GMP equalisation through conversion: resolving the deferred member carve-out

Update for pension schemes with guaranteed minimum pensions

July 2021

Pension briefing

HIGHLIGHTS

- Most defined benefit (DB) pension schemes in the UK are required to equalise for the unequal effect of guaranteed minimum pensions (GMPs) on men and women.
- Existing legislation permits GMPs to be converted into other scheme benefits so that they no longer have to be provided in accordance with GMP rules. One approach to equalising for unequal GMPs involves using conversion.
- GMP conversion raises potential tax problems for deferred members by causing them to fall outside the *"deferred member carve-out"* (DMCO). Deferred members who fall outside the DMCO risk becoming liable to an annual allowance tax charge.
- Our solution to these problems is to treat the member's GMP and non-GMP benefits ("*excess over GMP*") as two separate *"arrangements"*. The member is then a *"pre-A day deferred member"* in respect of the GMP arrangement, meaning that the annual allowance regime does not apply to the GMP.

In this briefing, we explain how the DMCO tax issue could arise and our approach to dealing with this. The effect of our solution is that deferred members will not become liable to pay an annual allowance tax charge upon GMP conversion – making it a more attractive method of equalisation.

INTRODUCTION

Following the *Lloyds* case, occupational pension schemes have begun to address the process of equalisation for the effect of guaranteed minimum pensions (GMPs) providing different benefits for men and women.

There are different possible methods of equalisation, one of which is GMP conversion (please see the box below). One line of thought in the industry is that upon GMP conversion, deferred members could become liable to pay an annual allowance tax charge. This has made GMP conversion a less popular method of equalisation.

For an explanation of why GMPs result in unequal benefits for men and women, please see Appendix I.

Further details of the *Lloyds* decision, and explanations of the different methodologies for equalising GMPs, are set out in Appendix II.

GMP conversion

Trustees have a statutory power to convert GMPs to regular scheme benefits which are not subject to the special GMP rules. Several safeguards apply, including the following.

- GMPs must be replaced with benefits at least actuarially equivalent to the pre-conversion benefits.
- Conversion of GMPs to money purchase benefits is not allowed.
- Pensions in payment may not be reduced.
- The employer must consent to the conversion.
- The affected members must be consulted.

Some commentators had doubted that the legislation permitted the conversion of survivors' benefits in payment at the conversion date. Helpfully, the judge in the *Lloyds* case ruled that the legislation is not defective in this way and that it allows survivors' benefits to be converted.

Glossary

Arrangement:

- A concept in pension tax legislation meaning any contract, agreement or arrangement for the purposes of which a scheme holds sums and assets relating to an individual member, and under which benefits are provided.
- There may be multiple arrangements in a single scheme relating to an individual, and there are no limits on how many arrangements a member can hold under a scheme.
- For the purposes of our approach to GMP conversion, the member's GMP and the excess over GMP are treated as separate arrangements.

Pre-A day deferred member: a member who became a deferred member under an arrangement before 6 April 2004 (A-day). The annual allowance regime does not apply to an arrangement where the member is a pre-A day deferred member.

BACKGROUND: ANNUAL ALLOWANCE CHARGE

If the value of a member's accrual across all their pension schemes during a tax year exceeds the annual allowance, they will become liable to an annual allowance tax charge payable at their marginal rate of taxation. For most members, the annual allowance is £40,000 (plus any unused annual allowance carried forward from the previous three years).

Revaluation of deferred benefits

For defined benefits (DB), the value of a member's rights at the end of the tax year must be compared to the value of those rights at the start of the year. Because of revaluation, deferred DB rights usually increase in value each year, even though the member is no longer in active service under the scheme.

Revaluation of deferred DB benefits usually falls outside the scope of the annual allowance charge because either:

- The member is a pre-A day deferred member (please see the Glossary) in respect of the arrangement; or
- The revaluation is within the limits of the deferred member carve-out (DMCO) (please see the box below).

What is the deferred member carve out (DMCO)?

For the DMCO to apply, a deferred member must meet two conditions:

- The member must be a deferred member during the whole tax year (with very limited exceptions); and
- The increase in the "*relevant rights of the individual*" in the arrangement during the tax year must be less than or equal to the "*relevant percentage*" plus the "*relevant statutory increase percentage*".

The "*relevant rights of the individual*" means the value of the member's benefits in the arrangement *excluding* their GMP.

The "*relevant percentage*" is, broadly, the rate of revaluation set out in the scheme rules or (if the scheme rules are silent) uncapped CPI.

The "*relevant statutory increase percentage*" is, broadly, an increase attributable solely to one of the following statutory increases:

a) Late retirement factors applied to the GMP;

b) Revaluation of the GMP;

c) Revaluation of the excess;

d) An anti-franking uplift; or

e) Application of the statutory sex equality rule.

ANNUAL ALLOWANCE: ISSUES FOR GMP CONVERSION

There are many options available for a scheme using GMP conversion, ranging from leaving members with broadly the same benefit structure as pre-conversion, to approaches that involve significant benefit re-shaping. (For examples of benefit re-shaping which schemes may choose to adopt, please see the box below.)

The shape of converted benefits: examples

Examples of benefit re-shaping which schemes may adopt on GMP conversion include:

- Applying scheme rules on revaluation and increases in payment to the whole of the member's benefits, including the former GMP.
- Converting all pre-1997 benefits, both GMP and excess over GMP, to flat rate pensions (since legislation does not require pensions accrued before 6 April 1997 to be increased). This would result in higher starting pensions.
- Choosing a single pension increase date on which to increase converted benefits in payment for all members.
- Deciding a single age at which converted benefits (both former GMP and former excess over GMP) will be payable.
- Under GMP rules, male pensioners who retire before age 65 should receive an uplift when their GMP comes into payment at age 65. Post-conversion benefits could be structured to remove this step-up.

In the year of GMP conversion

When equalising for GMPs using conversion, the GMP is replaced with a regular scheme benefit. The result is that a member's non-GMP benefits (the "*relevant rights of the individual*") increase by the value of the former GMP, plus the value of any equalisation uplift.

The equalisation uplift does not impact the DMCO, as it results from the application of the statutory sex equality rule and so is an increase falling within the "*relevant statutory increase percentage*". However there are some difficulties with arguing that the part of the increase representing the value of the former GMP comes within either the "*relevant percentage*" or the "*relevant statutory increase percentage*".

This means that, in the year of GMP conversion, deferred members will fall outside the DMCO and some may incur an annual allowance tax charge.

In subsequent years

In each tax year after the year of conversion both the former GMP and the former excess will comprise a member's "*relevant rights of the individual*" for the purposes of the DMCO.

Following conversion, where a scheme retains fixed rate revaluation and/or statutory late retirement factors for the former GMP, further annual allowance issues can arise:

- Post-conversion, the combined revaluation of the former GMP and former excess would usually be more than the "*relevant percentage*". Since the former GMP is no longer subject to the statutory GMP requirements, the revaluation increase is not clearly "*attributable solely to*" statutory revaluation. It follows that revaluation increases to the former GMP are likely to be outside the "*relevant statutory increase percentage*".
- This means that, in each year following conversion, deferred members may continue to fall outside the

DMCO and, again, may incur an annual allowance tax charge.

OUR SOLUTION TO THE DMCO ISSUE

Step 1: separate arrangements

A member's GMP and excess in the scheme can be regarded as two separate arrangements (please see the Glossary above) if the facts and the scheme rules support this. This should usually be the case: GMP and excess are calculated differently under scheme rules and legislation, and most administrators maintain separate records of the two benefits.

Step 2: pre-A day deferred member in respect of GMP arrangement

GMPs ceased to accrue in 1997, so all members with GMPs became deferred members of their GMP arrangements in 1997 (or earlier, if they had previously left pensionable service). Deferred members with GMPs are therefore pre-A day deferred members (please see the Glossary above) in respect of their GMP arrangement. It follows that the annual allowance regime does not apply to the GMP arrangement.

Step 3: DMCO in respect of excess arrangement

We would expect most deferred members to fall within the DMCO in respect of their excess over GMP arrangement.

However, if the scheme provides certain benefits such as a final salary link for members still in service with the employer, or an enhanced revaluation link, any members currently accruing such benefits will not be "deferred members" and will therefore fall outside the DMCO.

Step 4: GMP conversion and equalisation

Benefits in the member's GMP arrangement are converted to non-GMP benefits.

A member will remain a pre-A day deferred member in respect of their former GMP arrangement provided that they do not accrue any benefits in this arrangement after A-day.

At the same time as GMPs are converted, future benefits are equalised for the effect of GMPs (Method D2 – for details please see Appendix II). Any uplift required to equalise a member's benefits will be added to the member's excess over the former GMP.

Annual allowance – year of conversion

For annual allowance purposes, in the year of conversion:

- The equalisation uplift will increase the member's excess over the former GMP arrangement. As the uplift arises from the application of the statutory sex equality rule, it falls within the *relevant statutory increase percentage* (please see the box on the DMCO above) and so the DMCO continues to apply.
- So long as there is no benefit accrual in the former GMP arrangement, the member remains a Pre-A Day deferred member in respect of this arrangement.

Annual allowance – subsequent years

In subsequent years:

- Provided that the member accrues no further benefits under the former GMP arrangement, the member will remain a Pre-A Day deferred member, meaning that the arrangement continues to be outside the scope of the annual allowance. The member can benefit from revaluation, application of late retirement factors (where applicable), plus increases when in payment without losing this status.
- Pension from the excess arrangement (including any equalisation uplift) will revalue in deferment in accordance with the scheme rules (or statutory revaluation if there is no revaluation rule). We would expect this revaluation to fall within the *relevant percentage* for annual allowance purposes, meaning that the DMCO will continue to apply.

CONTACT US

We would be pleased to speak to employers or trustees who would like to discuss GMP conversion or any other aspect of equalising for the effect of GMPs. For further information, please contact one of the pension partners listed at the end of this note.

APPENDIX I: WHAT IS A GMP AND WHY ARE THEY UNEQUAL?

Defined benefit (DB) pension schemes that were contracted-out of the State Additional Pension (SERPS) in the period from April 1978 to April 1997 are required to provide members with a minimum level of pension (known as the Guaranteed Minimum Pension – GMP). The GMP replaces part or all of a member's SERPS entitlement.

GMPs, like SERPS at the time, were calculated differently between men and women in that:

- the age at which GMP becomes payable (GMP Age) is 60 for women but 65 for men; and
- women earned GMP at a faster rate than men.

Women's state pension age started to be equalised upwards from 1997. However, no changes were made to GMP Age, meaning that the inequalities between men and women entitled to GMPs remain hard-coded in legislation.

The *Barber* judgment

Following the European Court's May 1990 decision in the *Barber* case, most schemes took steps to equalise normal retirement ages (NRAs) between male and female members. Commonly, this meant increasing women's NRA to 65, to match the male NRA. This usually meant that overall benefits at the date of retirement, or leaving pensionable service, were equal for men and women (typically, a pension of $1/60^{th}$ of final salary for each year of pensionable service, payable from age 65).

Unequal benefits and the "cross-over" point

The statutory GMP requirements, combined with the effect of the particular scheme's rules on any benefit in excess of the GMP, mean that a male is unlikely to receive exactly the same pension in payment as a female comparator.

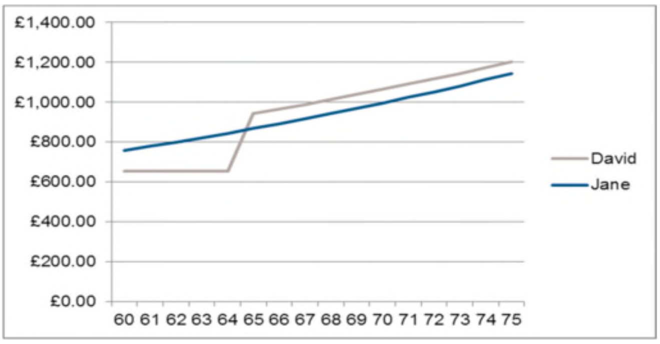
The chart below illustrates how benefits can differ between comparable male and female members – with the female receiving higher benefits between 60 and 65 and then being overtaken by the male at some point after he reaches GMP Age.

Differences can arise because:

- a man who leaves pensionable service before GMP Age will have his GMP revalued for a longer period of deferment than an equivalent woman who leaves pensionable service at the same age;
- a woman's GMP will be subject to statutory increases from age 60, while the GMP of her male comparator will only be increased from age 65;
- the notoriously complex "anti-franking" requirements of legislation (please see the box below), can result in differing treatment of male and female benefits.

The level and severity of the difference in treatment between men and women varies from scheme to scheme, depending on a number of factors – the most important being:

- how a scheme's rules increase pensions in payment;
- whether there is a period of deferment before the pension comes into payment (and, if so, what revaluation is applied in deferment); and
- the scheme's administration policy on anti-franking (please see the box below).



Anti-franking and GMPs

A member whose accrued right to pension is greater than the level of his/her GMP, will have rights to both the GMP and to the "excess over GMP". If the member leaves pensionable service before reaching GMP Age, the GMP must be revalued (protected against inflation) in line with statutory requirements.

"Anti-franking" legislation protects the member's deferred benefits – by ensuring that the growth in the GMP cannot simply be offset by making a corresponding reduction to the member's excess over GMP.

The anti-franking provisions are highly complex.

WHAT HAVE SCHEMES PREVIOUSLY DONE TO EQUALISE GMPS?

In practice, schemes have usually only sought to equalise for the effect of GMPs if the scheme was in winding up or was entering the Pension Protection Fund (PPF).

Otherwise, very few "ongoing" schemes have attempted to deal with inequalities caused by GMPs – most are aware of the issues but have been waiting for answers as to how to achieve equality (recognising that GMPs themselves cannot be equalised unless the legislation changes).

Schemes winding up needed to consider how to adjust benefits (both past and future) to reflect unequal GMPs and those that made any adjustment tended to adopt a rough and ready approach adjusting only future benefits. This was seen as a pragmatic approach to an insolvable problem.

Where schemes of insolvent employers enter the PPF, adjustments are made to compensation according to the PPF's methodology and adjustments are made to correct past underpayments resulting from GMP inequality.

APPENDIX II: THE LLOYDS BANK CASE

In July 2018, the High Court heard an application brought by the trustee of some of Lloyds Bank's pension schemes seeking directions as to whether and, if so, how the schemes should adjust benefits to compensate for the inequalities of GMPs.

The judge was presented with the unenviable task of deciding whether there is a correct way to adjust benefits, or whether several different methods would be acceptable. He was also asked to consider what needed to be done regarding back-payments where members had been underpaid (including for those who had transferred out of the scheme).

Judgment was handed down on 26 October 2018.

EQUALISATION METHODS

In the *Lloyds Bank* case, four main methods of equalising GMPs (most with their own sub-variants) were presented to the Court. Methods A, B and C are based on the amount (quantum) of benefit paid. Method D, which is the method favoured by the DWP, looks at the actuarial value of male and female benefits.

Method A

Method A broadly speaking involved equalising different parts of the benefits. Method A3 involved equalising each "part" of the pension (GMP plus the pension which was the "excess over GMP") and levelling up each part. This would result in both male and female members receiving more in each year of payment than either would have had without equalisation. Method A is therefore a particularly expensive means of equalisation.

Method A was favoured by the representative beneficiaries.

Method B

Under Method B, each payment of pension (GMP combined with excess over GMP) is equalised, with the member receiving the higher of the benefit each year paid to a male or a female member in otherwise identical circumstances.

Under this method, in the early years of pension payment the female's pension would be higher – so the male pension would be topped up. After the "cross-over" point (please see Appendix I), the male pension would exceed the female, so a female pensioner would receive a top up.

Under Method B, both male and female pensioners would receive greater amounts over the course of their expected retirement than if the benefits had not been equalised.

In *Lloyds Bank*, no one argued that Method B was the right one to adopt.

Method C

Under Method C1, the male pension would be increased to the level of the female pension in the early years of payment but the increase would be treated (for the male) as a credit for early payment. After the "cross-over" point, the male pension would remain at the level of the female pension (by then lower than the male pension) until the accumulated credit had been used up – the second cross over point.

After the second cross-over point, both male and female pensioners would receive the amount of pension payable to a male.

For many schemes, there will be no cross-over members – in which case Method B and Method C will produce the same results.

Under a variation of Method C (Method "C2"), interest would be added to the credit for early payment, resulting in lower overall payments being made than under method C1.

Method C was favoured by the sponsoring employer.

Method D

Method D looks at the actuarial value of the projected income stream (of GMP and excess over GMP) for male and female members and would seek to equalise for the difference in treatment on a "once and for all" basis.

The DWP favoured a variation: Method "D2". Under this method, the actuarial value of benefits of an equivalent male and female member would be calculated, and the higher amount used for conversion into scheme benefits. The converted benefit would all be treated as non-GMP, with the result (in many cases) that the starting amounts of pension would be lower than before conversion. After a "cross-over" point, pension payments would be higher than pre-equalisation for both men and women.

Equalisation methods: what did the judge say?

When assessing the various suggested methods, the judge relied on the principle of "minimum interference" with parties' rights. He concluded as follows.

- Methods A, B, C1 and C2 were all permissible means of achieving equal treatment.
- The sponsoring employer could require the trustees to adopt method C2 as the method which would involve least cost (and therefore the minimum interference with the employer's rights). Similarly, method C2 is the method trustees could use without the employer's agreement to any other method.
- Method D1 was not permissible as it would infringe the rights of the beneficiaries (while other methods would not). Conversion under method D2 would also interfere with beneficiaries' rights, but this is permitted under the conversion legislation. In a second judgment given on 6 December 2018, the judge clarified that method D2 could be used for future benefit payments, while benefits already paid should be equalised using one of methods A, B or C.
- Trustees must make back-payments to make good arrears of underpaid pension, including interest at 1% simple over base rate.
- Scheme rules may limit back-payments to those falling due within the previous six years. Where the rules do not contain such a provision, there is no limitation on how far back arrears must be paid.

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