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Test-Achats: are the days now numbered for sex-specific actuarial factors?

In brief

- On 1 March the ECJ ruled on the Test-Achats case.
- Although the case concerned sex equality in insurance contracts, it could potentially affect UK pension schemes, which might now be required to use unisex actuarial factors.
- It is important to note, however, that the position is far from clear at present.

Next steps

- As a first step, trustees might wish to determine which of their actuarial factors are sex-specific.
- Trustees carrying out or about to carry out a review of actuarial factors might wish to adopt unisex factors to avoid having to change again in the near future.
- Trustees should consider seeking legal advice, but should also be aware that clarity might prove elusive for some time.

On 1 March 2011, the European Court of Justice (ECJ) passed judgment on the Test-Achats case. This case was widely reported in the press for its impact on insurance premiums which will need to be equal for men and women from 21 December 2012. Although it concerned insurance contracts, the case could also potentially affect UK occupational pension schemes.

Background

The case concerned whether it is compatible with EU fundamental rights to take the sex of an insured person into account as a risk factor in insurance contracts.

The EU Goods and Services Directive (2004/113/EC) prohibits sex from being taken into account as a factor in calculating insurance premiums and benefits in respect of insurance contracts which were concluded after 21 December 2007. However, there is an exception (known as a derogating provision) allowing Member States to permit sex-specific differences provided that it can be demonstrated by "relevant and accurate actuarial and statistical data" that sex is a determining risk factor.

A Belgian consumer organisation, Association Belge des Consommateurs Test-Achats, and two individuals brought an action before the Belgian Constitutional Court which referred it to the ECJ. The ECJ was asked to rule on whether the derogating provision is compatible with higher-ranking law, namely the principle of equal treatment for men and women under European Union law.

The ECJ judgment

The full ECJ judgment was published on 1 March 2011 and found that the derogating provision in the Directive is incompatible with the principle of equal treatment between men and women. The judgment went on to rule that the derogating provision will be considered invalid with effect from 21 December 2012; in other words, the exception from the EU directive allowing sex-specific insurance premiums/benefits will become invalid from that date.

What does the ECJ judgment mean?

The case concerns insurance contracts and it is very likely that all premiums and benefits paid in relation to an insurance contract in the UK will have to be unisex with effect from 21 December 2012.

Because the ECJ ruling is concerned with insurance contracts, it is not clear what the impact will be on UK occupational pension schemes. UK defined benefit schemes use actuarial factors in a number of calculations such as transfer values and early/late retirement pensions. At present, in the UK, certain actuarial factors are permitted to be sex-specific under an exemption in the Equality Act 2010. It appears possible that the ruling in the Test-Achats case could be interpreted as directly requiring this exemption be removed. It seems more likely that it will instead render it vulnerable to being ruled illegal indirectly.

It also seems possible that, in amending UK legislation in respect of insurance policies, the UK Government will at the same time make similar amendments in respect of occupational pension schemes.

This is a very complex legal matter involving the interaction of various pieces of EU and UK legislation and other ECJ rulings and clarity on the implications might well not be available for some time. It is therefore impossible to make any definitive statements about the implications of the ruling at the current time.

It is also worth noting that the European Parliament passed a resolution on 16 February 2011 urging "the Commission and the Member States to obligate occupational and other supplementary pension providers to use gender-neutral mortality tables when calculating pension benefits so as to prevent women from being punished for their higher life expectancy".

How might it impact defined contribution schemes?

Typically, on retirement, members of defined contribution (DC) schemes will use their accumulated fund to purchase an annuity from an insurer. At present men's annuities are, all other things being equal, higher than women's as they are not expected to live as long. As a result of the ruling, unisex annuity rates must be used from 21 December 2012. Male annuity rates might be expected to worsen, with female annuity rates improving. It remains to be seen exactly how and when the pricing of insurance contracts will change.

How might it impact defined benefit schemes?

There are a number of areas where defined benefit (DB) schemes might use sex-specific actuarial factors to reflect differences in expected longevity that could all potentially be affected by the judgment.

Cash equivalent transfer values

Typically, trustees use sex-specific factors to calculate transfer values. We expect the impact of the judgment is most likely to be higher transfer values for men and lower ones for women, rather than schemes being required to "level up" to the better of the two. The impact on cost for the scheme sponsor will depend on the scheme's male/female membership split and whether or not transfer values are being reduced for underfunding.

Calculating pension to be exchanged for a lump sum on retirement (known as "commutation")

Many, but by no means all, schemes will have sex-specific commutation factors. We expect that, following the ruling, unisex factors would be set at a level between male and female factors resulting in a better deal for male members but a worse one for females. The impact on cost will depend on what factors are set and on the scheme's male/female membership split.

Early/late retirement pensions

Some schemes will use sex-specific early/late retirement factors. The cost implications from switching to unisex factors would not be expected to be too significant.

Other possible affected areas

Schemes will typically also make different assumptions on the longevity of men and women in determining their funding position and company accounting disclosures. As the purpose of scheme funding is to determine the level of employer contributions to meet the benefits the scheme actually expects to pay, we would not expect the ruling to have a direct impact on the funding assumptions adopted; however, changes to transfer values, commutation factors and early/late retirement factors might change the likelihood of people exercising those options which could feed through into the funding assumptions.

Whilst individual annuity rates are expected to change, the likely impact on full buy-out costs i.e. the cost of securing the liabilities of a scheme in full with an insurer, appears less obvious. It will be interesting to see if the pricing of bulk buy-ins or buy-outs alters in future as a result of the ruling.

What should trustees do now?

A first step for trustees would be to determine which of their current actuarial factors are sex-specific. Trustees who are currently going through or about to undertake a factor review, for example to take account of the switch to the Consumer Prices Index (CPI), might wish to consider using unisex factors in order to avoid the risk of having to review again in the near future.

Trustees concerned about the potential impact of the ruling on their scheme should consider seeking legal advice. However, clarity as to the implications of the judgment for pensions may not be available for some time.

Summary

It could well be some time before the fog of confusion currently surrounding the impact of this ruling on UK DB pension schemes clears. It does, however, give an indication of the way the wind is blowing and trustees might therefore wish to anticipate a requirement for unisex actuarial factors.

Where can I get further information?

For specific advice, please get in touch with William Fitchew on 020 7839 8600 or by email to william.fitchew@puntersouthall.com. Alternatively, speak to your usual Punter Southall contact.

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