERPS benefit given up via contracting-out.
- Law requires pension benefits to be equalised between men and women (from May 1990).
- However, state benefits need not be equalised and therefore GMP calculation rules will not be adjusted.
- Schemes must therefore equalise benefits taking into account these inherent inequalities – ie for the "effect of GMPs" without actually equalising the GMP itself...

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What the judgement said

1. Schemes are required to equalise (for the effects of) GMP

The judge (Mr. Justice Morgan) ruled that the Lloyds Schemes Trustee is "obliged to adjust the benefits payable under the Schemes in excess of the GMP in order that the total benefits ... are equal."

Justice Morgan was clear that this interpretation extends to all formerly contracted-out salary-related schemes (COSRS). Equalisation is however only required in respect of benefits accrued since the effective date of the Barber judgement (ie 17 May 1990) – in which it was determined pensions are deferred pay and therefore subject to the requirement for gender-based equal treatment.

GMPs ceased accruing in April 1997 from when COSRSs contracted-out on an (already equal) reference scheme test basis.

In brief **two**: the judgement

- The judge confirmed schemes are required to equalise for the effects of GMPs
- Several methods for equalisation are permissible whilst others are not.
- The case considered 4 main methods of equalisation (see box A below), each with up to three variants.
- Focus on method C2 – a relatively complicated year-by-year comparison of true and opposite-sex benefits.
- D2 (equalisation and conversion on value basis) also possible, and likely to be popular for the majority of formerly contracted-out DB schemes. Existing legislation requires sponsoring company to consent to method D2.
- Arrears will be payable. The look-back period will depend on what scheme rules say.

2. Several methods for equalisation are permissible (but some are not)

The judge considered a number of different approaches to equalisation (summarised below). Ultimately, the judge identified two key methods which could be considered viable approaches (though in so doing hasn't necessarily ruled out other approaches for other schemes):

- **[C2]** An administratively complicated yearly check that members' pensions paid to date would not have been greater if they were of the opposite sex (and if so, the pension would be uplifted); or
- **[D2]** A one-off value-based uplift and conversion of the GMPs into 'main scheme' benefits. It is expected that this will be the more popular approach with many formerly contracted-out schemes.

Method A was largely ruled out on the basis that it didn't embody the principle of "minimum interference" when considered from the Employers' point of view.

Method B was considered a valid approach, albeit potentially resulting in uplifts for both male and female members which could be over-generous, but similarly was ruled out on "minimum interference" grounds.

Method C is similar to B, but the comparison takes into account cumulative pension paid to date so that individuals are not over-compensated. Two variants were considered – without and with interest adjustments in the comparison (labelled C1 and C2 respectively).

Method C2 was ultimately favoured by the judge, and it was noted the Employer in this case could effectively compel the trustees to adopt that method.

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Method D involves an actuarial-equivalence test comparing the value of male and female benefits. Under variant D1, any difference in value is paid in the form of additional pension. Under method D2, existing legislation is used to convert the GMP into excess pension on a value basis.

D1 was effectively ruled out as it didn't satisfy the "minimum interference" test when considered from the members' point of view, but because of this the judge did not comment on whether an actuarial-equivalence test could be a truly equitable solution for an ongoing scheme.

Method D2 on the other hand was considered workable, albeit employer consent is necessary in line with existing legislation – ie section 24E(2) of the Pension Schemes Act 1993.

Whilst not explicitly stated, the implication was that methods A & B could be adopted for other schemes if the employer gave consent.

3. Arrears must be paid

The judgement set out that, where pensions are already in payment, arrears must be paid with interest. In current market conditions, the judge considered that the appropriate rate of interest rate to add would be the Bank of England base rate +1% pa.

The judge also ruled that no statutory limitation period would apply to the payment of arrears. However, where a scheme's rules include a suitable "forfeiture clause", this can be used to limit the period for looking back. Legal advice will be imperative here if a forfeiture clause is to be relied on.

Equalisation methods – technical summary

The judge considered several possible equalisation methods, some more complicated and costly than others.

Method A (3 variants)

- Considers each component of a member's pension separately.
- Review pension in payment annually (or when an increase due)
- Uplift if member would have got more as opposite sex

Largely ruled out as didn't meet the 'minimum interference' test.

Method B

- Considers member's pension as a whole.
- Annually review pension amount
- Uplift if member would have got more as opposite sex

Ruled possible, but likely to be complicated and expensive to implement

Method C (2 variants)

- Based on Method B, but only requires uplift if accumulated pension to date is unequal (no need to consider each annual increase separately).
- Two variants – one without interest adjustment to the accumulated pension (method C1) and one with an adjustment (method C2) – which ordinarily leading to smaller uplifts.

Method C2 was preferred over C1.

Method D (2 variants)

- Both method D1 and D2 are 'actuarial' value-based adjustments.
- D1 considers any upward equalisation adjustment with an additional pension of equivalent value put into payment.
- Method D2 involves converting all of the member's GMP into a non-GMP benefit, using existing legislation, and including an equalisation uplift at the same time.

Method D2 was considered workable, though legislation requires sponsoring employer consent to the conversion.

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4. Uncertainties remain

It is not clear from the judgement whether trustees' duty to equalise for the effect of GMPs extends to benefits that have previously been transferred out of their scheme, or where a member has since died or fully commuted their benefits.

It is also not clear to what extent trustees must take into account the relative costs of each approach when compared with the additional benefits granted.

Finally, it is possible that this judgement may be appealed (although many legal commentators have already said they consider it unlikely).

What to do next?

The judge noted that the points made in the Lloyds case apply to "many other occupational pensions [sic] schemes". It is clear therefore that, whilst this ruling relates specifically to ongoing arrangements (ie not schemes in windup or PPF assessment), all formerly contracted-out schemes are likely to be affected in one way or another.

The DWP is expected to issue further guidance on valid approaches in due course. However, trustees and employers should not wait for this guidance before taking certain steps - immediate actions for trustees and employers to consider include:

- Agreeing their approach to quoting and paying transfer values. There are good arguments for continuing to pay transfer values without allowing for GMP equalisation but this is not without risk. Alternatives might be to pay a subsequent top-up for GMP equalisation after an initial transfer has been paid, or temporarily suspending transfer payments until systems are in place to include GMP equalisation, but taking note of statutory time limits for quotations and payment.
- Reviewing the terms for buy-in and buy-out policies under negotiation. In particular, where an allowance for GMP equalisation is made, the trustees may wish to ensure appropriate indemnities are in place.
- Discussing with actuarial advisers and auditors how much to reserve in the next set of Company Accounts to reflect the costs of equalising.
- Liaising with scheme administrators to ensure that scheme GMPs have been adequately reconciled with HM Revenue and Customs' (HMRC's) records.
- Writing to members to inform them of plans regarding GMP equalisation and/or adding additional comments to standard member communications.
- Obtaining broad estimates for the impact of GMP equalisation on the scheme's funding position.

In brief **three**: the actions

- Don't panic!
- Speak to existing advisers about transfer values – buy some time if necessary.
- Liaise with insurers where buy-outs or buy-ins underway
- Look out for further guidance from the DWP
- Attend our webinar – see below.
- Consider impact on corporate accounts with actuaries and auditors.
- Discuss possible adjustments to funding with advisers.
- Consider feasibility of conversion

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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