

Letter 1

Thank you for your email of 12 August on behalf of a number of your constituents about the indexation of pre-1997 defined benefit pensions.

It might be helpful if I first explain the reason for the differences in the indexation requirements for defined benefit pension rights earned before and after 1997. The Pensions Act 1995 provides for workplace pension schemes to increase that part of the pension in payment built up on or after 6 April 1997 by the annual percentage increase in inflation or 5 per cent, whichever is the lesser. This requirement is known as limited price indexation.

The Pensions Act 2004 introduced changes that reduced the level of the cap for pensions paid by defined benefit pension schemes from 5 per cent to 2.5 per cent, but only for benefits built up on or after 6 April 2005.

Prior to the introduction of the Pensions Act 1995, mandatory indexation applied only to certain rights in contracted out schemes. When limited price indexation was introduced to cover workplace pensions generally, including non-contracted out pensions, the requirement was not backdated to cover all pension rights accrued in the past.

Changes to pensions are not normally backdated (in the sense of applying to existing pension rights), but only apply to benefits that are built up following the change. The reason for this is that it is generally seen to be unreasonable to add liabilities to pension schemes that could not possibly have been considered in the funding assumptions that determined the contributions to be paid at the time.

This remains the case today, if the Government changed the law to require schemes to now pay indexation on pre-1997 accruals, this would be a retrospective change. The amount of additional liabilities that would be added could be very significant. In some cases, the additional requirement may be a significant burden to the employer, putting its business operations, and ultimately the pension scheme, at risk.

However, there is nothing that prevents schemes from making more generous arrangements through the scheme rules. If the scheme rules provide for increases on pensions in payment earned before April 1997, those increases must continue to be paid.

Some schemes can and do provide additional indexation on a discretionary basis. In some cases, these discretionary increases may be paid on a regular basis but are not part of the pension package promised by the employer. Whether or not such discretionary increases are paid is a matter for the scheme trustees and the sponsoring employer.

The Government's role is to ensure that the fundamental promise of the defined benefit scheme, as set out in the scheme rules, is met.

The rules relating to defined benefit pensions inevitably involve striking a balance between the level and security of members' benefits and employer affordability. The minimum requirements have to be appropriate for all defined benefit schemes and for all sponsoring employers of those schemes.