Summary
• Most DB schemes will have a cap on inflationary increases.
• The decision to offer discretionary increases often lies with the scheme sponsor rather than trustees.
• Trustees will need to have a clear communication strategy in place to explain below-inflation increases to members.

A question of discretion

Should defined benefit scheme trustees and their sponsors award discretionary increases to pensioners? Maggie Williams explores the pros and cons

With RPI inflation running at an eye-watering 12.6 per cent in September 2022 and CPI not far behind at 11.1 per cent, retired defined benefit (DB) pensioners will be feeling the pressure of the cost of living as much as the rest of us.

But while employees can put pressure on their employers to pay higher wages, when it comes to pension increases pensioners are entirely at the mercy of their scheme's rules, along with the discretion of trustees and sponsors.

Years of low inflation came to a screeching halt in 2022. During those years, trustees would have been able to make pension increases in line with RPI or CPI with few concerns. Pensioners who are entitled to inflationary increases would also have become used to seeing their payments go up accordingly in line with RPI or CPI.

This year will be different. Trustees and sponsors will need to make difficult decisions about whether to award costly inflation-matching increases. "Trustees are very sensitive to this situation," says Sackers partner, Fuat Sami. "They have members' best interests in mind and they are aware that the cost of living is hitting pensioners' standard of living."

But, while trustees may want to support pensioner members as best they can, the decision is not entirely in their hands.

"The way that benefits are linked to inflation will vary between schemes," says Hymans Robertson partner, Laura McLaren. "Most private sector DB schemes that allow for inflation-linked benefit increases cap these at 5 per cent or lower, and some may have elements of pension accrued before 1997 that receive no guaranteed increases."

"With inflation running relatively low until now, this is an area that may not have been considered for many years. In most cases there will not be a well-articulated policy in place," adds McLaren.

Awarding a discretionary increase above a cap will also depend on scheme rules. "Trustees will need to know who has the power to award discretionary increases," explains Zedra Governance client director, Melanie Cusack. "Sometimes trustees alone can make that decision, but more typically it also involves the sponsor. And, even if trustees have that power, they should check with the sponsor as this could affect wider funding decisions."

Convincing sponsors to fund discretionary increases is likely to be a tough battle. "Employers also have to focus on their current workforce and how they are struggling in the current environment. They need to be seen to be acting fairly, and former employees may be lower down on their priority lists," says Sami.

WTW head of UK corporate pensions consulting, Bina Mistry, explains that, despite the sensitivity of the topic, "we are seeing significantly more schemes considering a review of discretionary increases, or at the very least trustees making requests for a review".

However, the outcome is rarely falling in pensioners' favour. "Schemes and sponsors that are awarding discretionary increases are in the minority," says Mistry. "Sponsors and trustees have to think carefully about their funding positions, past practices and future strategy. There are also accounting considerations for sponsors as discretionary increases could result in an unplanned hit to corporate profit and loss figures."

"Of the few schemes where we are seeing some consideration of discretionary increases, there are usually scheme-specific circumstances at play," says McLaren. "For example, discretionary increases might have been awarded historically, or the scheme is very well-funded with a strong sponsor."

A question of surplus

A rare positive outcome from late 2022's market instabilities was the improvement in many scheme's funding positions. Schemes targeting buyout got closer to their goal, and some even found themselves in surplus. Could that provide a source of funding to top up pensioners' incomes?

"This is a tricky conversation for trustees," says Cusack. "Where schemes have become better funded or in surplus, should they use that money to top up pension payments, or work towards an existing end goal such as buyout?"

Where schemes are planning to buyout, a lot will also depend on their position in that journey. "If a scheme hasn't yet committed to buyout but plans to do so in the future, they may not know the costs involved. They might not want to commit to discretionary increases until that picture is clearer," adds Cusack.

"Focusing on buyout is likely to be a stronger target for many DB schemes," confirms Mistry. "While schemes are genuinely considering increases, the current funding regime and The Pensions Regulator's focus on strengthening positions will mean schemes need to be cautious."

"Schemes with buyout targets may be less inclined to add to their liabilities before they reach that point. Any discretionary benefits that the trustee and company want to insure with surplus at the point of buyout will need to be codified and these will then become guaranteed," adds McLaren.

The strength of the employer covenant is another factor to consider. "Unless there is a strong employer covenant, a discretionary increase could impact the wider strength of the scheme," says Sami.

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Balancing buy-ins

As part of their de-risking journeys, many schemes will have carried out buy-ins for tranches of their pensioner populations, but McLaren says trustees should still be able to manage discretionary increases in the same way for all groups. "It's unlikely that members within the same scheme would be treated differently just because the trustees have secured their benefits with an insurance policy. After a proposed buy-in transaction the trustees will still retain the right to exercise their discretions in line with the scheme rules."

However, she cautions, "it could create some mismatch between the benefits insured and the benefits paid to members that would need addressed if the scheme was to move to buyout in future. If members have routinely been awarded discretionary increases, it would typically be reasonable to take this into account when deciding what benefits to secure."

Breaking the news

Many pensioners will have become used to receiving annual increases in line with inflation, so a 5 per cent or similar cap could come as a shock. "We will see pensioner members coming to trustees and asking about inflation without wider knowledge of the scheme's position," says Mistry. "Trustees will need to make sure they have done their due diligence and know how they will respond to members' questions."

"Communications are going to be very important and there is a balance to achieve between being transparent with members and not causing unnecessary concern," says Cusack. "Pensioner members will be feeling stretched, but are unlikely to have the bigger picture around the sponsor's and scheme's other priorities such as buyout and securing benefits in the long term."

"Trustees will need to be more sensitive in their letters about pension increases than they have been in the past," confirms Sami. He recommends: "Be clear about the level of increase that is being paid, and why. Explain the trustees' duties and how increases are being paid in line with scheme rules. Some trustees may want to pre-empt enquiries and explain their decision before the increases are applied – but that is going to be a decision for individual schemes. Others might prefer to remain silent and address members' questions on a case-by-case basis."

With many trustees, sponsors and pensioners dealing with the prospect of below-inflation pension rises for the first time in many years, deciding whether to award a discretionary increase above scheme rules will be a challenging question for most DB schemes. The outcome has potential long-term consequences for scheme funding, but in the short term it will also require careful communications with members, as they struggle to make ends meet.

Written by Maggie Williams, a freelance journalist