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GMP equalization obligation extends to historical transfers

In the latest instalment of the *Lloyds Banking Group* litigation, the judge concludes that trustees must top-up past transfer payments if no provision was made for the need to equalize benefits for differences attributed to guaranteed minimum pensions.[1]

History

On 17 May 1990, the European Court of Justice (ECJ) ruled that, from that date onward, occupational pensions had to be equal for men and women in similar circumstances.[2] Despite significant judicial development of the principle and its implications in the years since—and much, *much* debate—it was not until the first *Lloyds* judgment in 2018 that the courts confirmed that the obligation to equalize applies to differences attributable to guaranteed minimum pensions.

Rights to GMPs, as they are known, were accrued by members of defined benefit (DB) occupational pension schemes that were 'contracted out' of the earnings-related aspect of the UK's State pension system between 1978 and 1997. The accrual rate of GMP differed for men and women, as did (does) the age at which payment commences. These disparities, and differences in the ways in which GMP and non-GMP benefits are revalued during deferment and increased whilst in payment, mean that a man and a woman of the same age and with identical service and salary histories may be entitled to different benefit totals; and that the advantage may shift from one sex to the other over time.

The October 2018 *Lloyds* ruling established (among other things) that trustees have an obligation to adjust non-GMP benefits so that the total pensions received by men and women in comparable circumstances are equal. However, there are several lawful methods by which this equalization can be accomplished. The parties to the *Lloyds* litigation have since returned to the court twice to obtain guidance on issues raised by the initial decision: a judgment in December 2018 was concerned with the use of statutory powers to convert GMPs into non-GMP benefits, and the latest (20 November 2020) ruling was about trustees' obligations in connection with historical transfers.

[1] *Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank PLC* [2020] EWCH 3135 (Ch).
[2] *Barber v Guardian Royal Exchange* (Case C-262/88).

Judgment on past transfers

Individual statutory transfers

The judge ruled that, in cases in which the member exercised the statutory right to transfer, the trustee was under a duty to make a transfer payment that correctly reflected the member's right to equalized benefits, and remains liable to the member if it breached that duty by making an inadequate transfer payment. That was the case despite discharge provisions in the transfer legislation, scheme rules, and the forms signed by transferring members. Members' claims to a top-up transfer payment were not barred either by scheme forfeiture rules or the *Limitation Act 1980*.

The judge stopped short of saying that the trustee was under an obligation to identify and rectify transfers shortfalls *proactively*. Having noted that he was asked not to take into account wider considerations such as the potentially disproportionate costs entailed by proactivity, he concluded that all he could usefully say was that

> '*the Trustee does need to be proactive in that it must consider the rights and obligations… identified, the remedies available to members and the absence of a time bar and then determine what to do.*'

Bulk transfers without member consent

Where the transfer was not the result of an exercise of the member's statutory right to transfer, but one that took place without the member's consent under the preservation legislation that protects early leavers, the judge said that the trustee had been discharged from the obligation to equalize. However, it appears that he was asked specifically about 'mirror-image' transfers in which members obtain rights under the receiving scheme that are identical to their rights under the transferring scheme, so it is unclear that this discharge from the equalization obligation would apply in all cases.

Individual extra-statutory transfers

The judge was also asked about member-instigated transfers that took place outside of the statutory right to transfer. This can happen, for example, when trustees exercise their powers to permit a transfer despite the member having passed the date that falls one year before his or her normal pension age. He said members in such cases would no longer have rights under the transferring scheme, unless the court set aside the trustees' exercise of their powers, and that it would only do so if the trustees had breached their duties by giving '*inadequate deliberation*' to the matter. As that would involve investigation of the circumstances of each particular transfer, and he had not been provided with relevant evidence or asked to set aside such a decision, he left the question there.

Inward transfers

In 1994's *Coloroll* judgment, the ECJ decided (among other things) that when an employee changes job and transfers pension rights from one occupational scheme to another, the receiving scheme is bound to equalize the benefits attributable to post-17 May 1990 service under the transferring scheme.[3] This was on the assumption that the transferring scheme had not already gone through the process of *Barber* equalization, and the capital amount transferred was therefore inadequate. The judge in the *Lloyds* case saw no conflict in the member having rights to equalized benefits under the receiving scheme whilst also having a right to require the transferring scheme to top up its transfer payment.

The ruling will be good news for some members who took a transfer value, as they may now be in line for a top-up payment. However, the effort involved in revisiting transfers paid out by pension schemes across the industry over the last 30 years will be a very significant challenge, and in many cases historical data will not be available.

For sponsors of pension schemes who report accounting figures under IAS 19 the ruling is likely to trigger a need to assess extra accounting liabilities and the impact on P&L. Those due to report as at 31 December 2020 do not have much time to analyse this.

The impact of the judge's findings about the limited effectiveness of discharge clauses and the absence of a time bar may be felt beyond the confines of GMP equalization. Ex-members may be emboldened to challenge past transfer payments on other grounds, such as calculation errors or misinterpretation of scheme rules.

[3] *Coloroll Pension Trustees Ltd v Russell and others* (Case C-200/91).

No RPI reform before 2030; no compensation in prospect

Her Majesty's Treasury (HMT) and the UK Statistics Authority (UKSA) have announced the outcome of their joint consultation exercise about reform of the Retail Prices Index (RPI).[4] The Chancellor of the Exchequer will not consent to early implementation of the change that the UKSA proposes (essentially turning the RPI into a clone of the CPIH—the Consumer Prices Index variant that incorporates a measure of owner-occupiers' housing costs); the UKSA is nevertheless expected to proceed with its reform in 2030, when it can do so unilaterally. The Government does not intend to compensate holders of index-linked gilts.

The Chancellor acknowledged the force of the UKSA's statistical arguments, but concluded that, in order to minimize the impact on the holders of index-linked gilts, he should withhold his consent to any implementation of the proposed change before 2030. The reasoning behind the decision, and the significance of the year 2030, are as follows.

The prospectuses of certain index-linked gilts contain clauses allowing their holders to redeem the gilts early if a fundamental change is made to the RPI and it is materially detrimental to the gilt-holders' interests. The UKSA is not allowed to make such a change without the consent of the Chancellor of the Exchequer. The last remaining gilt to come with this sort of early redemption clause matures in July 2030, and there are no plans to issue any more. The final RPI statistic to be used in connection with the 2030 gilt will be that for November 2029, which would typically be announced the following month (mid-December 2029). The UKSA has concluded on that basis that it can '*legally and practically*' make the change to the RPI in February 2030.

The RPI will continue to be published beyond 2030, but beneath the bonnet its moving parts will have been swapped in from the CPIH. In recent years, the rate of inflation under the CPIH measure has averaged around one per cent a year lower than that on the RPI basis. The difference could be material for pensioners with RPI-linked pensions, and for schemes with RPI-linked assets and liabilities; the implications for scheme funding positions will depend on their individual mixes of ingredients. Although the Government has no plans to pay compensation, the sums at stake may make it worthwhile for someone to challenge that policy. So far, the market's reaction has been rather restrained. For more information and analysis, please see our Sixty Second Summary.[5]

DB superfund guidance

The Pensions Regulator has published guidance for defined benefit (DB) trustees and sponsoring employers considering a move to a superfund.[6] The guidance sets out the Regulator's expectations and the approach that it will take to such transfers.

Regulatory 'gateways'

Before a transfer to a superfund can occur, the Regulator expects trustees to explain why that it is in their members' best interests, in particular by demonstrating that it satisfies three 'gateway principles'. They are that:

- the scheme cannot afford to buy out its liabilities with an insurer at the point of transfer—the affordability of the buy out is to be based on an assessment made by the scheme actuary no more than one month before an application is made for clearance (see below);
- there is no prospect of a buy-out in the foreseeable future—the Regulator indicates that this could be a period of up to five years, but acknowledges that it may be appropriate to consider shorter timescales in situations where the covenant is uncertain or fragile; and
- the transaction improves the likelihood of members receiving their full benefits.

The guidance sets out in detail what needs to be considered under each principle.

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[4] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938008/RPI_Response_FINAL_VERSION_.pdf>.
[5] *RPI reform* (November 2020) <www.hymans.co.uk/insights/research-and-publications/publication/sixty-second-summary-rpi-reform>.
[6] <www.thepensionsregulator.gov.uk/en/trustees/managing-db-benefits/db-superfunds/superfund-guidance-for-prospective-ceding-trustees-and-employers>.

Clearance

The Regulator considers a transfer to a superfund to be a new 'Type-A' event, so that a clearance application is expected (an application may not be appropriate during assessment for entry into the Pension Protection Fund). The ceding employer will formally apply for clearance, but trustees are expected to play a substantial part in the process; in particular, confirming to the Regulator that the three 'gateway principles' are met. Both the trustees and the superfund itself will be involved as '*directly affected parties*'.

Notably, the trustees are expected to contribute their assessment of the detrimental effects of any past corporate activity or value extraction, and whether it will be mitigated by the superfund transfer. They are also expected to explain if the proposed transfer is part of a greater plan for the employer.

The Regulator will only issue a clearance statement once the superfund has been assessed against the requirements set out in its interim guidance.[7] Once clearance has been granted the transaction should normally proceed within three months.

Due diligence

Although trustees can take comfort from the Regulator's assessment of the superfund, and will not be expected to duplicate it, they are expected to show that they have undertaken their own due diligence on the prospective transfer, proportionate to their resources. The appropriate due diligence should include consideration of other possibilities open to the employer and scheme, any changes to the superfund since the Regulator's assessment, the suitability of the superfund (including its fees, funding and investment objectives), any modelling produced by the superfund, and the risks associated with any retained liabilities.

Advice

Trustees should assess their own experience and consider appointing an independent trustee if necessary. It is almost certain that trustees will also considerable require actuarial, covenant and legal advice in addition: the employer is expected to foot the bill.

Communication with members

The Regulator encourages trustees to be open and transparent in communicating with members, especially since some may decide to transfer their benefits elsewhere before the transaction. The guidance provides a list of trustee considerations. Any member-options exercises should be conducted in accordance with industry best practice.

The guidance shows that the Regulator is committed to making a go of superfunds and is supportive of transactions happening ahead of a statutory authorization regime.

One key issue for the viability of transactions for smaller schemes is to ensure that the frictional costs of getting the right advice to support a transaction do not outweigh the benefits. It is therefore helpful that the guidance allows trustees to take comfort from Regulator's own assessment of the superfund. It is also good to see it say that superfunds should provide ceding trustees with a summary of Regulator's assessment. A key judgement for them is then the level of advice required and the due diligence that they must carry out on top of it, which the guidance suggests should be proportionate.

[7] <www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-superfunds>.

Options for indexation of public-sector GMPs

The Treasury is consulting on how it proposes to meet past commitments to public-service employees regarding the full indexation of public service pensions, including any related GMP element, following the introduction of the new State pension.[8] It appears as though the current '*interim solution*' (full indexation by the pension schemes) will almost certainly be extended, at least to cover those reaching SPA before 6 April 2024, to buy public-sector administrators time to deal with the fallout from *McCloud* and other court judgments before they have to grapple with the thorny issue of GMP equalization. Whatever the Treasury's decision, its effects will be felt beyond the budgets of central government departments: the costs of compliance will also fall upon Local Government Pension Scheme employers and even the sponsors of some private-sector schemes.

Background

Pension scheme members who were, prior to 6 April 1997, contracted out of the additional State pension ('SERPS') via a salary-related occupational scheme will have built up rights to guaranteed minimum pensions (GMPs) as a consequence. The GMPs were calculated in a broadly similar way to the State pension rights that they replaced, but increase differently once in payment: whilst the State pension would have been fully indexed, only GMPs accrued after 5 April 1988 are inflation-linked, and the annual increase is capped at three per cent.

Due to the way in which State pension entitlements are reviewed, annually, for those who attained State pensionable age (SPA) prior to 6 April 2016, any shortfall in GMP increases versus full indexation is effectively (in most cases) paid by the Department for Work and Pensions (DWP). However, that process of annual review is not undertaken for those who reach SPA from 6 April 2016. Instead, a one-off assessment of their additional State pension rights was made to establish their entitlements to the new 'single-tier' State pension that came into effect on that date, replacing the old combination of basic and additional State pension benefits.

That created a problem for the Government, in connection with members of the public-service pension schemes. It had established a practice of fully indexing their public-sector occupational pensions, *inclusive of GMP*, in the few cases in which they were not getting their GMP increases topped up by the DWP (this could happen, for example, if the GMP worked out higher than the additional State pension that it replaced). The Government concluded that a commitment had been made that it should continue to honour, even though the switch to the new State pension has meant that the undertaking now affects all members retiring on or after 6 April 2016 with GMPs.

On 1 March 2016, as an 'interim solution'—the reason for the quotation marks will shortly become apparent—the Government announced that it would fully index the public-sector pensions of those who reached SPA from 6 April 2016 to 5 December 2018 (inclusive). This was supposed to buy it time to find a longer-term solution to the indexation problem, and also to the need to equalize the total benefits paid to men and women where there are differences attributable to GMPs. It mooted conversion of GMPs into non-GMP benefits as one potential remedy. However, whilst deliberating on the matter it found it necessary, on 22 January 2018, to extend the interim solution so as to cover public-service pensioners who reached SPA before 6 April 2021.

Consultation

Now, as that revised cut-off date fast approaches, the Government is concerned that public-sector scheme administrators are already burdened with a great deal of complex work to achieve compliance with recent court judgments in discrimination cases. The *McCloud* ruling, for example, drove a coach and horses through the transitional arrangements put in place in conjunction with the switch from final salary to career average revalued earnings (CARE) benefits across the public sector. There is insufficient capacity to implement a solution to the public sector's GMP indexation and equalization problems whilst that other work is being done.

The Government has identified three possibilities:

- extend the interim, full-indexation solution to cover those reaching SPA up to 5 April 2024;
- extend the interim solution even further, for example to those reaching SPA up to March 2030; or

[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/924807/02.10.2020_GMP_indexation_consultation_final.pdf.

- discount conversion as a long-term policy solution and make full GMP indexation the permanent solution for public service pension schemes (although the consultation document notes that there are cases in which this will not achieve equalization).

The Government is 'aware' that whatever decision it reaches will affect some private-sector schemes that are bound to follow the public sector's policy on pension increases, but says that it 'is not responsible' for their rules.

The consultation period ends on 30 December 2020.

New Code for sole trustees

Under sole trusteeship the traditional board of trustees is replaced either with an individual trustee or, more commonly, a professional independent trustee company.[9] The Association of Professional Pension Trustees (APPT) has published a new Code of Practice setting out a range of governance and risk controls to which it says it members who act as professional corporate sole trustees should adhere.[10]

The Code aims to protect scheme member interests by setting out 'best-practice' recommendations on various issues, such as appointment, decision-making and fees. In particular, sole professional trustees will be asked to determine whether they need to report to the Pensions Regulator if they are removed or resign from an appointment as a result of the sponsoring employer's actions. Professional trustee firms should ensure that they have due diligence procedures in place for new professional corporate sole trustee appointments and put in place measures to ensure that any potential conflicts of interest are managed.

The Code comes into force on 1 January 2021.

HMRC as a preferential creditor

A reminder that, in insolvency proceedings commenced on or after 1 December 2020, preference will be given to certain debts owed to Her Majesty's Revenue and Customs (HMRC).[11] This change may reduce the company assets available for distribution to creditors who rank lower in the priority order (and may also make it harder for solvent businesses to obtain financing).

The order of priority in corporate insolvencies is, broadly:

1. Fixed charge holders;
2. Insolvency practitioners (fees and expenses);
3. Preferential creditors (e.g. employees' in respect of unpaid wages, and pension schemes in respect of some unpaid contributions);
4. Floating charge holders;
5. Unsecured creditors (e.g. trustees of defined benefit schemes in respect of s. 75 debts, unless they have been able to obtain a stronger position); and
6. Shareholders.

From 1 December, HMRC will rank after the ordinary preferential debts in category 3 and before floating charge holders (category 4) in respect of any '*secondary preferential debts*' owed to it. The new category of preferential debts owed to

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[9] We discussed sole trusteeship in our February 2018 publication *DB Consolidation: When, Not If* <www.hymans.co.uk/media/uploads/DB_Consolidation_-_when%2C_not_if.pdf>.

[10] <appt.org.uk/wp-content/uploads/APPT-CoP-for-Sole-Trusteeships-final.pdf>.

[11] *Policy paper: HMRC as a preferential creditor* (30 November 2020) <https://www.gov.uk/government/publications/hmrc-as-a-preferential-creditor/hmrc-as-a-preferential-creditor>.

HMRC includes any value added tax (VAT), 'Pay As You Earn' (PAYE) income tax and employee National Insurance contributions (NICs) owed by the insolvent company.

A company's defined benefit pension scheme is often one of its most significant creditors. In recent times many trustees have been able to use their heft to negotiate additional forms of security. Those that have not find themselves near the end of the queue for distributions in sponsor-insolvency situations. The change to HMRC's ranking will re-write the equation and prompt many to reassess their positions.

Act soon—the Bill's at the door

The *Pension Schemes Bill* is on the threshold of becoming an Act of Parliament, the only stages remaining being a back-and-forth ('ping pong') between the Houses of Commons and Lords to resolve any lingering disagreements, and Royal Assent. At the time of writing no dates had been set for these events. The Bill contains the basis for a new style of benefit provision (collective money purchase), raises the stakes for those inclined toward malfeasance by bringing in serious new criminal and civil sanctions, fixes roles and obligations in respect of the forthcoming pensions dashboards, supports the Regulator's impending shake up of defined benefit scheme funding, shines a (low-energy, long-life, carbon-efficient LED) spotlight on climate-change risk, and permits (nay, requires) trustees to reject fishy transfer applications. Specific details will in most cases be provided by secondary legislation (regulations). For more details of what is—and isn't—in the Bill on the eve of its debut, please read our most recent summary.[12]

News

Furlough scheme extended (again)

The Chancellor of the Exchequer announced on 5 November that the Coronavirus Job Retention Scheme (AKA 'furlough scheme') will be extended until 31 March 2021 for all parts of the UK.[13] Employers can claim 80 per cent of furloughed employees' wages (capped at £2,500 a month) for hours not worked, but are responsible for paying the associated National Insurance and employer pension contributions.

The Job Support Scheme that was set to take over from the CJRS on 1 November, before the resurgence in coronavirus infections and consequential reintroduction of restrictions, has been postponed.

[12] *Pension Schemes Bill enters final stages* <www.hymans.co.uk/media/uploads/Pensions_scheme_bill_enters_final_stages.pdf>.
[13] <www.gov.uk/government/news/government-extends-furlough-to-march-and-increases-self-employed-support>.

And Finally…

At this stage in the earth's orbit around the sun it's traditional for monthly publications to wish their readerships the best for the coming festive period and the new year. But don't hold your breath waiting for *AF* to—we understand that there may be health issues associated with prolonged interruptions to normal respiratory function.

Oh, OK then, rein in the sad-face emojis and Ebeneezer Scrooge comparisons. The shade of Jacob (or was it Bob?—there was wailing) Marley and the Ghosts of Christmases Past, Present and Oh-Please-Don't-Let-This-One-Be-Indicative-Of-Things-Yet-To-Come have dropped by and persuaded us (through subtle arguments, magical glimpses of moments in time, and judiciously induced episodes of abject existential terror) to mend our ways:

A Merry Christmas and a Happy New Year [*Editor's note: other religious and cultural traditions are available*] to all our readers…

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