Guaranteed minimum pensions — Equalisation

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Abstract The purpose of this paper is to consider the extent to which there is any legal requirement to equalise guaranteed minimum pensions, and if so the ways in which this might be achieved.

Keywords: *guaranteed minimum pensions, equalisation, contracted out*

Introduction

Prior to 6th April, 1997, occupational pension schemes were able to contract out of the state second tier pension arrangement, the State Earnings Related Pension Scheme (SERPS), on the condition that the occupational pension scheme provided members with a pension of a prescribed amount, which was called the guaranteed minimum pension (GMP). The method of calculating GMPs is laid down in the Pension Schemes Act 1993 and related legislation (the contracting-out regulations). As a consequence of the way in which GMPs are calculated and treated in accordance with the contracting out regulations, the total scheme benefits payable to male and female members for comparable pensionable service are likely to be unequal. This situation is at odds with section 62 of the Pensions Act 1995, which imports an equal treatment rule into occupational pension schemes to the

effect that if the scheme contains a term which is less favourable to a woman than to a man (or vice versa) the term must be amended so that it is not less favourable.

The potentially discriminatory features of GMPs were the basis of a complaint to the Pensions Ombudsman in the *Williamson case*¹ and were subsequently considered by the High Court on the appeal from the Pension Ombudsman's determination in December 2001. The case itself was decided on purely technical jurisdictional grounds. Therefore, the crucial question of whether legislation requires total scheme benefits to be equalised to eliminate the effect of any differences in GMPs (accrued after 17th May, 1990) as between men and women with a comparable pensionable service history has been left open. This question is due to be considered again by the Pensions Ombudsman. However, the complainants are currently awaiting the extension of the Pensions Ombudsman's

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jurisdiction to hear class actions, which is not expected before summer 2002.

What is a GMP?

Background

Between 6th April, 1978 and 6th April, 1997, the UK Government provided a State Retirement Pension in two parts:

- a basic flat rate pension; and
- an additional earnings related pension called SERPS.

SERPS is based on an employee's earnings between the lower earnings limit and the upper earnings limit (band earnings) for each year of the employee's working life. SERPS was latterly targeted at providing a pension equal to 20 per cent of an employee's band earnings over the working lifetime of the employee, the tax years between the employee's 16th birthday and the employee's 65th birthday if male and 60th birthday if female. SERPS accrues over 49 years for a man and 44 years for a woman. The result of this is that SERPS accrues at a faster rate for women than for men.

When SERPS was introduced in 1978, many pension schemes were already providing generous pensions and the Government allowed employers to contract out of SERPS by providing an equivalent benefit under the scheme. (Otherwise in effect the employer would end up paying for SERPS through additional NI contributions on top of the pension benefits it was already providing through the scheme.)

Between 6th April, 1978 and 6th April, 1997, occupational pension schemes could contract out of SERPS if the scheme provided a particular pension to be known as the guaranteed minimum pension, which had to behave in a

certain way. This GMP was targeted to be broadly equivalent to the SERPS which the employee would have received had the scheme not contracted out. Therefore GMPs were designed to replicate the inequality of SERPS. GMPs continue to be targeted at age 60 for women and 65 for men in the same way as SERPS.

How GMPs are calculated

The method of calculating GMPs is laid down in the Pension Schemes Act 1993 and Regulations. GMP figures may be obtained from the National Insurance Contracted-Out section (NICO) when, for example, a member reaches state pension age or a member leaves pensionable service before that.

The actual GMP calculation is complex and depends on various factors, one of which is the age of the member when SERPS was introduced. GMPs are calculated for each member using that member's Band earnings for each tax year. These earnings for each tax year are then revalued in line with National Average earnings and the revalued earnings for each tax year are added together. An appropriate divisor is then applied which effectively spreads the target pension (ie 20 per cent of the revalued earnings) over the employee's working life. So the net result of this is that usually a female member with the same employment record and profile as a male member will have a higher GMP because it is based on a working life up to age 60 and not age 65.

Treatment of GMPs

The Pensions Schemes Act 1993 and the related Regulations also deal with how GMPs must be treated under occupational pension schemes and this has a distorting effect on the GMP.

For example, take a female and male member who leave service at the same age before normal pension date, both of whom are entitled to a deferred pension. The deferred pension is made up of a GMP element and what is referred to as the excess over the GMP, ie, the difference between the GMP and the scale pension. Between the date of leaving and GMP age (60 for women and 65 for men) the GMP element is revalued at the required rate depending on the date of leaving (could be 8.5 per cent, 7.5 per cent, 6.25 per cent or 4.5 per cent for post 6/4/02 leavers — or capped at 5 per cent if a state premium had been paid) while the excess over the GMP is revalued in line with LPI. As set out above, the female GMP is usually higher than the male GMP. This has the result that a greater part of the female member's deferred pension, which is attributable to the GMP, is increased at a higher rate.

Between the ages of 60 and 65, the GMP element is increased/revalued at a different rate as between male and female. For females, their (post-1988) GMP must be increased by the lower rate of 3 per cent or RPI, whereas the whole of a male member's GMP is still being revalued at the required rate (8.5 per cent, 7.5 per cent, 6.25 per cent etc). After 65, the rates of increase are equal as between the sexes, however, the actual increases paid will be different because the rate is applying to a different starting pension. Again, that part of the pension which represents the GMP element will be increased at the lower rate of 3 per cent or RPI, whereas the excess over the GMP will be increased in accordance with the rules of a particular scheme, but subject to a minimum of LPI for post 6/4/97 service. For male members, annual increases between 60 and 65 on the amount of the pension in payment equal to the

deferred GMP which had accrued at 60 may be offset against the amount of the revaluation between age 60 and 65.

The above is a much simplified description of the contracting-out requirements, but is intended to illustrate some of the inequalities which could arise in the calculation of GMPs and their treatment.

GMPs — potentially discriminatory features

The fact that GMPs of men and women are unequal would not of itself have any impact on the total benefits payable under a pension scheme. The GMP is simply a minimum level of benefits that a contracted-out scheme is required to pay to a particular member. In most cases, the actual pension payable under contracted out schemes exceeds the GMP. However, inequalities can result from the way in which the GMP is revalued during deferment (where a member leaves pensionable service prior to normal pension date) or increased after the member has retired, as explained above.

The differences in GMPs would be relatively easy to level up were it not for anti-franking provisions of the contracting-out regulations. The anti-franking provisions mean that most if not all, of the revaluations and increases must be paid as a supplement to the Member's overall scheme pension.

Lessons from the *Williamson* case

Mr Williamson had asked the Ombudsman to determine among other things a dispute of law as to whether section 62 of the Pensions Act 1995 (the equal treatment rule) requires GMPs to be equalised. (Section 62 gives UK legislative effect to the *Barber*² decision that benefits in respect of service on or

after 17th May, 1990 must be equal for men and women.) An equal treatment rule is deemed to be included in every occupational pension scheme. This means that if the scheme contains a term which is less favourable to a woman than to a man (or vice versa) the term must be amended so that it is not less favourable. As mentioned above, the equal treatment rule is at odds with the requirements of the contracting-out regulations. As a consequence of these regulations the total scheme benefits payable to male and female members for comparable pensionable service are likely to be unequal.

The Ombudsman decided that the equal treatment rule did require the equalisation of GMPs and made the direction that the trustees and the company should 'as soon as reasonably practicable, ensure that GMPs are equalised in accordance with the equal treatment rule'. However, the Ombudsman did not offer any guidance as to how the GMPs should be equalised in practice.

The trustees and the company appealed against the Ombudsman's determination on two main grounds:

- the jurisdiction ground
- the substantive ground that the Pensions Ombudsman was wrong in law to make the direction he did.

Because the Court decided that the appeal succeeded on the jurisdiction ground, there was strictly no need for it to consider the substantive ground (whether or not the Ombudsman was correct in saying that the equal treatment rule requires the equalisation of GMPs).

However, the High Court was asked by Counsel for the Company to consider one aspect of the substantive ground. There are two ways of looking at the substantive ground:

- Does the equal treatment rule require equalisation of GMPs themselves? (The narrow question, which was the Ombudsman's interpretation.)
- Does the equal treatment rule require the equalisation of the total benefits actually payable so as to eliminate the effects of any differences in the calculation and treatment of GMPs and overall benefits? (The broader question.)

In respect to the narrow question, the High Court concluded that GMPs in isolation do not have to be equalised.

Counsel for the Company had made it clear that the Company wished to keep open the broader question of whether the equal treatment rule requires any pension payments to be equalised where the differences relate to GMPs and so this was not considered by the Court.

Is equalisation of GMPs required at all?

The fundamental question is whether equalisation of GMPs is required at all? Does section 62 of the Pensions Act 1995 and/or Article 141 of the EC treaty require equalisation of guaranteed minimum pensions? For these purposes it is assumed that section 62 is not intended to go further than Article 141.

Section 62 Pensions Act 1995

The Ombudsman decided that the equal treatment rule covered GMPs and made his direction that the Trustees and the Company should 'as soon as reasonably practicable, ensure that GMPs are equalised in accordance with the equal treatment rule'.

Also, it seems as if the Government intended that section 62 cover the equalisation of GMPs. Lord Mackay of Ardbrecknish in speaking for the

Government against an amendment that would have expressly permitted the non-equalisation of GMPs for pensionable service after 17th May, 1990 had said: 'The European Court of Justice has made absolutely clear in rulings over recent years, that equality is required for periods of pensionable service from 17 May 1990, the date of its ruling in the *Barber* case. It has ruled that there may be certain exceptions to equal treatment where differences result from the use of sex related actuarial factors or where bridging pensions are payable, and we are providing for those exceptions in clause 56. But it has not ruled that differences may be permitted where they result from GMPs. GMPs do, in certain circumstances, create inequalities. But European law is clear that pensions must be equal for service from the 17 May 1990.' Lord MacKay seems to be saying that EC law is what it is because the ECJ has failed to decide the point.

However, what Lord Mackay went on to say is also quite interesting: 'There can be no doubt that equality must be provided in the overall rate of pension accrued since 1990, but we have concluded that contracted-out salary related schemes should have the freedom and flexibility to make their own arrangements as to how that should be achieved rather than having arrangements imposed on them by government.'

The Court in *Williamson* said that 'whatever section 62 did intend to be embraced by the Equal Treatment Rule it could not sensibly be interpreted as including the equalisation of GMPs'. The argument is that the features of GMPs which lead to inequality between men and women are laid down by statute in provisions passed before (the Pension Schemes Act 1993 sections 13 to 23), and affirmed by regulations (the Occupational Pension Schemes (Contracting-out) Regulations 1996),

made after the passing of the Pensions Act 1995. Against that background it is impossible to construe section 62 as having been intended in effect to modify the statutory provisions relating to GMPs by requiring that GMPs be equalised. It is clear that section 62 did not have any such effect.

The Court in *Williamson* also said that: 'The 1995 Act contains a number of amendments to sections 13 to 24 of the 1993 Pension Schemes Act but one thing it abstains from doing is repealing the discriminatory provisions relating to GMPs which that Act requires of contracted-out occupational pension schemes. In those circumstances, to interpret section 62's equal treatment rule as requiring scheme managers to rewrite the 1993 Act's provisions relating to GMPs so as to eliminate the very discrimination which the 1995 Act appears tacitly to reaffirm involves attributing to the legislature a perverse intention.'

It is not clear whether these remarks are confined to the narrower question of whether GMPs in isolation require to be equalised, or whether they extend to the broader question of whether the overall pension needs to be equalised to eliminate the effect of the differences in the calculation and treatment of GMPs.

European Community law

It can also be argued that the relevant Article in the Treaty of Amsterdam does not require GMPs to be equalised. There are two main arguments.

GMPs are not 'pay' within the definition in Article 119/141 but rather they are in the nature of state social security payments. It was held in the *Defrenne* case³ that benefits under state social security schemes are not pay.

The distinguishing element of such schemes noted in *Defrenne* was (see

paragraph 23 of the decision in *Barber*) that the financing of the scheme is contributed to by 'workers, employers and possibly the public authorities in a measure determined less by the employment relationship than by considerations of social policy.'

As with SERPS, the provisions as to GMPs in any occupational pension scheme are laid down by statute and therefore determined by consideration of social policy rather than by the employment relationship.

GMPs may be unequal but that does not, when the deduction of GMPs from the amount payable under SERPS is taken into account, normally result in unequal treatment. When a member gets to state pension age, the member's SERPS pension (or what would have been the member's SERPS entitlement if the member had not been contracted-out) is calculated but is then reduced by a contracted-out deduction equal to the GMP (or if less the SERPS pension).

If the GMP in respect of a woman is larger than would have been the case in respect of a comparable man, the woman will suffer a larger deduction from SERPS. In determining whether the terms on which the man is treated are less favourable to the man than to the woman, the deduction from SERPS which is a part of the statutory background which the scheme operates should be taken into account and in that context the man is not treated less favourably. It would therefore be wrong to direct equalisation of benefits payable under the scheme when the overall effect of doing so after taking into account the benefits payable under SERPS may actually be to produce an inequality which did not previously exist.

This is a difficult argument to run as any difference between the scheme pension payable to a man and that

payable to a woman in the same circumstances is not necessarily matched by a difference of equal amount in the amounts deducted from the pension which would otherwise be payable under SERPS.

It would seem that the weight of the argument supports equalisation as outlined by Lord Mackay to achieve equality in the overall bill of pensions. The crucial question is, therefore, how this may be achieved.

Ways of equalising GMPs — Preliminary issue

Schemes need to know what they have to equalise: is it the GMP element itself, or can the overall pension be adjusted to the extent necessary so as to eliminate the effect of the differences in GMPs on total benefits?

The issue here is one of transparency; that is to say the extent to which it is necessary to equalise the member's benefits or perhaps even each attribute of a member's benefits eg, pension increases. Section 62 refers to each 'term' while the ECJ cases require transparency in relation to each element of pay.

The High Court in *Williamson* was of the view that GMPs themselves do not need to be equalised. The High Court said that schemes must have regard to the potentially discriminatory effects of the GMP regulations in ensuring that pension payments to members were not discriminatory.

Methods of equalising GMPs

The methods of equalising GMPs include the following:

Method 1

The simplest and most straightforward way would simply be to treat men and women as accruing GMPs on an

identical basis (eg either the male or the female basis). However, such an approach would directly conflict with statutory requirements for the calculation and treatment of GMPs set out in the contracting-out regulations. As the Court in *Williamson* said, 'by what power can the Scheme managers 'equalise the GMPs' so as to change the legislation in this respect and put the man on par with a woman?'

Method 2

Another method would be to compare the pension actually paid to a male and female member (with comparable pensionable service history) on a year-by-year basis and pay the higher amount.

This approach appears to accord with the provisions of section 62 of the Pensions Act 1995 and seems the most sensible. Section 62 appears to modify a rule only insofar as it results in less favourable treatment of one sex, so far as is necessary to ensure that the sexes are treated equally. Insofar as a rule does not have a less favourable effect it would not seem to be affected by section 62. Regulation 14 of the Occupational Pension Schemes (Equal Treatment) Regulations 1995 also proceeds on the assumption that GMPs will remain unequal.

Method 3

Another method, which has been put forward, involves giving the member at retirement the higher starting pension (which a person treated as a female for post-17th May, 1990 GMPs would have) and in subsequent years give pension increases on the basis that the member is treated as a male or female (again for post-17th May, 1990 GMPs) according to which one produces the greater increase in benefit.

In the final analysis, if one proceeds

on the basis that the GMP and the non-GMP part of the pension are wholly different benefits and that advantages of one type of benefit should not be set off against the advantages of a different type of benefit when attempting to equalise, one is driven to equalise both the GMP and non-GMP elements of each pension (ie double upwards equalisation).

However, this does not address the problem of the statutory requirements for GMPs. Furthermore, it treats GMPs as if they were a separate pension (requiring equalisation), rather than a factor to be taken into account in calculating the overall Scheme pension. It also means that the scheme must equalise upwards not only the overall benefit, but both the GMP and non-GMP elements of the overall pension. This 'best of all worlds approach' is likely to result in a pension which is considerably higher than that produced simply by equalising the overall pension.

Other issues

Timing issues

If schemes can achieve equalisation by comparing the pension actually paid to a male and female member (with comparable pensionable service history) and pay the higher amount, then a timing issue arises — that is to say, the point in time when the equality test must be applied. Can schemes attempt to eliminate differences arising as a result of GMPs at a single point in time or do they have to review continually a member's benefits while in payment with the aim of eliminating any difference as those differences arise?

An 'ongoing' method would be to compare continually the benefits as between men and women and then to pay the higher benefits at each point, thus allowing the member to 'switch

sexes' if being a member of the opposite sex would produce higher benefits. Ongoing equalisation will involve maintaining a dual record, a 'Jack and Jill' record, for each member so as to track the benefits at all times from retirement to death. The cost of setting up the programs might be considerable. A large number of different variables would have to be written into the program, each creating a separate field, adding level upon level of complexity. Obviously in a smaller scheme this might have a significant impact on funding.

A 'once and for all' method would involve assessing on actuarial advice whether the member is likely to be better off with their own benefits or the 'opposite sex's benefits and simply pay what appear to be the more valuable benefits. This approach might be suitable in a winding up — the point in time being when the benefits are bought out.

Of course, if it can be shown that there is a point in time after which it is clear that the benefits of one sex are always likely to be greater than that of the other sex; then in this situation there would appear to be little difference between a once and for all approach and an ongoing approach.

Commutation and early retirement and priority on winding up

Although many differences in benefits caused by unequal GMPs can be dealt with by paying additional pensions to the member of the opposite sex, there are situations when this will not achieve the desired result. For example, the effect of section 13(1) of the Pension Schemes Act 1993 is that members may not commute their pension into a cash sum to the extent that their residual pension would be less than their GMP. Where those GMPs are different, then the sex with the higher GMP may not take as

big a lump sum as the opposite sex. Equalisation in this situation (if required) is problematic. Similar issues arise in relation to early retirement. Both of these issues are impossible to address under the scheme and that there should be no need to address them provided that the pre-commutation pension is equalised.

Winding up

Arguably the most difficult problems arise in relation to a winding up of the scheme. If a scheme goes into winding up with a funding deficit, section 23(2) of the Pension Schemes Act 1993 (but not section 73 of the Pensions act 1995) requires GMPs to be paid in priority to other benefits. Obviously this may lead to inequality between men and women in that a female will be in a better position as a result of her sex. There is no obvious way of a scheme remedying this inequality without ignoring the statutory rules.

'Permitted' differences in treatment

Under regulation 13 of the Occupational Pension Schemes (Equal Treatment) Regulations 1995 additional bridging pensions payable by schemes to male members prior to State Retirement Age, to compensate them for the fact that the state pension has not yet come into payment, are permitted. A sensible view would be that 'bridging pensions' is a side issue to the GMP equalisation debate as the bridging pension is an add-on to the scheme pension and it is the scheme pension which would have to be adjusted for GMP equalisation.

Under regulation 14 of the Occupational Pension Schemes (Equal Treatment) Regulations 1995, unequal increases in pensions in payment under the rules are permitted to the extent that

they do not exceed the increase which the woman has got on her GMP (through SERPS) which she would not have got had she been a man. Regulation 14 relates to the scheme pension and this should be treated as an exception to any requirement for GMP equalisation.

It is also appropriate to ignore other types of permitted discrepancy such as those resulting from sex based actuarial factors (see Regulation 15 of the Occupational Pension Schemes (Equal Treatment) Regulations 1995) when equalising to eliminate differences.

De minimis

It will be appreciated that, although the calculation and elimination of differences caused by unequal GMPs can be very complicated, at the end of the day the

actual differences between males and females, particularly on retirement at NRD can be very small indeed. There may be a de minimis level at which differences in treatment are so small so as not to require alteration.

Conclusion

If section 62 does apply to GMPs then it must apply only to the overall pension to be adjusted to the extent necessary so as to eliminate the effect of the difference in GMPs on total benefits, in which case Method 2 is the only sensible approach.

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References

- 1 2001 PBLR Vol. 16, p. 28.
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- 3 80/70 1971 ECR 445.