



# GUIDE TO GMP EQUALISATION AND HOW TO DEAL WITH IT

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# GETTING TO GRIPS WITH GMP EQUALISATION

## NOW IS THE TIME TO GET TO GRIPS WITH GMP EQUALISATION

The High Court ruled in October 2018 that pension schemes with GMPs are under a legal obligation to increase benefits where necessary, to remove the inequality in the way that GMPs treat men and women.

Trustees have been left since then in a state of uncertainty over how – and when – to do that. It is clearly unsustainable that trustees are, every month, not paying pensioners their full entitlement, and the more time that passes, the more difficult it becomes.

Our 'Guide to GMP equalisation and how to deal with it' (the Guide) brings together all of our thinking on this issue in a single place. In the following pages, the Guide:

- provides a plain English background to the issue by explaining what GMPs are and why GMP equalisation is a problem for pension schemes;
- outlines the key points from the High Court's judgments in *Lloyds Banking Group Pensions Trustees Ltd v Lloyds Bank Plc & Ors* and explains what the judgment means for trustees of pension schemes that contain GMPs;
- sets out the main points from guidance issued by the Department for Work and Pensions (DWP) and HM Revenue & Customs (HMRC) on GMP equalisation and what this means for trustees; and
- highlight next steps for trustees who are dealing with or getting ready to deal with GMP equalisation.

In addition, the Guide sets out contact details for Gowling WLG's GMP equalisation experts and provides a useful glossary of key terms and a timeline of the main developments in the long journey towards GMP equalisation.

GMP equalisation will only go away when trustees address it, and they need to do so in order to be compliant with their legal duties. If handled well, the project can have some upsides, in the form of benefit simplification and liability management.

There is now sufficient knowledge and capacity in the pensions industry for this project to move forwards. Once data is in good shape and immediate settlements have been equalised, the project planning for the more challenging task of equalising pensions payable out of the scheme can begin.

The first step is to put in place a good project plan, and the forthcoming autumn round of trustee meetings is a good time to get this underway.



**CHRISTOPHER STILES**  
Partner

# GOWLING WLG'S PENSIONS TEAM AND GMP EQUALISATION

## KEY CONTACTS ON GMP EQUALISATION

Gowling WLG's pensions team is one of the UK's largest. The team is dealing with GMP equalisation issues across the breadth of its practice, including advising trustees, employers, third party professional service providers and insurers.

### JASON COATES

Partner

+44 (0)20 3636 7886  
+44 (0)7717 813789  
jason.coates@gowlingwlg.com



### CHRISTOPHER STILES

Partner

+44 (0)121 393 393 0663  
+44 (0)7921 881484  
christopher.stiles@gowlingwlg.com



### PAUL FEATHERS

Partner

+44 (0)20 3636 7952  
+44 (0)7974 176303  
paul.feathers@gowlingwlg.com



### IAN GORDON

Partner

+44 (0)20 3636 7871  
+44 (0)7770 981827  
ian.gordon@gowlingwlg.com



### IAN CHAPMAN-CURRY

PSL Legal Director

+44 (0)20 3636 7870  
+44 (0)7841 322732  
ian.chapman-curry@gowlingwlg.com



### SARA CHAMBERS

Legal Director

+44 (0)121 393 2159  
+44 (0)7867 169986  
sara.chambers@gowlingwlg.com



# GMP EQUALISATION GLOSSARY AND TIMELINE

TERM	DEFINITION
<b>Anti-franking</b>	Anti-franking operates to prevent the member's Excess being used to satisfy the obligation to revalue the member's GMP during the interval between the member leaving contracted-out service and the GMP coming into payment.
<b>Contracting out</b>	It was possible to 'contract out' of the benefits provided by SERPS. One of the most common ways of contracting out was for employers to provide occupational pension schemes that included a promise to pay GMPs.
<b>Excess</b>	Whilst a member, GMP simply underpins the main benefit. However, from the point of leaving service, the main benefit is divided into two separate elements of pension: the GMP, and the remainder of the pension above the GMP. The remainder is often referred to as the excess (or, sometimes, main scheme benefits).
<b>GMP</b>	Guaranteed Minimum Pension - the minimum pension entitlement for members of an occupational pension scheme that was contracted out of the additional state pension (i.e. at the relevant time, SERPS).
<b>GMP Working Life</b>	Working life for GMP purposes is defined as the period starting from later of 6 April 1978 (i.e. when SERPS started) and the tax year in which they reach age 16 and ending at the tax year in which they reach age 60 for women but age 65 for men.
<b>NICs</b>	National Insurance Contributions - a tax payable to HM Revenue & Customs by employees, their employers, and by self-employed workers.
<b>Revaluation</b>	Revaluation is intended to preserve the value of pension benefits when a member is no longer an active member of the scheme. There are different rules that apply to the revaluation of GMPs and the Excess and different rules that apply at different points in time.
<b>Pension increases</b>	Pension increases are the increases that are applied to help ensure that the value of a pension in payment keeps pace with the cost of living, they are calculated in accordance with scheme rules for the Excess (with certain statutory requirements) and by legislation for GMPs.
<b>SERPS</b>	State Earnings Related Pension Scheme - this was a second-tier to the State Pension and was intended to provide an additional pension related to earnings. This would be a top up to the Basic State Pension.

### Changes to SERPS introduced

The Social Security Act 1986 is brought into force reducing the level of benefits in SERPS in various way.

### ECJ judgement in *Allonby*

ECJ makes clear that benefits should be equalised even in instances where there was no comparator of the opposite sex.

### Abolition of DB contracting out

Contracting-out on a defined benefit basis came to an end with the introduction of the single-tier State Pension. The majority of contracted-out rights accrued before that date are to be preserved.

### First High Court decision in *Lloyds*

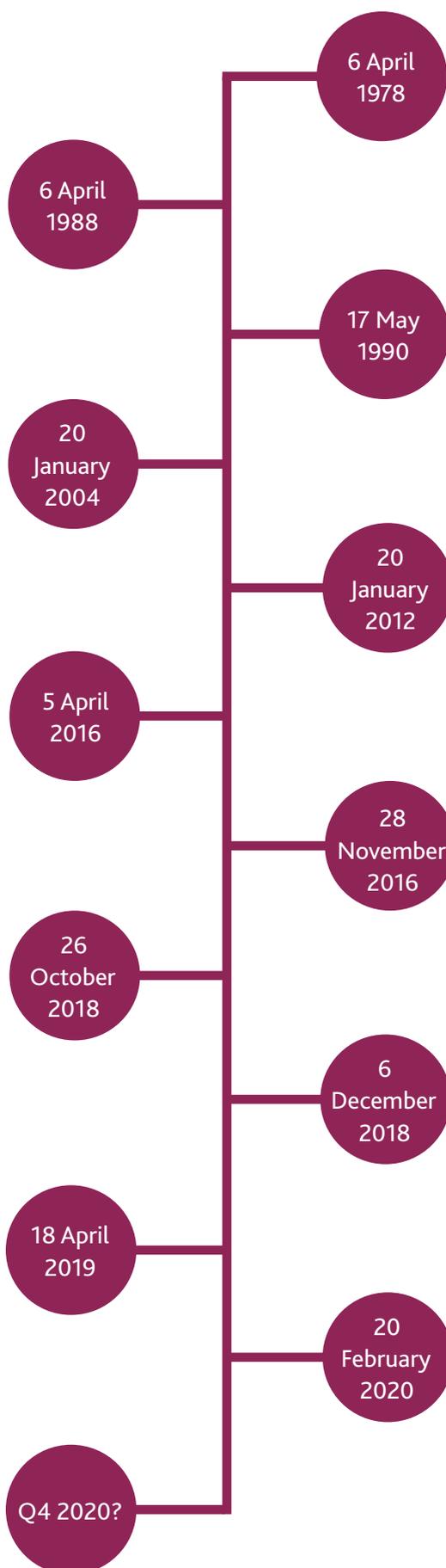
The first *Lloyds* judgment provides clarity on two key questions - there is a legal duty for schemes to equalise and there are legally acceptable methods to achieve equalisation.

### DWP issues guidance on the use of the GMP conversion legislation

The guidance describes how schemes could use the GMP conversion legislation to achieve equality.

### Third High Court decision in *Lloyds*

A third hearing has been held in the High Court focusing on transfers out and in. The pensions industry were expecting a judgment in July 2020, but this has been pushed back to Q4 2020.



### Introduction of SERPS

On 6 April 1978, the State Earnings Related Pension Scheme began, providing an earnings-based benefit as a top up to the basic state pension.

### ECJ judgment in *Barber*

The ECJ hands down the landmark equal pay case requiring pension schemes to provide equal benefits for male and female members.

### First DWP consultation on GMP equalisation legislation

The DWP issues a consultation with proposals setting out the DWP's preferred approach to GMP equalisation.

### Second DWP consultation on GMP equalisation legislation

The DWP's second consultation sets out an equalisation method for private occupational schemes wishing to equalise and convert GMPs to standard scheme benefits.

### Second High Court decision in *Lloyds*

The second High Court decision in *Lloyds* confirmed that a single-step approach to GMP conversion was permissible.

### HMRC issues first edition of the GMP equalisation newsletter

HMRC's Pension Schemes Services publishes guidance aimed at tackling the tax issues and queries that have been raised by the pensions industry on GMP equalisation.

# WHAT ARE GMPS AND WHY ARE THEY PROBLEMATIC?

On 26 October 2018, the High Court handed down an important judgment on equalisation of guaranteed minimum pensions (GMPs) in *Lloyds*. This section of the guide explains the equalisation problems that are inherent with GMPs. It will be useful for those who are new to this subject or for anyone wanting a refresher.

## FIVE KEY POINTS ON GMPS AND WHY THEY ARE PROBLEMATIC

### 1. EMPLOYERS WERE ABLE TO 'CONTRACT OUT' IN RESPECT OF THE ADDITIONAL STATE PENSION

On 6 April 1978, the government introduced a second tier of state pension provision in addition to the basic state pension. This additional state pension was called the State Earnings Related Pension Scheme (SERPS). It was possible to 'contract out' of the benefits provided by SERPS. The ways to do this have changed from time to time, but for present purposes, we are concerned with the option that existed from 1978 to 1997 for employers to provide occupational pension schemes that included a promise to pay GMPs, in return for being able to contract out of SERPS.

### 2. GMPS ARE INTENDED TO REPLICATE CERTAIN STATE BENEFITS

GMPs are intended to replicate members' SERPS benefits to try to ensure that a member would not be worse off as a result of being a member of an occupational pension scheme which was contracted out of SERPS.

### 3. WORKING LIFE FOR GMP PURPOSES ENDS AT AGE 60 FOR WOMEN AND AGE 65 FOR MEN

GMP works out average earnings over the member's working life.

Working life is defined as the period starting from the later of 6 April 1978 (i.e. when SERPS started) and the tax year in which they reach age 16 and ending at the tax year in which they reach age 60 for women but age 65 for men (GMP Working Life). This is where the inequality comes from.

### 4. GMPS ARE UNEQUAL FOR A NUMBER OF REASONS

A woman could accrue the same GMP as a man in a shorter time. This was designed to reflect a shorter working life for women. In addition, women's GMP becomes payable five years earlier (i.e. at age 60 compared to a man's GMP which becomes payable at age 65). This is further complicated because of how GMPs interact with the rest of their scheme benefits (the Excess) when pensions are revalued in deferment and increased in payment.

### 5. ANTI-FRANKING LEGISLATION ADDS ANOTHER LAYER OF COMPLICATION

So-called 'anti-franking' legislation operates to prevent the member's Excess being used to satisfy the obligation to revalue the member's GMP during the interval between the member leaving contracted-out service and the GMP coming into payment.

## MORE DETAIL ON THE PROBLEMS WITH GMPS

### THE KEY ELEMENTS OF GMPS

GMPs accrued between 6 April 1978 and 5 April 1997 for members of occupational pension schemes which were contracted out of SERPS.

The GMP was intended broadly to replicate the member's SERPS benefit to try to ensure that he or she would not be worse off as a result of having contracted out of SERPS [1].



A GMP is a career average benefit. It works out average earnings over the GMP Working Life and pays a pension in respect of them. As outlined above, GMP Working Life is the period starting from the later of 6 April 1978 (when SERPS began) and the tax year in which the individual achieved age 16, and ending at the tax year in which they achieved:

- age 60 for women; but
- age 65 for men.

This reflected the former state pension ages and is the root of the inequality that is inherent in GMPS.

Most occupational pension schemes followed the state pension system in having unequal retirement ages for men and women (usually, but not always, age 60 for women and age 65 for men). Occupational pension schemes have since had to equalise benefits following a landmark equal pay decision of the European Court of Justice in 1990 [2].

However, the career average nature of the GMP benefit, and its interaction with the overall benefit payable by the pension scheme, makes GMP equalisation considerably more complicated than equalisation of most non-GMP benefits.

## HOW IS A GMP CALCULATED?

To understand why, we need to understand how a GMP is calculated. For ease of reading, the following simplified description uses words whereas the legislation uses formulae. This description only applies to GMPS accrued since 6 April 1988 [3].

To calculate the GMP, a scheme must:

- take all the member's earnings that are pensionable for SERPS purposes;

- revalue them up into today's money; and
- then divide that total by the length of the GMP Working Life. As a reminder, in determining the length of GMP Working Life, any part of it that falls before 6 April 1978 is ignored and there is a minimum length of 20 years.

This division gives the member's average annual earnings in today's money. That amount is multiplied by 20%, and the result is the GMP.

## REASONS WHY GMP IS UNEQUAL

### GMP WORKING LIFE, ACCRUAL AND PAYMENT

#### 1. Women have shorter GMP Working Life

As a woman's GMP Working Life is five years shorter than an equivalent man's (ending at age 60 instead of age 65), when a woman's total earnings are divided by the length of the GMP Working Life, the result will be bigger than it would be for a man who had exactly the same earnings history and date of birth. Dividing by a smaller number gives a bigger result.

#### 2. Women have faster GMP accrual

Put simply, a woman can accrue the same GMP as a man in a shorter time. There was a logic to that: because a woman's working life was shorter, she needed to be able to accrue her GMP faster in order to get the same overall benefit.

#### 3. Women's GMP becomes payable earlier

The problem is then compounded by the fact that the woman's GMP not only accrues faster, it becomes payable five years earlier, at age

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## Footnotes

[1] Although the GMP can and does differ from the corresponding SERPS benefit in certain circumstances.

[2] *Barber v Guardian Royal Exchange Assurance Group* (1990) C-262/88.

[3] The calculation was different from 1978 to 1988, but that does not matter for present purposes as the duty to equalise between men and women only applies to benefits deriving from service from 17 May 1990.

60, whereas a man's GMP payment age is age 65. Again, this reflects the old state pension age.

#### 4. If a woman's GMP is postponed, it is increased

A woman's GMP would often be postponed (e.g. if her retirement age in the pension scheme was 65) but she is then entitled to an increase in respect of the postponement. The man's GMP comes into payment at 65 with no such enhancement.

### INTERACTION BETWEEN THE GMP AND THE OVERALL SCHEME BENEFIT IN PRODUCING FURTHER INEQUALITIES

It would seem from the above that the inequality in GMPs favours women over men, but that is not necessarily the case. This is because the GMP is not a standalone benefit; it is a guaranteed minimum to be compared against the (usually bigger) pension payable by the pension scheme.

At the point in time when the member ceased being in contracted-out pensionable service, the GMP simply underpins the main benefit. However, from that point on, the main benefit is divided into two separate elements of pension: the GMP, and the remainder of the pension above the GMP (i.e. the Excess).

#### 5. Differences in revaluation and pension increase rates for GMP and Excess

These two elements are usually (but not always - the benefit design of the scheme in question always needs to be specifically checked) increased differently, both in respect of:

- revaluation during the period (if any) between leaving service and drawing a pension; and
- increases due when the pension is in payment.

The increases payable on the GMP may be less generous than the increases payable on the excess. That is more likely to be the case in respect of increases payable after the pension starts to be paid, but it varies. So, counterintuitively, giving somebody a bigger GMP could

make them worse off because the total pension is still the same; and by making the GMP bigger, one simply makes a larger proportion of the pension subject to the less generous pension increases.

#### 6. Application of anti-franking legislation

It becomes even more complicated where there is an interval between the member leaving contracted-out service and the GMP coming into payment. So-called "anti-franking" legislation operates to prevent the Excess being used to satisfy the obligation to revalue the GMP during that interval.

For present purposes, it suffices to say that the legislation requires an "anti-franking" test to be carried out at the commencement of payment of the GMP. As that test needs to be carried out five years later for men than for women, it adds to the potential for inequality. This element tends to favour men as, when the test is applied five years later, there is five years' more GMP revaluation to be protected.



# WHAT DID THE *LLOYDS* JUDGMENTS SAY?

On 26 October 2018, the High Court handed down its important judgment in *Lloyds*. This was followed up with a follow on judgment handed down on 6 December 2018. A third judgment is expected in the second half of 2020. Since the judgments were handed down, the pensions industry has been grappling with how to implement the equalisation of GMPs in practice. In this section, we distill the lengthy judgments and bring you a key point summary, a plain English explanation of the issues and suggestions on next steps for employers and trustees.

## SEVEN KEY POINTS FROM THE ORIGINAL *LLOYDS* JUDGMENT

### 1. TRUSTEES HAVE A DUTY TO EQUALISE GMPs

Trustees of pension schemes with GMPs are under a legal duty to adjust benefits to address the current inequality between men and women which is inherent in the GMP.

### 2. METHODS TO EQUALISE - VARIOUS METHODS ARE LAWFUL, BUT SOME ARE NOT

There is more than one method of adjustment that is permissible. In addition, there are some methods that are not permissible. Schemes and employers will need legal and actuarial advice in order to decide what method should be adopted.

### 3. ARREARS WILL NEED TO BE PAID WITH INTEREST

For pensions that are already in payment, arrears need to be paid, with interest, to make good the past underpayments.

### 4. FORFEITURE CLAUSES MAY LIMIT THE DUTY TO PAY ARREARS

No statutory limitation period applies to such arrears, but forfeiture clauses in scheme rules may limit the duty to pay arrears. This will vary from scheme to scheme and bespoke legal advice will be needed.

### 5. THE FORFEITURE POINT HAS A WIDER APPLICATION TO UNDERPAYMENTS GENERALLY

The point on forfeiture clauses limiting the duty to pay arrears has relevance to underpayments generally: it extends beyond the issue of GMP equalisation.

### 6. CERTAIN LEGAL ISSUES REMAIN UNRESOLVED

Certain legal issues remain unresolved following *Lloyds*. In particular, there remains the questions of what duties trustees have in respect of GMPs that accrued in their schemes but have been transferred out and whether a different method can be adopted where the costs of implementing one of the methods considered is greater than the additional benefits that would be conferred as a result.

### 7. EMPLOYERS AND TRUSTEES FACE PRACTICAL ISSUES IN IMPLEMENTING EQUALISATION

Whilst *Lloyds* has removed some of the legal uncertainty, it leaves a number of practical issues for employers and trustees to consider. These include the quality of member data, dealing with death cases, the impact on cash equivalent transfer value (CETV) calculations and ongoing valuation discussions.



## WHAT DID LLOYDS SAY ABOUT THE REQUIREMENT TO EQUALISE GMPs?

The *Lloyds* decision is clear that trustees of schemes with GMPs have a legal duty to equalise the benefits provided by the scheme, to remove the inequality deriving from the GMP [1].

This stems from the European law principle of equal pay for equal work, which has also been adopted into UK legislation. Because GMPs are paid by occupational pension schemes, they are a reward for work and therefore there is a duty to pay them on an equal basis between men and women.

However, this duty only arises in respect of GMPs accrued since 17 May 1990. This is the date from which European law requires employment-based pension benefits to accrue on an equal basis for men and women [2]. Identifying what portion of the GMP can be said to derive from post-17 May 1990 service is another practical difficulty when it comes to equalising them.

That there is a duty to equalise GMPs is unlikely to surprise those involved in the pensions industry. Pre-*Lloyds*, there were tenable arguments that GMP equalisation was not legally necessary, albeit few thought they would succeed in court. The best of these arguments was that GMPs were intended to mirror a social security benefit (i.e. SERPS). Social security benefits are not caught by the equal pay rule (the government is under no obligation to equalise the effects of SERPS) so it is illogical to treat GMPs more favourably. That argument was rejected in *Lloyds*.

The main reasons why schemes have been putting off equalising GMPs is doubt over the correct method to equalise them and the practical difficulties of calculating and administering equalisation. Schemes that have been wound up and bought out with an insurance company do usually equalise GMPs at that time.

There are some pension schemes that have only ever had members of one sex. For such schemes, the issues are different, and beyond the scope of this note.

## WHAT DID LLOYDS SAY ABOUT HOW TO EQUALISE GMPs?

### WHAT ARE THE VARIOUS METHODS FOR EQUALISING GMPs?

The most significant aspect of *Lloyds* is the guidance it gives in determining how to equalise GMPs. The case concluded that there is more than one possible method, despite arguments by the members that only one method was permissible.

*Lloyds* was also clear that trustees do not have a free hand over what method to adopt. They are constrained by the extent of their duty and the principle of "minimum interference" to the rights of either party, which we will discuss further below.

The case does however set out some useful principles which will apply to the majority of schemes.

The fact that there are now methods that have clear court approval will make the decision much safer for schemes than was the case before.

There are four broad families of methods for equalising GMPs, which (following the terminology in *Lloyds*) are labelled Methods A to D.

They can be broadly described as set out on the next page of this Guide. For most schemes, the order set out on the following page is a decreasing order of cost.

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### Footnotes

- [1] We will adopt the usual approach of describing this as 'GMP equalisation', but, strictly speaking, it is not the GMP that needs to be equalised, it is the overall benefit which incorporates the GMP.
- [2] This follows the decision of the European Court of Justice in *Barber v Guardian Royal Exchange Assurance Group* (1990) C-262/88.

**Method A** - the element-by-element method (several varieties of this were considered in *Lloyds*);

**Method B** - the compare and increase method;

**Method C** - the equal payments method (two varieties of this are considered in *Lloyds* and were distinguished as C1 and C2); and

**Method D** - the actuarial equivalence method (two varieties of this are considered in *Lloyds* and were distinguished as D1 and D2).

The court in *Lloyds* did not consider any other methods, but acknowledged the possibility that other methods may exist.

All the methods require a comparison between each member's benefit and the benefit payable in respect of a notional comparator of the opposite sex with identical date of birth, service and earnings history. In order to illustrate the various methods, this Insight uses a hypothetical man (M) and a hypothetical woman (F), to represent the member and the notional comparator.

Often, but not necessarily, a woman's pension will be higher than a comparable man's in the early years of the pension, because she benefits from the effect on the calculation of the shorter 'working life' and more generous revaluation in deferment. Over time, however, she increasingly suffers from the fact that once in payment the GMP is not increased as generously as the excess, and there may come a crossover point where the man's pension becomes more generous.

This does not always happen (it depends on the circumstances) but we will assume it is the case in respect of M and F.

## EQUALISATION METHODS IN MORE DETAIL

### METHOD A

#### THE ELEMENT-BY-ELEMENT METHOD

This Insight does not need to go into detail on the various Method A calculations as they were ruled out in *Lloyds*. They broadly involve

taking the various elements of pension separately and comparing them, and then putting together a composite benefit taking into account the most favourable treatment of each element. This is the method that the members in *Lloyds* (through the representative beneficiaries) were arguing for.

### METHOD B

#### THE COMPARE AND INCREASE METHOD

Method B is the method that was first proposed as a possible solution by the Department for Work and Pensions (DWP) in 2012. It involves, when the pension comes into payment, calculating the pension due to M and F, and paying whichever is the higher. Every time the pension is increased thereafter, a similar comparison is carried out and the higher benefit is always paid.

Method B would uplift M's pension to F's level in the early years, and uplift F's pension to M's level after the crossover point.

This means that using Method B to equalise their GMPs would result in both M and F getting more pension overall than would be the case if their GMPs were not equalised. That arguably over-compensates them, as the concept of equalisation simply requires the disadvantaged sex to be uplifted to the level of the advantaged sex.

### METHOD C

#### THE EQUAL PAYMENTS METHOD

Method C attempts to deal with that problem. On this method, M's pension is uplifted to F's level at the start. However, once the crossover point occurs after which M's level would be higher, F's level continues to be paid in respect of both M and F.

This is justified on the grounds that F, pre-equalisation, was only entitled to be paid that level of pension anyway, and although M, pre-equalisation, would have been entitled to more, the duty to pay him more can be said to have been satisfied by the uplifts he received on earlier instalments.



Only once the total value of those uplifts has been used up does the pension switch to be paid at M's level.

Under this method, both M and F are paid the same amount at all times, and the aggregate amount that has been paid to them at any time during their retirement is no greater than the aggregate amount that would have been paid to the more favoured sex prior to equalisation.

Academically, this is perhaps the most logical method, but it is also complex (and therefore expensive) to implement and then administer. The practical challenges of implementing it are likely to limit its appeal.

## METHOD D

### THE ACTUARIAL EQUIVALENCE METHOD

Method D is, in our experience, the method that has been adopted on most wind-ups. It involves making an actuarial calculation of the capital value of M's pension and F's pension. The difference in the capital value is then actuarially converted back into an additional element of pension, which is added onto the pension of whoever's capital value was the lower.

The considerable advantage of this method is that once the initial actuarial calculations have been carried out, there is no further work to do - the uplifted pension simply carries on being paid and increased in the normal manner. There is no administrative complexity at each pension increase, unlike the other methods.

However, because it involves reliance on actuarial assumptions, it is not as precise as the other methods. Actuarial assumptions by their nature will not accord with the reality, so there is an inbuilt error in this method.

### THE METHODS FAVOURED IN LLOYDS - METHODS C2 AND D2

The judge in *Lloyds* applied the principle that when deciding how to equalise benefits between men and women, "minimum interference"

should be made to the rights of either party. A method that is excessively generous infringes the rights of the employers; a method that is insufficiently generous infringes the rights of the members. As a result:

- Method A was ruled out, on the grounds that it involved more than minimum interference to the rights of the employer.
- Method B was permissible, but only if the employer agreed
- Method C was permissible, and the employer could require the trustees to use it (specifically, the Method C2 variant).
- Method D was permissible but only if the GMP was converted into a non-GMP benefit as part of the process (called Method D2). Otherwise, it offended against the principle of minimum interference to the rights the members.

Method C2 follows the 'Method C' description above but takes into account the time value of money, by adding a notional amount of interest when determining how much a member has been paid at any point in time. This makes it somewhat less generous to members than the other variant of Method C (Method C1), which does not make any adjustment for the time value of money.

Method D was ruled out because the use of actuarial assumptions goes against the interests of the beneficiaries. However, a variant on it, Method D2, was permitted.

Method D2 involves taking the GMP out of the benefit altogether, which is already possible under existing legislation known as the GMP conversion legislation. Under the GMP conversion legislation, the converted benefit must be of no less actuarial value than the value of the benefit including the GMP. In order to use Method D2, however, employer consent is required.

Because the GMP is required to be equalised, when carrying out that actuarial comparison, it is necessary to value the equalised GMP.

Using this legislation makes Method D possible, because there is already statutory authority for using an actuarial value test to convert GMPs into non-GMP benefits. If this process is being carried out, all that needs to be done is to make an actuarial assessment of the

value of the equalised GMP, and the effect is to equalise the GMP via actuarial assumptions, which would not be permissible otherwise.

The method the Government consulted on in 2016, its second consultation on a possible method for equalising GMPs, is based on Method D2.

Our view is that this method is likely to find the most favour with both trustees and employers, although some schemes may have reasons to select a different method.

The need to convert the GMP into a non-GMP benefit adds a layer of complexity over the variant of Method D that does not include this, and schemes will need legal advice as well as actuarial advice on the steps required for this.

## PAYING ARREARS

For a pension that is already in payment, there is a duty to pay arrears in respect of the past instalments of pension which were paid on an unequalised basis. Interest must also be paid on the arrears.

*Lloyds* contains useful instruction to trustees when it comes to paying arrears. The relevance of this extends beyond the GMP equalisation issue, as it could also apply to any situation where benefits are found to have been previously underpaid.

The key points of *Lloyds* in relation to arrears are as follows:

- in current market conditions, 1% over base rate is the appropriate interest rate to pay. This can be calculated using simple rather than compound interest.
- the appropriate interest rate may change: the judge noted that 0% over base rate would be acceptable if base rate were higher (but there does not appear to be any clear basis for determining this); and
- no statutory limitation period applies when paying members arrears of pension.

However, if the scheme rules contain a forfeiture clause, that may limit the time period in respect of which arrears are payable. Whether or not that is the case depends on the construction of the forfeiture clause in the particular scheme.

Some forfeiture clauses give Trustees a discretion on whether to pay older benefits or treat them as forfeit. There is little in *Lloyds* by way of useful guidance as to how Trustees should exercise that discretion in an underpayments situation. Scheme-specific legal advice will therefore be particularly important for schemes with such rules.

## WHAT AREAS ARE STILL UNCERTAIN AFTER LLOYDS?

### DOES LLOYDS ANSWER ALL THE QUESTIONS ABOUT GMP EQUALISATION?

*Lloyds* has provided a clear judicial ruling on many of the issues relating to GMP equalisation. It also focuses consideration on the practical issues relating to how schemes calculate, administer and pay equalised GMPs.

Although *Lloyds* answers the big questions about whether and how to equalise GMPs, there will still be challenges in respect of a number of points of detail, however.



# WHAT HAVE THE DWP AND HMRC PROVIDED IN TERMS OF GUIDANCE?

Following the judgment in *Lloyds*, trustees, employers and pension professionals awaited guidance from the DWP on the use of GMP conversion legislation and HMRC on dealing with the tax issues on GMP equalisation projects. Now that some of this has been provided, this section of the Guide provides a key point summary of the guidance along with setting out detail what the DWP and HMRC have said and what it means for trustees and employers of occupational pension schemes who are dealing with GMP equalisation.

## NINE KEY POINTS ON THE DWP GUIDANCE ON THE USE OF THE GMP CONVERSION LEGISLATION

This section focuses on nine key points and issues arising from the DWP's 'Guidance on the use of the Guaranteed Minimum Pensions (GMP) conversion legislation' (18 April 2019) (the Guidance) on the use of the GMP conversion legislation.

### 1. NO SINGLE METHOD FOR EQUALISATION

The government has not asserted that there is a single method that will be appropriate for all schemes in order to equalise benefits for the effect of GMPs. The Guidance simply puts forward one possible method for equalising benefits.

### 2. TRUSTEES WILL NEED TO TAKE ADVICE AND MAKE DECISIONS

It is for the trustees of each scheme to decide the methodology that is most appropriate for their scheme, having taken advice.

### 3. THE DWP HAS PROPOSED A METHOD WHICH USES THE CONVERSION LEGISLATION

For the purpose of equalisation, this method:

- places an actuarial value on benefits accruing between 17 May 1990 and 5 April 1997;

- takes the higher of the value of a member's benefits and the value it would have been had the member been of the opposite sex during the period; and
- converts this higher value into benefits that are no longer subject to the (unequal) requirements of the GMP legislation.

### 4. DWP HAVE PROVIDED A STEP PROCESS FOR CONVERSION

Should trustees decide to pursue the conversion route, the Guidance sets out a 10 stage process.

### 5. PAST ARREARS ARE NOT DEALT WITH IN THE GUIDANCE

The method set out in the Guidance does not deal with the past arrears due to pensioners. This is a difficult area and one in which legal advice will be needed (especially if conversion is the chosen equalisation method for future instalments).

### 6. THE METHODOLOGY WILL RESULT IN SCHEME AMENDMENT

Under the DWP's methodology, a scheme is amended so that it no longer contains benefits subject to the GMP rules in respect of some or all members with GMP entitlements.



## 7. ALL GMP AND THE BENEFIT WHICH ACCRUED ALONGSIDE WILL NEED TO BE CONVERTED

For a selected member, all of their GMP and the benefits which accrued alongside this GMP need to take part in the conversion process, not just those relating to accrual between 17 May 1990 to 5 April 1997.

## 8. TRUSTEES DO NOT NEED TO CONVERT GMPS FOR ALL MEMBERS

The employer and the trustees can decide which members will have their benefits converted. The Guidance provides an example

of deferred and pensioner members being converted first, and then waiting until the active members become deferred members before converting their benefits.

## 9. A NUMBER OF POINTS REMAIN UNRESOLVED

The Guidance does not cover all of the questions that have been asked by the pensions industry.

For these issues, trustees will need to take advice and/or wait for further guidance.

# THE GUIDANCE IN MORE DETAIL

## WHAT IS THE AIM OF THE GUIDANCE?

The Guidance describes how schemes could use the GMP conversion legislation to achieve equality going forwards but it is important to note that the method described in the Guidance is not the only possible way of effecting equalisation and it should not be seen as prescriptive.

## WHAT IS NOT COVERED IN THE GUIDANCE?

The DWP is not:

- placing any obligation on schemes to use the method described in the Guidance;
- providing advice to schemes on how to equalise; or
- providing a definitive statement of how equalisation should be effected.

## WHAT IS THE RELEVANCE OF THE GUIDANCE?

Following *Lloyds*, conversion of GMPS has been seen as one of the more attractive ways of addressing GMP equalisation. As a result,

the Guidance is likely to be of interest to most trustees. Even if, in the end, trustees decide not to adopt the DWP's approach to equalisation, they will need to understand all of their options.

## IN A NUTSHELL: HOW DOES THE DWP METHODOLOGY WORK?

The DWP method:

- places, for the purpose of equalisation, an actuarial value on benefits accruing between 17 May 1990 and 5 April 1997;
- takes the higher value of a member's benefits and the value it would have been had the member been of the opposite sex during the period; and
- converts this higher value into benefits that are no longer subject to the (unequal) requirements of the GMP legislation.

The scheme is amended so that it no longer contains benefits subject to the GMP rules in respect of some or all members with GMP entitlements. The result is that the GMP rules, which create inequality between the sexes, are removed for the relevant members going forward.

## HOW DOES THE DWP'S METHOD COMPARE WITH THE DEFAULT METHOD UNDER LLOYDS?

The judge in *Lloyds* set out a default method for equalising GMPs, which he called 'Method C2'. For those who are familiar with *Lloyds* jargon, the DWP method is equivalent to Method D2. Unlike Method C2, it can only be adopted with employer agreement.

Method C2 involves adjusting the pension continually throughout the time when it is in payment, to ensure that the amount received by the member is no less than they would have received if they had been of the opposite sex during the period from 17 May 1990 to 5 April 1997. The DWP method, with its use of conversion, avoids that complexity, because it is a one-off adjustment to benefits. However it achieves that simplicity at the cost of doing greater violence to the original benefit design that members were promised.

Although it will not be the right solution for everyone, we expect the DWP's method to be popular with many schemes and employers, because it avoids the complexities and costs of operating Method C2. The nature of the reshaping of the benefit under the DWP's method is therefore an important decision for trustees, on which legal advice will be required. Trustees will need assurance that whatever reshaping they adopt is consistent with their legal duties and safe from member challenge. GMP conversion also creates possible opportunities to reshape benefits in a manner which facilitates the scheme's objectives more generally - again, schemes will need legal and actuarial advice on this.

## HOW DOES THE DWP METHODOLOGY WORK?

Before trustees start resolving inequalities, it is important that they are satisfied that they hold the correct GMP figure. The Guidance sets out a 10 stage process which results in an adjustment to an individual's benefits to compensate for post 16 May 1990 GMP inequalities as well as conversion of all of the individual's GMP. The

10 stages of the process for resolving GMP inequalities through GMP conversion are summarised as follows.

### STAGE 1 - REACH AGREEMENT WITH THE EMPLOYER

The trustees agree with the employer that GMP conversion is to be undertaken and the terms on which benefits are to be converted as part of the conversion exercise (see stage 2). Agreement has to be with the employer in relation to the scheme. This means that where the participating employers have changed over the years, legal advice will be needed as to how (or whether) the consent requirement applies.

### STAGE 2 - SELECT THE MEMBERS FOR CONVERSION AND AGREE WHICH BENEFITS ARE TO BE CONVERTED AND THE FORM OF THE NEW BENEFITS

In practice there are three elements to stage 2:

#### Selecting the members

It is not necessary to convert benefits for all members, nor to convert at the same time. Therefore, the trustees and the employer need to identify and agree which members will have their benefits converted. Members who trustees and employers may want to consider including in the conversion process are:

- those members with service between 17 May 1990 and 5 April 1997, even if no equalisation uplift is required;
- survivors in receipt of GMP survivors' pensions following the death of a previously contracted out member; and
- members who left active service before 17 May 1990 (but for them there will be no need to undertake an equalisation step).



### Agreeing the benefits to amend as part of the conversion process

The trustees and employers will also need to decide which benefits will be amended as part of the conversion process. The trustees are required to remove the GMP rules relating to the selected members.

For pre-1990 service, the Guidance explains that it is not necessary to reshape either the GMP or the Excess, as both can remain unequal. The Guidance does, however, make it clear that for a selected member, all of their GMP and the benefit which accrued alongside this GMP need to take part in the conversion process, not just that relating to 17 May 1990 to 5 April 1997 accrual.

### Deciding the form of the post conversion benefits

A decision regarding the form the post-conversion benefits will take will also be required. The form of these is constrained by legislation. In particular, the post conversion benefits:

- must be actuarially at least equivalent to the pre conversion benefits;
- must not include money purchase benefits, apart from those provided under the scheme immediately before the conversion date;
- must include survivors' benefits in accordance with legislative requirements;
- for pensions in payment, the amount of pension to which a member had an immediate entitlement before the conversion must not be reduced as a result of the conversion.

Because of the legislative constraints on the form for the post-conversion benefits, this is an area in which trustees will need specific legal advice.

### STAGE 3 - SET THE CONVERSION DATE

The trustees and the employer agree the date at which conversion is to be effected (the "conversion date").

### STAGE 4 - PRE-CONVERSION CONSULTATION

The trustees need to write to the selected members to inform them of the proposed conversion and seek their views. Trustees are required to take all reasonable steps to consult members. Consultation should be at a high level. The Trustees will be required to send more personalised information once calculations have been concluded and benefits adjusted.

### STAGE 5 - VALUATION

The trustees then need to instruct the scheme actuary to value for each selected member an amount A and amount B:

**Amount A** - this is the member's benefits to be converted (along with attaching survivor benefits) - typically those in respect of that part of pensionable service up to 5 April 1997 during which the GMP that is being converted accrued. Amount A is effectively the pre conversion, pre GMP equalisation value of these pre 1997 benefits.

**Amount B** - this is the member's benefits (along with attaching survivor benefits) in respect of the same part of pensionable service (so typically up to 5 April 1997 during which the GMP that is being converted accrued), but assuming that for the period from 17 May 1990 to 5 April 1997 the GMP entitlement had been calculated as if they were of the opposite sex, with the excess over GMP being adjusted accordingly. Both amounts A and B need to be calculated as at the conversion date and on the same basis.

It will be necessary to value and compare the whole (non-money purchase) benefit accrued in the selected period, not just the GMP, because members with a higher GMP will have a lower excess over GMP.

The trustees are responsible for determining the actuarial equivalence of the pre and post conversion benefits. In doing so, they must arrange for the scheme actuary to calculate the actuarial values of the pre and post conversion benefits. The trustees are required to obtain and consider advice from the scheme actuary in deciding what assumptions are appropriate. The Guidance points out that the choice of approach may substantially affect some members' benefits,

in particular where benefits increase at different rates pre and post conversion.

The Guidance says that the scheme's cash equivalent transfer value (CETV) basis will often be an acceptable starting point for a basis to calculate amount A and B. Points which will require consideration include:

- whether the current CETV basis should be reviewed;
- the use of assumptions which are non-unisex;
- the state of the pension scheme's data in respect of pensioners;
- how to 'roll back' the pension to when the individual left pensionable service (if this is required); and
- how to value benefits for active members.

## STAGE 6 - EQUALISATION

The trustees adjust for the effects of unequal GMPs by using a conversion value for each selected member: this is the higher of amount A and amount B from stage 5 above, so the more valuable of the male or female benefit structure.

## STAGE 7 - CONVERSION

Determining the post conversion benefit: once the conversion value for the selected member has been determined, this forms the budget from which new benefits are costed to replace those benefits in which GMP accrued. So this amount is turned back into a revised pension benefit. A consistent approach to the Stage 5 valuation should be used. For pensioners, the conversion approach only assesses the effect of GMP equalities from the conversion date- the trustees will need to use another equalisation method to deal with past payments.

## STAGE 8 - CERTIFICATION

The actuary 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 as equalised for the

effect of GMPs. The certificate must be sent to the trustees no later than 3 months after the calculations have been completed.

## STAGE 9 - MODIFICATION OF SCHEME TO EFFECT CONVERSION

The trustees need to choose how to effect conversion. They may use:

- the statutory power to resolve to effect the conversion on the agreed basis; or
- the scheme's amendment power to enable GMP conversion, in which case Sections 67 to 67I of the Pensions Act 1995 are disapplied.

## STAGE 10 - POST CONVERSION NOTIFICATIONS

The trustees must take all reasonable steps to notify the members and survivors (in the latter case, those with an immediate entitlement to benefits) whose benefits have been converted either in advance or as soon as reasonably practicable after the conversion date.

At this stage, members and survivors should be told what this means in terms of the amount and the shape of the benefit going forward.

HMRC also needs to be notified on or before the conversion date that the individual's GMPs have been or will be converted.

## WHERE DOES THE GUIDANCE LEAVE TRUSTEES AND EMPLOYERS?

The Guidance does not answer all the questions but it gives a clear framework which trustees can use to engage with employers and start seeking appropriate actuarial and legal advice.

As the Guidance notes, there are a number of unresolved issues. These include:

- pensions tax issues - HMRC is providing information and guidance.



- which employer needs to agree to the conversion of GMPs (an issue that will be especially relevant for schemes with complicated histories).
- how to deal with GMP underpins in defined contribution schemes.

The Government is considering changes to the GMP conversion legislation to clarify certain issues and the Guidance will be updated from time to time to reflect any changes to legislation that take place.

## HMRC GUIDANCE ON TAX ISSUES ON GMP EQUALISATION

### FOUR KEY POINTS ON THE HMRC GUIDANCE

#### 1. GMP EQUALISATION SHOULD BE AN ACTIVE PROJECT

Schemes that do not have a pressing need to complete GMP equalisation in the short term have generally stopped short of implementing an equalisation method for future pension payments, pending clarity from HMRC on the tax treatment of the various equalisation methods. However, there are some actions that all pension schemes containing GMPs should be carrying out now, supported by their legal and actuarial advisers.

There is also going to be a further court hearing on past transfers and guidance from the GMP Equalisation Working Group, the likely timings of which will form part of any project plan. This section, however, focuses on the tax questions.

#### 2. HMRC GUIDANCE PROVIDES SOME USEFUL ANSWERS

For schemes that have ruled out GMP conversion as a solution, the latest guidance will be helpful. Broadly, it confirms that there should be no annual allowance or lifetime allowance difficulties if schemes adopt the default equalisation method set out in the *Lloyds Bank* case ('Method C2').

#### 3. BUT IT LEAVES OTHER QUESTIONS UNANSWERED AND CREATES SOME PROBLEMS

The Guidance states that trustees may need to revisit past lifetime allowance calculations, back to 2006. This may be difficult, or impossible, for many pension schemes, whose trustees will need to discuss with their administration service providers and their legal advisers.

Individuals who were close to, or already above, the lifetime allowance will also potentially face additional taxation.

#### 4. SCHEMES CONSIDERING GMP CONVERSION STILL HAVE A DILEMMA

GMP conversion is a potentially attractive solution to GMP equalisation, because it can be done as a one-off exercise without requiring the administration team to run dual records, as well as enabling the benefit design to be simplified.

However, it gives rise to particular tax problems, which are not addressed in the Guidance but which are being addressed in a series of newsletters being issued by HMRC.

There are potentially significant tax risks in proceeding with GMP conversion in the meantime. These do not normally pose an insuperable obstacle if schemes have a pressing need to complete the

exercise, but other things being equal, it would be better to wait for the HMRC conversion guidance to be published. Schemes that need to move ahead because of an impending buy-out will need to engage with their insurers at an early stage.

Schemes that are keeping GMP conversion open as an option and which do not have a pressing reason to get started with the exercise are therefore in a bind, because they are under a clear legal obligation to equalise GMPs, and are underpaying pensions every month, for as long as they do not equalise.

Such schemes should be in active discussion with their legal and actuarial advisers to ensure that there is an acceptable plan for when and how to commence the exercise, in order to protect themselves from member claims.

## WHY IS TAX AN ISSUE WITH GMP EQUALISATION?

Because public policy is to encourage retirement saving, registered pension schemes enjoy a range of tax privileges. In order to maintain these privileges, it is necessary for benefits to stay within certain limits.

For present purposes, the relevant tax limits are as follows:

- the annual allowance, which limits the amount of pension saving an individual can make in any given tax year, and
- the lifetime allowance, which limits the overall value of tax-privileged saving over an individual's life.

The amounts have changed, but these limits have existed since the pensions tax system radically changed on 6 April 2006. Exceeding the allowances causes penal tax charges, known respectively as the "annual allowance charge" and the "lifetime allowance charge".

The following features of these allowances are particularly relevant.

The annual allowance is targeted primarily at members who are still accruing pension. Deferred members are largely excluded from the annual allowance, even though the value of their benefits will

usually increase every year through inflation-proofing. The legislation provides that such increases, provided that they stay within specified limits, do not count towards the annual allowance. This exclusion is often called the "deferred member carve-out".

Benefits are tested against the lifetime allowance when they "crystallise", on what is known as a "benefit crystallisation event". The most common benefit crystallisation event is the pension coming into payment for the first time, i.e. when the individual retires, although there are others.

To avoid retrospective taxation when the lifetime allowance was introduced, members whose benefits were already above the allowance were given the option of electing to have a higher lifetime allowance in return for committing not to accrue any further benefits in a registered pension scheme. Accruing further benefits would cause the protection to be lost. A similar system was used on the occasions when the lifetime allowance has been cut. These protections are called "enhanced protection" and "fixed protection" [2].

GMP equalisation raises numerous tax questions, but the biggest ones are:

- if the pension entitlement of deferred members is increased, to compensate them for GMP inequality, does this increase take their benefits outside the deferred member carve-out, such that their benefits may be hit by an annual allowance charge?
- if members have enhanced or fixed protection, does conferring additional benefits to compensate them for GMP inequality cause the protection to be lost?

## WHAT ANSWERS HAS HMRC PROVIDED?

HMRC has confirmed that it views a right to compensation for GMP inequality as a benefit that accrued at the same time as the GMP itself, i.e. between 1990 and 1997, not as a new entitlement arising as a result of the 2018 court case.



## THE GOOD NEWS

As the 1990-1997 period predates the introduction of the annual and lifetime allowances, it follows that equalising benefits, provided that a scheme does not go beyond the minimum necessary, does not cause the annual allowance to be exceeded in any tax year, nor does it cause a member with lifetime allowance protection to lose the protection.

Insofar as existing pensioners are concerned, HMRC has also confirmed that they can be paid an arrears payment to equalise past instalments of pension as a one-off lump sum. Although this will be subject to income tax, members can claim back excess tax from HMRC if it results in them paying more tax than they would have done had they received the money at the correct time.

## THE BAD NEWS

Any current pensioner who took their pension under the current tax system, i.e. from 6 April 2006 onwards, will have had the value of their pension tested against the lifetime allowance, on the benefit crystallisation event. However, if he or she is due an uplift to compensate for GMP inequality, and if the uplift accrued in the 1990-1997 period, then it follows that the value of it ought to have been taken into account at the benefit crystallisation event, because it was already an accrued right at the time of the benefit crystallisation event.

HMRC's guidance implies that schemes need to correct this, in order to ensure that the lifetime allowance test is accurate. In practical terms, revisiting benefit crystallisation events that are up to 14 years old is, for many schemes, going to be either difficult or impossible. Such schemes will need to consult their administrators and their legal advisers to understand what to do about this.

Correcting past benefit crystallisation events also means that individuals who were over, or close to, the lifetime allowance face a potential lifetime allowance charge as a result of GMP equalisation increasing the value of their benefits.

## WHAT QUESTIONS REMAIN UNANSWERED?

The biggest unanswered question relates to GMP conversion.

GMP conversion is a statutory power that allows pension schemes to reshape the pensions they provide, so that GMPs are no longer treated as a special class of benefit with their own rules. This is conditional upon the actuarial value of the benefits not being reduced.

GMP equalisation can be built into a GMP conversion exercise. An explanation of the possible attractions of conversion compared to the other methods for equalising GMPs can be found [here](#).

There are several tax pitfalls to avoid when it comes to GMP conversion, but a particularly acute problem relates to deferred members if the scheme provides "fixed rate revaluation" of GMP in deferment. The issue, in a nutshell, is how to avoid creating increased exposure to the annual allowance charge.

If the fixed rate revaluation is included in the post-conversion benefits, the conversion is likely to take it outside the deferred member carve-out.

If the fixed rate revaluation is not included post-conversion, though, the deferred pension may need to increase in order to maintain actuarial equivalence, and this increase is also unlikely to be covered by the deferred member carve-out.

Lifetime allowance protections also pose a problem.

There are solutions to these problems, but it would have been helpful if HMRC had indicated either that no tax would be levied (HMRC has the power to make extra-statutory concessions in certain circumstances, e.g. where there are gaps in the law) or that the Government has plans to legislate to address these issues.

There has been nothing to date on GMP conversion in guidance from HMRC. In its last newsletter, HMRC noted that: 'Any schemes wishing to use the conversion method should consider any tax implications that may arise in accordance with the existing legislation and guidance within the PTM and seek advice as appropriate.'

# WHAT SHOULD TRUSTEES AND EMPLOYERS DO NOW?

## THREE KEY ACTION POINTS FOR TRUSTEES

### 1. FIRST THINGS FIRST

Most schemes in our experience have already done this or are well advanced, but an immediate action point for all schemes is to ensure that their data is in sufficiently good shape to enable GMP equalisation (including completing GMP reconciliation) and to equalise transfer values and full commutations.

### 2. CONVERSION OR NOT?

This is the fundamental question which trustees and employers need to decide. The default way to equalise GMPs is to run a system of dual records, carrying out checks at every pension increase so that the overall amount received by the member and a notional comparator of the opposite sex would be the same. This is called "Method C2", and it is possible but administratively complex.

The alternative is to convert GMPs into non-GMP benefits which are of actuarially equivalent value, taking account of the need to equalise in that process. Conversion (also known as "Method D2") is an attractive option for many schemes, and can be done as a one-off project or when each member retires. It requires the employer's agreement. It does also have its challenges and risks.

There is no requirement to adopt the same approach for every member, so trustees might decide to use one method for one group and a different method for another.

### 3. MAKE A PLAN

Whether Method C2 or Method D2 is adopted, there will be some key commercial decisions which need to be made by trustees and employers – generally, these are the decisions as to what method will be used, and how benefits are to be reshaped. The more technical details can usually be left to advisers. Good project planning is essential to keep this project focused.

## THINGS TO CONSIDER BEFORE GRAPPLING WITH GMP EQUALISATION

### WILL GMP EQUALISATION GO AWAY ON ITS OWN?

GMP equalisation is a product of anti-discrimination laws in both the European Union and the UK. Whilst the European dimension may (or may not) disappear at the end of the year, there has been no indication from UK policymakers that they intend to exempt pension schemes from this obligation.

Whilst in most cases, GMP equalisation does not result in life-altering changes to any individual's entitlement, there are some cases where it does make a significant difference. Even where the differences are

minor, a trustee's most basic obligation is to pay the correct benefits in accordance with their trust deed and overriding law.

If the UK Parliament is not going to change the law, it falls to schemes and their advisers to bring benefits into line with the law, but in a pragmatic way that keeps the costs proportionate to the benefits.

### WHAT FREE HELP IS AVAILABLE?

Since the original Lloyds judgment was handed down, its implications have been clarified – to varying degrees of helpfulness – by the courts,



HMRC, the DWP and industry working groups. The most recent was further HMRC guidance, issued in late July.

The "GMP Equalisation Working Group", under the banner of the Pensions Administration Standards Association (PASA) is publishing a suite of guidance notes free of charge. We also have guidance from HMRC and DWP. This means that schemes only need to pay advisers to consider whether these recommendations are suitable for their schemes, and to consider the more difficult issues. It is not necessary to pay advisers to consider every issue from first principles.

The industry now has pretty much all the help we are likely to get. There is some further support still to come, including a further court

ruling about who is responsible for topping up past transfer values, and further guidance from the GMP Equalisation Working Group. None of those remaining pieces are expected materially to alter the industry's understanding of what the issues are and what tools are available to resolve them.

The autumn is therefore the time to be planning how to comply with this legal obligation. The existence of industry-wide guidance, which is all freely available and free of charge, will make the process less onerous.

## PUTTING TOGETHER A PLAN OF ACTION

### GET THE PRIORITY TASKS OUT OF THE WAY

The top priority is to ensure that the data is available for GMP equalisation to be carried out accurately. This includes completing the reconciliation of GMP data with that of HMRC, and considering the consequences of that for the rectification of benefits.

On the latter point, a decision needs to be made as to the timing for making the required changes to benefits following GMP reconciliation (known as "GMP rectification"). Trustees should consider whether there are any groups of members for whom corrections should be made without further delay (perhaps current pensioners, or those unaffected by GMP equalisation), or whether rectification can wait and be done at the same time as any changes required due to GMP equalisation.

Equal first priority also goes to the need to equalise GMPs for people who are taking all their benefits out of the pension scheme in one go – i.e. transfer values and full commutations. In our experience most schemes are now paying these on an equalised basis. Unless exceptional circumstances apply, we consider that all schemes should now be adopting an equalised approach to transfer values and full

commutations. Indeed, the July guidance from HMRC suggests that schemes could be getting themselves into more difficulty if they do not do this.

### TO CONVERT OR NOT TO CONVERT?

The biggest decision is whether or not to convert GMPs into non-GMP benefits of equal actuarial value. Legislation already exists to enable this conversion. At a conceptual level, it is simple to add equalisation into the process of converting benefits – the scheme puts an actuarial value on the benefits including the GMP, uplifts that actuarial value if it would have been higher if the member were of the opposite sex in the period after the duty to equalise came into effect, and then converts that actuarial value into a simpler benefit design that does not involve a GMP.

To answer the question we posed, of how to make GMP equalisation go away, conversion is therefore appealing. It enables equalisation to be dealt with as part of a single, one-off exercise. (We will question below whether that is actually as desirable as it sounds.)

Furthermore, conversion not only enables compliance with the duty to equalise GMPs, it has a positive advantage in its own right, by

simplifying the benefit design. It can also be combined with member options exercises in order to facilitate a funding advantage.

Although it is conceptually simple, conversion throws up a number of technical challenges, mostly involving tax. Schemes that are considering conversion will need their advisers to explain to them in plain English what those challenges are, and how they may be surmounted.

Conversion can only be used with the consent of the employer. Also, it is possible for trustees to decide to use one method for one group, and another method for another. This is something trustees will need advice on in order to fit the specific circumstances of the scheme.

## WHAT TO CONVERT INTO?

**If conversion is adopted**, the trustees need to determine the shape of the converted benefits.

We expect that in most cases, trustees will not want to deviate too far from the existing benefit design. As well as achieving equalisation, however, conversion can remove or simplify some of the more administratively problematic aspects of GMPs – a good example is the so-called anti-franking rules, which are notoriously complex.

Whilst a radical reshaping of the benefits is theoretically possible, we expect trustees to be reluctant to do this because conversion is forced on members without their consent (they must be consulted, but they cannot refuse to be converted).

A radical reshaping into a benefit design of equal actuarial value will create winners and losers, because even though a benefit may be of equal actuarial value, to a real-life individual it will alter the amount he receives over his retirement.

## WHEN TO CONVERT DEFERRED MEMBERS?

**If conversion is adopted**, the trustees need to determine whether to convert all deferred members and pensioner members as a one-off

exercise, or whether to convert pensioners as a one-off exercise but only convert deferred members as they reach retirement.

Part of the appeal of conversion is that it enables equalisation to be over and done with, as a single exercise. However, the possibility of converting deferred members on an individual basis when they reach retirement should not be ruled out, for two reasons.

First, it reduces the uncertainty in the actuarial calculations, meaning that the post-conversion benefit is less likely to be materially better or worse for the member than the pre-conversion benefit.

Second, it avoids some of the trickier technical issues that arise with conversion in relation to tax.

How to weigh those advantages against the appeal of a one-off exercise is a point which trustees should discuss with their advisers – the answer will not be the same for all schemes.

## ALTERNATIVES TO CONVERSION

**If conversion is not adopted**, the default way to equalise GMPs is the so-called "Method C2" from the Lloyds legal case.

This involves continual adjustment to the pension over the lifetime of the pensioner to ensure that at any given time, the cumulative amount actually received by the pensioner is at least as much as he or she would have received had he or she been of the opposite sex from the date when the duty to equalise came into effect. In calculating that cumulative amount, adjustments are made to reflect the time value of money.

It is a complicated method and requires dual administrative records for each member, so that the comparisons can be made. As such, it is likely to be relatively expensive and may increase the risk of administration errors.

However, the mainstream third party administration service providers are all developing this capability for schemes who wish to use it.



Simpler and more member-friendly methods also exist, but in most schemes these would require the agreement of the employer as they are effectively augmenting the benefits.

The fact that the market is now ready to deliver pretty much any reasonable method of GMP equalisation means that trustees can make the big decisions on the choice of method, having considered the advice of their actuarial and legal advisers, and leave it to their service providers to implement them.

## **CORRECTING BENEFITS FOR EXISTING PENSIONERS**

Existing pensioners present two distinct but related questions: how to correct their pension for the future (for which the above considerations apply), but also how to correct the instalments of pensions they have already received.

As well as the technical question of how the solutions adopted for the past and the future interact with each other, this aspect is likely to include the need for legal advice on whether historic underpayments, or part of them, can be regarded as being forfeited under the scheme rules (i.e. non-recoverable by the member due to the passage of time). This question will require analysis of the scheme rules and careful thought regarding the position of members and the employer.

# PRACTICAL NEXT STEPS

GMP equalisation involves many difficult technical challenges, and we have spared the readers of this note too much detail of these. Nobody intended the present situation to arise: the difficulty stems from the unpredictable interaction between the UK Government's rules for contracted-out pension schemes and the European court's interpretation of the requirement for equal pay for equal work between the sexes.

It is therefore vitally important that trustees and employers do not get lost in the weeds of this issue. It is important because there are so many weeds in which one could get lost.

To manage this risk, trustees need to distinguish between the following types of decision.



## KEY COMMERCIAL DECISIONS WHICH REQUIRE DECISION-MAKER INPUT

These are the decisions which affect the benefit design or scheme funding – for example, the decision on whether or not to use conversion, the shape of the benefits after conversion, and the decision on whether to exercise any discretionary power that may exist to treat historic underpayments as forfeit.



## TECHNICAL LEGAL OR ACTUARIAL POINTS

There are numerous questions that require the trustees to make a decision. Where that decision is of a technical nature it may be unclear how best to proceed in order to ensure compliance. On these, trustees should press their advisers to take a position and stand behind it. It is reasonable for trustees to be able to expect to rely on their advisers to confirm the best approach to technical points.



## PRACTICAL IMPLEMENTATION POINTS

Once the decisions have been made, they need to be implemented. Trustees should be able to rely on their third party service providers for this, whether that is an outsourced administration services provider or an in-house pensions administration team.

### ADVISERS CAN HELP

Advisers can help trustees to make the above distinctions. Ensuring that trustees only need to get involved in category 1 decisions will do much to make this a much more tolerable exercise for them.

Obviously in real life there will be a degree of overlap between the categories, and for many trustee boards, it may be more efficient to delegate the management of this project to a sub-committee comprising trustees and advisers, with the full Board only being involved in the crucial category 1 decisions.

We recommend that a comprehensive project plan be agreed at the outset, showing the actuarial, legal and administrative workstreams, and identifying the key decisions in accordance with the above categorisation.

### WHAT NEXT?

GMP equalisation will only go away when trustees address it, and they need to do so in order to be compliant with their legal duties. If handled well, the project can have some upsides, in the form of benefit simplification and liability management.

There is now sufficient knowledge and capacity in the pensions industry for this project to move forwards. Once data is in good shape and immediate settlements have been equalised, the project planning for the more challenging task of equalising pensions payable out of the scheme can begin.

The first step is to put in place a good project plan, and the forthcoming autumn round of trustee meetings is a good time to get this underway.



GOWLING WLG (UK) LLP

T +44 (0)370 903 1000

[gowlingwlg.com](http://gowlingwlg.com)

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