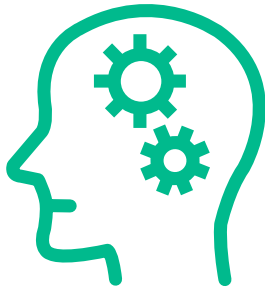


High price inflation and pension schemes



Annual CPI Inflation rose to 9.0% in April 2022 – its highest rate in the last 40 years. The Bank of England predicts no immediate respite is in sight, forecasting that inflation could exceed 10% within the next few months. It could then be at least a further two years before inflation reduces back towards its 2% target.

Most of the recent high profile media coverage of the “cost of living” crisis resulting from high short-term inflation has been focussed on the impact on businesses and individuals.

However, for many of those involved in running defined benefit pension schemes this will also be the first time in a generation they have had to consider the implications of high inflation on their overall strategy, member engagement and day-to-day operations.

Read on for Isio’s view on what this could mean for pension scheme risk management and the members of your scheme.

UK price inflation





Pensions in payment

In most circumstances, pensioners will not see their pensions rise to match price inflation.

Pensioners, who usually receive capped inflationary increases, will likely see a reduction in income in real terms, as their benefits will only increase by a proportion of actual inflation. Those in schemes that receive fixed increases will also see a fall in real incomes, and the hardest hit will be those with non-increasing pensions.

As a result of these potential real-terms reductions, some trustees may want to consider providing discretionary pension increases. They should review the strict legal power to apply such increases (including looking at past practice) and how any increase would align with their long-term objectives. Trustees will typically need to obtain support from sponsors to fund any discretionary increase. However, given the current economic environment, we don't expect many sponsors to agree to such funding requests.

Members approaching retirement

While there are limited options for members receiving pensions that are in payment, those that haven't yet retired have more complex choices. Examples include:

- Postpone any plans to retire to next year in order to capture a deferred pension increase that reflects recent high inflation in full. These members will often benefit from the full inflation increase as the cap on deferred increases applies over the whole period from leaving to retirement. This differs to increases to pensions in payment where caps are usually applied on an annual basis.
- Look to retire early, to access an additional source of income to help manage the cost-of-living increases arising from high inflation. This may be beneficial in the short-term, but will lead to a lower level of income in the longer term as the pension may be reduced to reflect an earlier start date.

Recognising that they can't provide individual advice to members, trustees may want to highlight the implications of high short-term inflation to members. For example, including warning notices on retirement quotes that delaying their retirement for a few months could have a significant impact on the benefits they receive.

However, trustees may equally feel this is inappropriate – prompting members to time their retirement to gain financial advantage may be detrimental to the overall security of the membership and could be viewed as favouring one group of members.

Additional member considerations

High inflation doesn't just affect the pension increases a member receives. Trustees and sponsors should also consider:

- Whether their scheme's approach to calculating transfer values needs to be adjusted to reflect short-term high inflation expectations (particularly for those transferring close to normal retirement age);
- If the scheme's early retirement, late retirement and commutation factors remain fair value; and,
- Where their scheme offers other retirement options (such as a bridging pension, pension increase exchange, etc) that the factors remain appropriate. Also, assumed take up rates could be revisited in anticipation of these options becoming more popular with members.

Where trustees are considering making changes they should be clear on the duration of their expected use (i.e. what would short-term inflation have to get to before they were reviewed again?).

Monitor scheme funding and sponsor covenant



High inflation can create a difficult environment for sponsoring employers. Depending on the sector a sponsor operates in, inflation can drive up costs whilst reducing demand for products or services, or in some cases drive up earnings faster than their cost base.

Trustees and sponsors should be engaging to understand the implications on the business and the resulting impact on covenant strength. It may be that there is pressure on existing deficit contributions, from lower profitability, higher borrowing costs, etc that will lead to a need for discussion or renegotiation. Equally, some trustees may be protected because of inflation linked deficit payments or having triggers that provide additional contributions or security.

Covenant challenges and higher inflation assumptions will push up liability values, but this may be offset by increased interest rates and wider hedging strategies. The overall impact should be considered in the round, looking through an integrated risk management lens and ensuring that robust monitoring processes are in place.

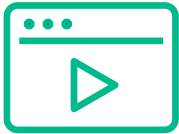
Review investment strategy



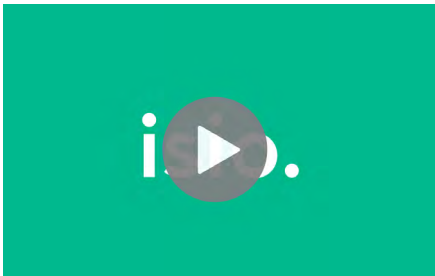
Most schemes will have some level of inflation hedging in place, providing some protection to their overall funding position from high short-term inflation. However, as Isio's Barry Jones points out in his article '[Inflation barks at last but will it bite?](#)', trustees need to consider what's next for the economy and what this might mean for their pension schemes.

Whether the longer-term outlook is a full recovery, or a period of 'stagflation', Barry recommends a few immediate actions for Trustees including:

- ✓ Rebalancing LDI portfolios for changes in schemes sensitivity to inflation;
- ✓ Ensuring schemes have sufficient liquidity available for leveraged LDI funds;
- ✓ Considering increasing hedging where schemes are underhedged; and,
- ✓ Holding liquidity for tactical investment opportunities.



Watch this short 2 minute video from our Chief Investment Officer, Barry Jones, as he provides his views on what inflation means for pension schemes accompanied by his recent article '[Inflation barks at last, but will it bite?](#)'



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