In Depth

Solving GMP equalisation by conversion

May 2019

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Contents

In a nutshell

In November we published an In Depth entitled **Solving the puzzle – equalising for GMPs** which looked in detail at the implications of the Lloyds Banking Group High Court ruling, and the options available to trustees and employers for pension schemes with Guaranteed Minimum Pensions (GMPs).

This In Depth focuses on a method of equalising GMPs which avoids the need to maintain dual (or multiple) administration records into the future – and allows schemes to remove GMP liabilities through a one-off exercise, by converting GMPs into an alternative benefit in a form chosen by the trustees. The Department for Work and Pensions has recently issued **guidance** on conversion.

Although conversion of GMPs is likely to be popular, there are significant issues to consider and trustees will need to work with scheme sponsors to agree an approach that works for everyone.

Background

In October 2018, The High Court ruled that trustees have a duty 'to equalise benefits for men and women so as to alter the result which is at present produced in relation to GMPs'. Our November 2018 In Depth summarised the background, the court case and the ruling, and the implications for schemes – including the various methods that might be used to equalise. This In Depth builds on our earlier publication and assumes this background knowledge.

Provided employer consent is obtained, one of the options available to trustees as part of the equalisation process is conversion of GMPs into a different form of benefit – this is referred to as 'method D2' in the judgment.

In this In Depth we focus on this conversion option. It is likely to be a popular method for consideration, given the ongoing complexities of the other methods – which will require dual administrative records to be maintained in future in order to achieve equalisation.

Irrespective of the method ultimately chosen, there is a significant amount of preparatory work required. This includes:

- GMP reconciliation and if necessary rectification;
- filling data gaps; and
- understanding scheme practices.

Legislation to permit conversion of GMP (and to set out the requirements) took effect from April 2009. However, the facility has been rarely used historically, partly because of the uncertainty over GMP equalisation that has only recently been resolved by the High Court ruling.

On 18 April 2019 the Department for Work and Pensions published guidance on conversion, which adds further clarity on the requirements. The DWP notes that the guidance will be updated from time to time to reflect any changes to legislation that take place in the future and any material developments in case law. It also notes that the government is considering changes to the GMP conversion legislation to clarify certain issues.

The High Court ruled that trustees have a duty to equalise benefits for men and women in relation to GMPs.

50% of schemes are considering conversion.

Aon Webinar, 4 February 2019

Overview of conversion

Under legislation, GMPs are defined differently for males and females. If GMPs are retained, the only way of equalising accepted by the High Court is to:

- calculate 'dual records' for service from 17 May 1990 to 5 April 1997 – one for the member's current benefits and one re-calculated assuming the member was of the opposite sex (and therefore has the opposite sex GMP and resulting differences in other benefits); and
- pay the higher of the two amounts (perhaps with adjustments for past payment differences – the various options are set out in our November 2018 In Depth).

As an alternative to calculating dual records for members, schemes have the option to convert benefits – removing GMP and the requirement to perform year on year checks. For each member you would value their existing benefits, add on the value of any uplift expected from equalisation, and provide members with a new benefit of equivalent value. As the same benefit can be provided to both males and females this achieves equalisation without the need to maintain dual records to calculate future pension payments.

A High Court supplementary judgment in December 2018 made it clear that conversion of future benefits could be carried out as a single 'one-step' process. There is no need to equalise future payments using one of the other methods as a first step. Conversion can simply be based on the value of the member's benefits including the value of benefits of an equivalent member of the opposite sex for service from 17 May 1990 to 5 April 1997, if higher. The ability to equalise and convert in a single step may offer schemes a cheaper way of implementing equalisation compared to running dual records many years into the future.

Conversion achieves equalisation without the need to maintain dual records.

The big decisions

Whether to equalise using conversion is a significant decision for trustees. Employer consent is required, and employers are likely to want to be involved in the project.

Potential advantages:	Potential disadvantages:
• Removes the administrative complexities that currently apply to GMPs and avoids the significant additional administrative complications that may apply with other methods of equalisation • Could lead to lower technical provisions, for scheme funding • Could lead to reduced settlement costs (eg on buy-out) • Gives an opportunity to simplify benefits • Could lead to benefits which are easier to hedge • Addresses many secondary implementation issues (such as how to equalise member options)	• Significant reshaping of benefits may be required to deliver small equalisation adjustments, or even where no equalisation adjustment is required for one gender (but GMPs are converted to ensure benefits are equal for both genders) • Reshaping benefits could introduce winners and losers depending on how long people live compared to the underlying assumptions. It may be difficult for trustees and sponsors to become comfortable given that member consent is not required. • It may be harder to communicate to members the impact of the changes • Could lead to increased accounting costs • There could be additional pension tax implications • Significant changes could be forced on members

If a decision is made to go ahead with conversion, and the principles underlying the approach to conversion are agreed, there are further issues to consider. The answers will also impact on the data requirements and benefit periods which need to be considered so an early decision may be advantageous:

Who to convert – the exercise could be limited to those members with GMPs accrued between 17 May 1990 and 5 April 1997, or extended to cover all members with GMP (no equalisation adjustment would be required for any GMPs in respect of pre-17 May 1990 service, but those earlier GMPs would still be converted).

If conversion does not apply to all GMPs, this could increase scheme complexity.

The guidance notes that conversion can be carried out for different groups in stages. It also comments that trustees may wish to take advice in relation to members for whom the estimated cost of calculating and implementing equalisation is the same as or greater than the projected additional benefits to which the member would be entitled as a result of equalisation.

What benefits to convert – In addition to GMP, conversion of other benefits may be possible. Legal advice is likely to be required and the answer will also depend on the principles discussed on the next page.

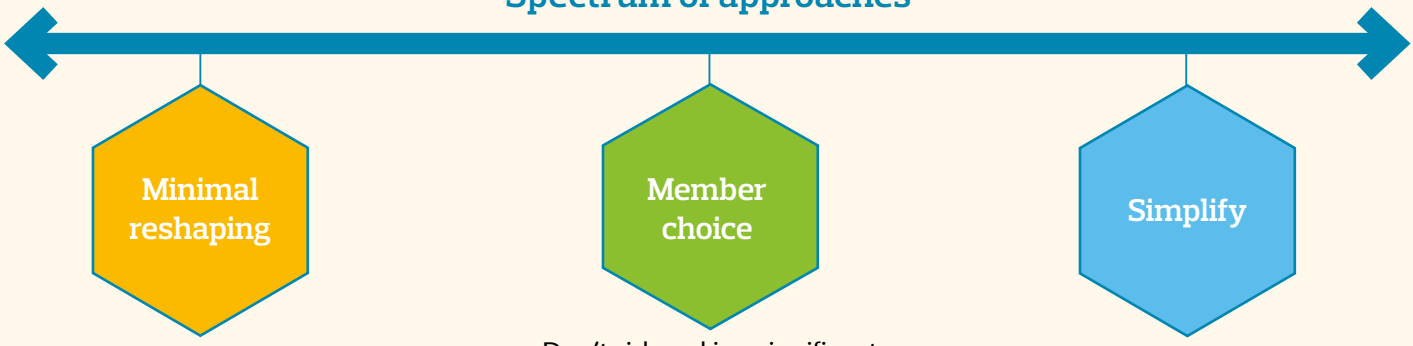
Which benefits to convert to – the answer to this question will also depend on the principles discussed on the next page but the details of the converted benefit structure will need to be agreed.

The approach to conversion may be relevant to the decision on whether the outcome would be acceptable to both the trustees and the employer. There is a range of approaches that might be adopted. The two ends of the spectrum might be described, in principle, as follows:

- **Minimal reshaping** – aim to set new benefits which are as close as possible to current benefit expectations, while achieving equalisation; and
- **Simplify** – aim to use the conversion exercise as an opportunity to simplify the benefit structure.

Legal advice will be needed on whether the proposed approach will satisfy the legislative requirements and any limitations in the rules. As noted on page 10, the legislation allows other changes to benefits to be made which 'the [trustees] think are necessary or desirable as a consequence of, or to facilitate, the GMP conversion'.

Spectrum of approaches



Reshape to the extent needed

Changes still significant for some schemes

Don't risk making significant changes without a member choice available

But tougher admin and bigger implementation task

Single calculation

Focus on admin simplification

But create member winners and losers

Minimal reshaping?

If a decision is made in principle to minimise changes, the impact of conversion will be highly dependent on the current benefit structure of the scheme.

For some schemes it will be possible to achieve post-conversion benefits which for most members are very similar to existing benefit expectations. For other schemes, even minimal changes will involve quite significant amendments for many members.

Member choice?

One way to address the issue of significant change without consent might be to offer members a choice between:

- a converted benefit which is similar to the current benefit expectation, using a 'minimal reshaping' approach; and
- a more radical benefit change using a 'simplify approach' or range of simplified options.

Such a choice would be similar to a Pension Increase Exchange exercise in many ways and consideration of the Code of Practice on incentive exercises is likely to be appropriate.

Simplify?

If the trustees and employer wish to consider simplification of benefits as part of the exercise this may lead to more significant variation from current benefit expectations. This will require serious consideration, particularly given that members are not required to consent to conversion and so would not have an opportunity to reject a proposed amendment that could potentially result in a big change in future benefit expectations. Ultimately, there will be winners and losers, as a result of a significant change in benefit structure.

Financial impact

At the scheme level, the financial impact of GMP equalisation will generally be small – typically less than 1% of liabilities for many schemes, although a handful have seen an impact of up to 4%. However, for individual members the impact can be more dramatic. For a small minority of members uplifts to pensions can be 20% or more.

Where conversion is used, this will have an additional financial impact. Depending on the conversion benefits, the financial impact of conversion may be more significant than the cost of equalising for GMPs.

The employer is likely to want to consider the financial impact of conversion from several perspectives. This is because the impact will be different, depending on the financial measure used. Consideration of the following measures may be necessary:

- Technical Provisions, used for scheme funding purposes;
- The relevant company accounting standard, such as IAS 19;
- The cost of securing benefits with an insurance company; and
- The 'best estimate' cost of providing benefits.

Depending on the form of the post-conversion benefit and the conversion assumptions, conversion could increase or decrease liabilities. It may even lead to an improvement on some measures and a deterioration on others.

For example, a scheme might typically be converting an inflation linked benefit to a benefit with fixed or nil increases. If conversion is on a best estimate basis, any prudence in the inflation linked assumption would be released, leading to a reduction in liabilities.

An example

To illustrate how conversion could have a different impact on different financial measures, we set out a hypothetical example; a pension linked to the Consumer Prices Index (CPI) is converted to a pension with fixed increases. Conversion is carried out assuming future CPI will be 2.25% pa – for simplicity we assume members are provided with an identical pension but increasing at a fixed 2.25% pa post conversion.

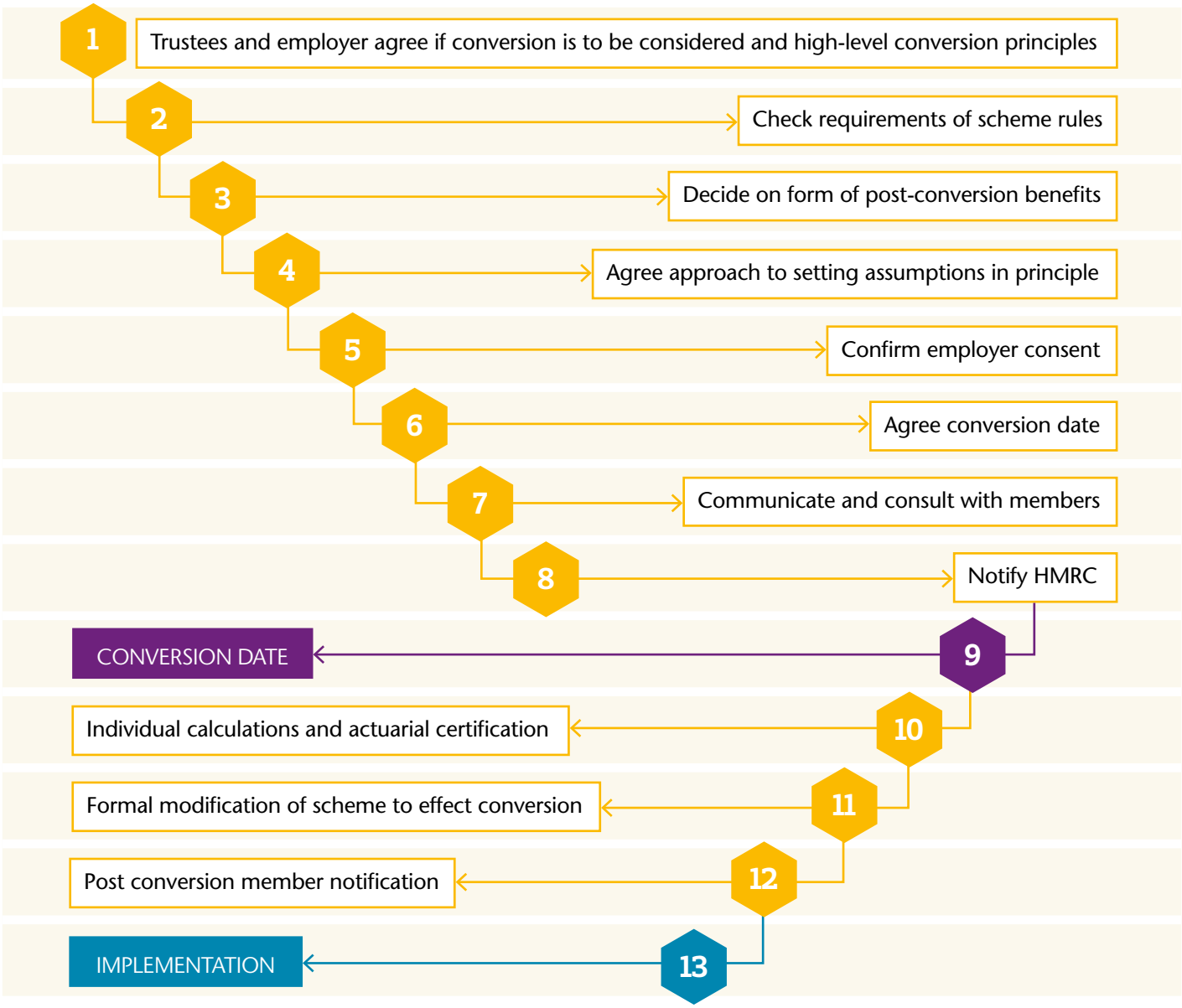
Financial measure	Assumption for CPI in the basis	Impact on converted liabilities of changing from CPI to 2.25% fixed
Company Accounting	2.0% pa	+3%
Technical Provisions	2.5% pa	-3%
Insurance Company buy-out	3.0% pa	-9%

Based on company accounting assumptions, future increases have moved from an assumed 2.0% pa to a fixed 2.25% pa. This results in an increase in the value of the benefits converted by around 3%. However, for Technical Provisions the 2.25% pa fixed increases are lower than the 2.5% pa that had been assumed and so there is a reduction in the liability value. The impact on the insurance company buy-out assumptions is even more pronounced, as the (hypothetical) CPI assumption was higher.

This simplified example is intended to demonstrate only that converting from inflation linked to fixed increases can have a range of financial impacts, depending on the basis under consideration.

The conversion process

There is a significant amount of work to complete prior to the conversion exercise, such as filling data gaps and confirming benefit specifications. Our section on project planning at the end of this In Depth provides further information. Once this is done, the conversion process can begin.



Once decisions are made in principle on the approach to be adopted, who will be included in the exercise, and the benefits to be converted there is a strict process to follow.

Our understanding of the key steps in the process are set out overleaf, based on the 2009 legislation and the latest guidance. Trustees should liaise with their scheme actuary and legal adviser to ensure all the necessary steps have been complied with.

We have not attempted to cover schemes in wind-up, to which special provisions apply.

Complying with scheme rules

Trustees should check the requirements of their scheme rules and consult their legal advisers.

It may be possible to make the conversion modification under scheme rules (and the conversion legislation disapplies the modification restrictions set out in s67 of Pensions Act 1995 where the modification is carried out under scheme rules).

Alternatively, trustees have a legislative power to modify schemes by resolution to permit GMP conversion – although using this power expands on the consultation requirements – see 'Communication and consultation with members' on page 11.

In either case, legislation allows any other changes to be made which '[the trustees] think are necessary or desirable as a consequence of, or to facilitate, the GMP conversion'.

Deciding on the post-conversion benefits

The trustees will need to decide on the form of benefits to be provided post conversion. The employer is likely to be interested in this decision as it may have a financial impact.

The legislation imposes certain restrictions on the form of benefit that can be provided post-conversion:

- Post conversion benefits must be at least actuarially equivalent to pre-conversion benefits;
- Pensions currently in payment cannot be reduced;
- Money purchase benefits cannot be created by the conversion process; and
- Survivor benefits must satisfy certain conditions – broadly these require a pension of at least 50% of the member's pension entitlement, in respect of post-conversion benefits, where a survivor's pension would have been payable under legislation in respect of GMP for that contracted-out service. Detailed consideration may be required – for example, where a scheme pays a survivor pension of less than 50% in circumstances where a GMP pension would be payable under legislation.

There are also restrictions on the benefits that can be taken into account – for example, the actuary must ignore discretionary benefits that might be awarded in future, when providing a certificate of actuarial equivalence (see page 12).

The form of post-conversion benefit that works best will depend on the original benefit structure and also the approach being adopted to conversion – minimal reshaping or simplify.

Deciding approach to setting assumptions for actuarial equivalence

The trustees will need to decide on the approach to setting assumptions for actuarial equivalence.

Actuarial equivalence is determined by the trustees, having obtained and considered advice from the scheme actuary about what assumptions are appropriate at the conversion date. The trustees must choose the assumptions and must then ask the scheme actuary to calculate the actuarial values of the post-conversion benefits and the pre-conversion benefits. In practice, it is likely to be necessary to confirm the approach to setting assumptions in advance of the conversion date, so that employer consent can be obtained.

The trustees will need to discuss the impact of the assumptions to be used with the scheme actuary. The employer may also want to contribute to the discussion, as the assumptions will impact on technical provisions and company accounts. Issues which will require consideration include:

- Is the transfer value basis a suitable starting point?
- Are amendments needed for unisex mortality?
- Is the allowance for inflation appropriate (this can have a big impact if inflation linked liabilities are converted to non-inflation linked liabilities)?

Certain assumptions can have a significant impact on the cost of equalisation. For example:

- What allowance should be made for future withdrawals of current active members?
- When should non-pensioner members be assumed to retire?

Although the approach to setting assumptions can be discussed in principle before the conversion date, it may not be possible to confirm final assumptions until financial conditions at the conversion date are known.

The guidance notes that careful consideration should be given to the use of any conversion assumptions which are not unisex, and trustees may wish to seek legal advice on such an approach.

Employer consent

Employer consent is required in advance. It is likely the employers will want to engage with the process both because of the financial impact discussed earlier and due to the impact on current and former employees.

Employers are likely to be interested in the high-level principles, the form of benefit to be provided post conversion and how the conversion assumptions will be determined. They may wish to consider these issues in detail before providing their consent.

Where the scheme is a multi-employer scheme, legal advice is likely to be required, particularly where participating employers have changed over the years. Consent may be required from multiple employers.

Set the proposed conversion date

This will need careful thought. Challenging deadlines follow the conversion date – the actuarial calculations need to be carried out and certification will be required within three months of those calculations being completed. The trustees will need to implement the revised benefits as soon as possible following this certification. A project plan will need to be drawn up, to ensure that all the work can be completed within acceptable timscales and that the post-conversion benefits can be implemented from the conversion date.

Communication and consultation with members

Once a decision has been made to go ahead and the date has been agreed, communication with members will be required.

Trustees must take 'all reasonable steps' to consult 'earners' whose GMPs are being converted, in advance of the conversion. Although the legislation is not completely clear, we suspect this includes actives, deferred and 'own right' pensioners. If the legislative modification power is used (see 'complying with scheme rules' above) dependent pensioners must also be consulted, and trustees may decide to consult with dependent pensioners as a matter of good practice, even if it is not a legislative requirement.

The consultation document for the 2009 conversion legislation explained that all affected members should be given an explanation of the conversion and have an opportunity to make representations to the trustees, before the trustees make the final decision on whether to go ahead with the conversion.

DWP approach to consultation:

The consultation should be at a high level including statements that:

- GMPs are proposed to be converted into non-GMP form, with benefits accrued alongside these GMPs also being adjusted;
- this process will resolve the GMP inequality issue;
- although the process may result in change to benefits, the member will experience no reduction in their overall actuarial value; and
- more personalised information will be made available once calculations have been concluded and benefits adjusted.

The trustees should give details of the person to be contacted if there are any questions or comments.

For deferred members, trustees may need to explain how the process has the potential to reduce the starting amount of pension but that the value of the payments over their expected period of retirement has been independently assessed to be the same before and after conversion.

On the requirement to take all reasonable steps to consult earners, the guidance states that the usual disclosure requirement process for contacting members is likely to be sufficient.

In a November 2016 consultation (which explored some aspects of the conversion legislation that could be improved), the DWP indicated that the pre-conversion consultation requirements could be replaced with one which simply requires the member to be notified before and after the conversion takes place. It noted that this would require a change to primary legislation – but perhaps such a change could be incorporated into the Pensions Bill anticipated shortly.

If a decision has been made to provide members with a choice, for example between a 'minimal reshaping' benefit and a simplified benefit as discussed above, careful thought will need to be given to integrating the legislative requirements for consultation with offering the member a choice of benefits.

The opportunity could be taken to carry out a wider communication exercise with affected members – and this would be essential if members are to be provided with a choice of the benefit shape after conversion.

HMRC notification

HMRC must be notified, that the conversion will occur and of those affected, on or before the conversion date. It is possible that this requirement might be removed, perhaps in the Pensions Bill anticipated shortly.

Conversion date

Once the conversion date is reached the conversion assumptions can be confirmed – based on the principles previously agreed – and the individual calculations and certification can be carried out.

Trustees will need to consider whether it is necessary to place any processes – such as transfer values – on hold between the conversion date and the date on which revised processes based on converted benefits can be implemented.

Individual calculations and actuarial certification

For each member to be converted the pre-conversion benefits (including allowance for GMP equalisation) and the post-conversion benefits must be calculated as at the conversion date. The two benefits will also need to be valued for each member at the conversion date using the assumptions set by the trustees at the conversion date.

The scheme actuary must provide an actuarial certificate for the process to proceed. This needs to certify that the calculations have been completed and that the post-conversion benefits are actuarially at least equivalent to the pre-conversion benefits (on the assumptions selected by the trustees). The certificate must be sent to the trustees within three months of the calculations having been completed. In considering whether a certificate can be provided, the scheme actuary must ignore:

- Money purchase benefits;
- Benefits that have been commuted;
- Amounts that have been paid or became due before the conversion date; and
- Discretionary benefits that might be awarded in the future.

Modification of the scheme to effect conversion

At this stage the decision can be made to modify members benefits, provided the process has been complied with. The trustees should liaise with their legal advisers. Our comments above under 'complying with scheme rules' will also be relevant.

Post–conversion member notification

The trustees must notify all members and survivors affected by the conversion as soon as is reasonably practicable after the conversion date.

The notification should say that the benefits have been converted as at the conversion date. The DWP guidance states that members and survivors should be told what this means in terms of the amount and the shape of the benefit going forward, including the date on which any benefits in payment will change (or have changed). Again, the trustees must take 'all reasonable steps' to notify the members and survivors.

Implementation

The converted benefits will need to be implemented, which will mean changing member records and, for pensions already in payment, may mean amending the amount of pension payable.

The converted benefits will become payable from the conversion date. For pensions in payment, it is very likely that it will not be possible to complete the process and implement a change in pension payments before the next payment date following the conversion date. This issue, and possible solutions, will require careful consideration in the project plan.

Regulator powers

The Regulator has powers to declare a conversion void if the legislative conditions are not complied with. Trustees who fail to take all reasonable steps to ensure compliance with the requirements are potentially liable to civil penalties.

Dealing with past payments

The conversion process deals with future benefit payments. For pensions that are already in payment consideration of back-payments will also be required.

For members with benefits in payment it will be necessary to consider back-payments based on actual benefits already paid to them compared with what they would have received if they were the opposite sex. This is effectively a dual-records style calculation for each member, albeit a one-off calculation rather than an annual test.

Members need to be compensated for back-payments separately from equalising future payments. The conversion regulations do not allow schemes to effectively combine the two into a single benefit change.

As for other equalisation methods, consideration will also need to be given to equalising in respect of historic payments, such as transfer values paid out and death benefits.

For members with benefits in payment it will be necessary to consider back-payments.

Tax issues

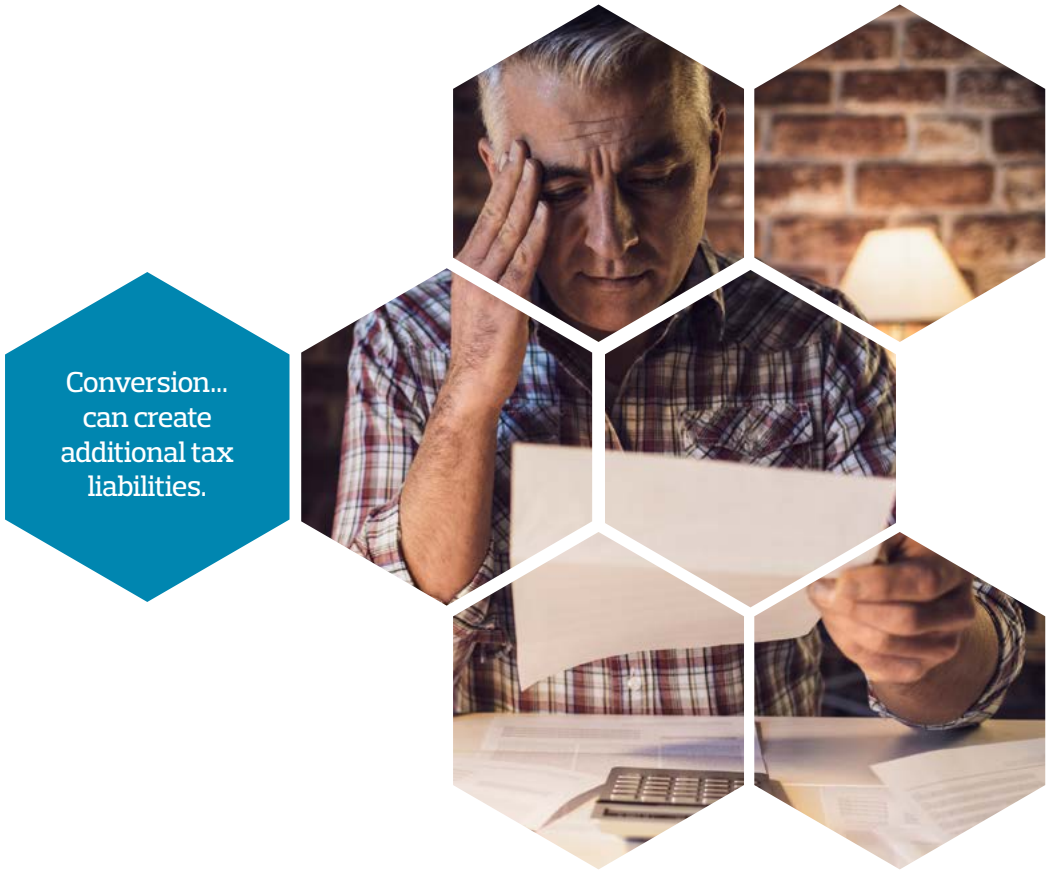
As the conversion legislation does not allow pensions in payment to be reduced, converted benefits for pensioners could be higher than current pension levels, with lower future increases. Benefits that have yet to come into payment might also be reshaped to a higher starting level with lower increases.

These aspects can create additional tax liabilities and other tax issues:

- They could lead to active members (and those within a year after retiring) having a higher pension input amount in the year of conversion, that might cause them to exceed the annual allowance and lead to an annual allowance charge;
- Similarly, they could lead to deferred members (and those within a year after retiring) having a higher pension input amount in the year of conversion, which might cause them to lose the deferred carve-out exemption, exceed the annual allowance and lead to an annual allowance charge (particularly if they are accruing significant pension benefits elsewhere);
- They could lead to active or deferred members suffering lifetime allowance tax charges (and potentially losing enhanced or fixed protection);
- For pensions in payment there could be a BCE3 (ie the increase in pension could be regarded as excessive), potentially leading to a lifetime allowance charge; and
- Deferred members could lose their carve out exemption for future years. This could cause administrative effort for the scheme and the member and may lead to additional annual allowance charges in future years if significant pension benefits are accruing elsewhere.

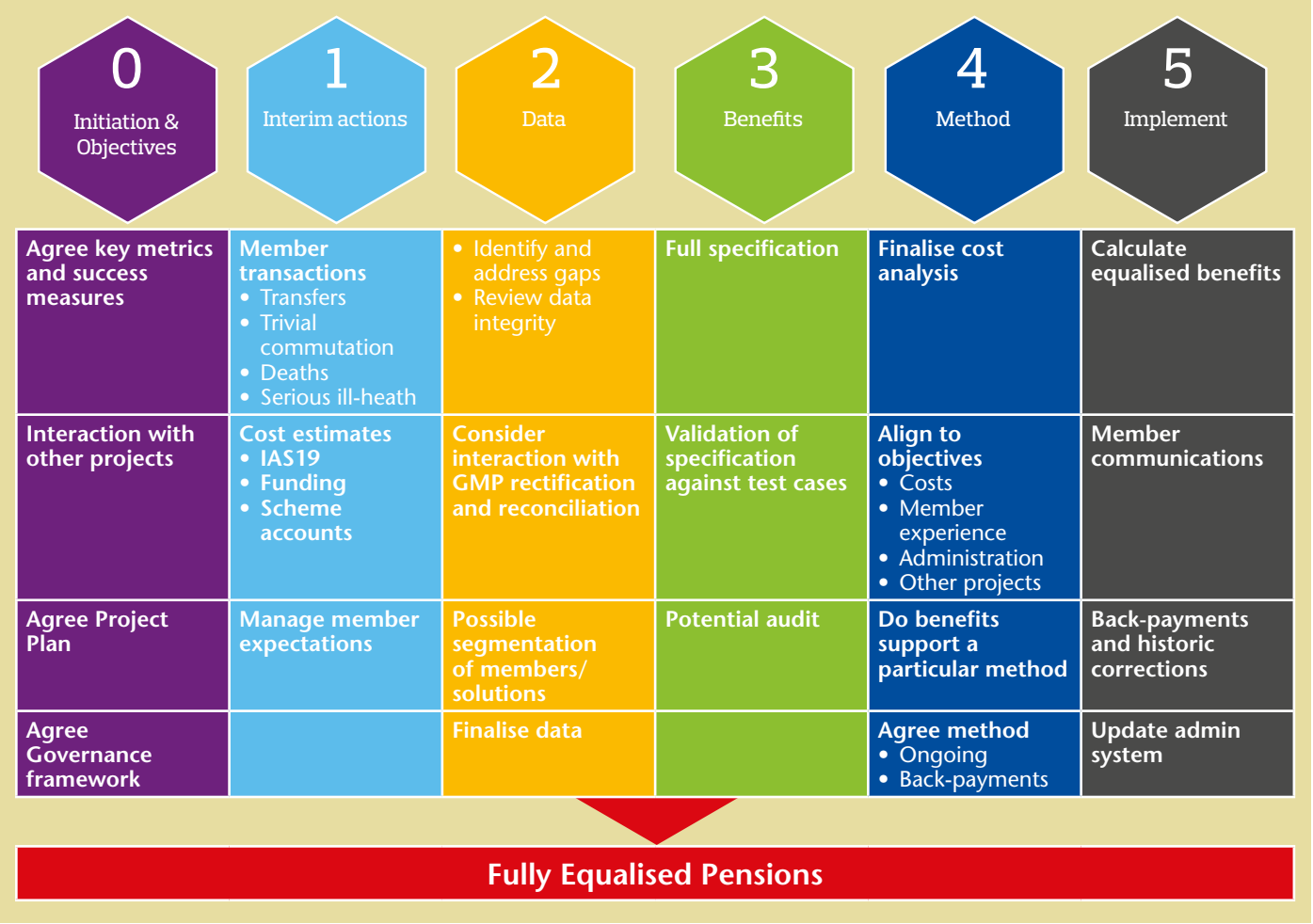
The DWP guidance notes that various tax issues are being discussed with HMRC. HMRC stated in January, in its Newsletter 106, that it will give more information in Newsletters 'in the coming months'. At this stage it is not clear whether any easements might be introduced in respect of conversion.

The conversion approach can be modified to minimise the tax impact of current legislation. However, this is likely to make conversion a more complicated process.



Project planning

Conversion of GMPs is just one potential piece of the GMP equalisation project. A wider overview was set out in our November In Depth, and consideration will also need to be given to how GMP equalisation ties in with other projects, such as GMP reconciliation and rectification. We have been developing detailed project plans with clients – a high level overview of such a plan is set out below.



There is a significant amount of preparatory work that can be undertaken even before a decision on equalisation method, such as conversion, is taken. Most schemes have now addressed immediate concerns over the treatment of member benefit payments that were (or will have been) made prior to the equalisation exercise, and have estimated the financial impact of the default (non-conversion) equalisation approach. The next steps are:

- to assess data integrity, identifying and addressing gaps – GMP equalisation will require data which may not have been used for the day-to-day administration of the scheme for some time; and
- to confirm benefit specifications, potentially considering scheme rules and administration practices – some aspects of the benefit specification which have minimal impact on most members' benefits can be significant for GMP equalisation calculations.

Both of these areas will require consideration irrespective of the method ultimately adopted. By progressing analysis of these areas now, schemes will be in a much better position to implement equalisation in due course.

In addition, carrying out such exercises may have wider benefits – such as reducing the amount of work required for a future buy-in or buy-out.

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Aon's GMP Equalisation team is a 40 strong team of consultants, experts and project support staff.
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