

Cash equivalent transfer values – the new regime

Introduction

A new regime for the calculation of cash equivalent transfer values (CETVs) came into effect on 1 October 2008.

The basic process of providing statements of entitlement and paying CETVs remains as before, but there is a shift in responsibilities from the actuary to the trustees when it comes to determining the actuarial assumptions that are to be used to calculate members' CETVs in defined-benefit (DB) pension schemes. There are also some changes to the way underfunding can be taken into account and to the disclosure requirements.

A number of schemes have put off reviewing transfer values pending publication of the new regulations. Whether or not changes will be required to comply with the new regulations, it is likely that trustees will take the opportunity to review fundamental assumptions, such as those relating to longevity and investment returns.

This edition of *In Focus* takes a look at how the new CETV regime will affect DB schemes, with an emphasis on what is changing and the actions trustees should be taking.

The regulations should be considered in conjunction with the Pensions Regulator's guidance for trustees of private sector schemes. The Regulator's guidance is summarised in *italics* below.

Key actions

If they have not already done so, trustees would be well-advised to:

- open discussions with their actuary to review the assumptions underlying their scheme's current CETVs
- consider whether they need to obtain an insufficiency report.

New terminology

Some new terminology has been introduced.

The phrase "initial cash equivalent" (ICE) means the member's CETV before any permissible reductions have been made and "cash equivalent" means the net amount after any such reductions, ie the amount that would be paid if the transfer were to proceed. Also, what used to be commonly known as a "GN11 report" (required if the trustees wish to reduce transfer values to reflect underfunding) is now called an "insufficiency report".

Responsibility for determining CETV assumptions

Trustees are now responsible for determining the assumptions underlying CETVs, having taken their actuary's advice. This is similar to the way trustees are responsible for determining valuation assumptions under the scheme-specific funding regime, although there is no statutory requirement to consult the employer.

Previously, it was the Scheme Actuary who determined the assumptions, having regard to the Actuarial Profession's Guidance Note GN11: "Retirement Benefit Schemes - Transfer Values" and, in many cases (but probably not all), in discussion with the trustees. Guidance Note GN11 no longer applies and, as the Board of Actuarial Standards has said it is unlikely to issue a new guidance note (given trustees rather than actuaries will now be responsible for the assumptions), much of the detail set out in GN11 has been reproduced in the new regulations.

Minimum level of initial cash equivalents

The new regulations define the minimum level for ICEs.

The minimum level of an ICE should represent the expected cost within the scheme of providing the member's accrued benefits, with the assumptions used being on a "best estimate" basis.

In particular, for private sector schemes, discount rates should reflect the investment policy and any relationship between that policy and the different classes of member.



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However, trustees can adopt an alternative approach if they consider it appropriate, provided each member's ICE is no lower than the minimum and they first have regard to anything in their scheme's rules that requires them to consult with the employer. This will not necessarily require two calculations to be carried out, particularly if the assumptions underlying the alternative approach are clearly more prudent than the best estimate basis.

Special provisions apply to public service pension schemes, for which HM Treasury has issued guidance on the setting of discount rates.

Regulator's Guidance:

If the employer has requested the trustees to adopt a more generous calculation than the minimum, the trustees must consider whether it is appropriate for them to do so, bearing in mind they may need both actuarial and legal advice and they may need to consider how well the scheme is funded relative to the statutory funding objective and how quickly any shortfall is being made good.

Trustees should ensure that any CETV calculated on the alternative basis whether or not reduced for underfunding is no lower than the (reduced) CETV on the minimum "best estimate" basis.

Determination of assumptions

Trustees must determine the economic, financial and demographic assumptions to be used to calculate members' ICEs, having taken their actuary's advice.

In determining the demographic assumptions, the trustees must have regard either to the main characteristics of the scheme's members or, if the scheme is not large enough to derive such assumptions, the characteristics of a wider population thought to share similar characteristics.

The regulations say: "The trustees must also have regard to the scheme's investment strategy when deciding what assumptions will be included in calculating the discount rates in respect of the member". The DWP's response to the consultation exercise carried out in July/August 2007 clarifies that the policy intention is that the discount rates (for funded private-sector schemes) should have regard to the scheme's long-term investment strategy in respect of the membership. For example, if the scheme intends to back the payment of members' pensions by investing in gilts or bonds that should be reflected in the selection of the post-retirement discount rates.

As the discount rates are to be set by reference to the scheme's investment strategy, short-term tactical switches in the assets held should not require them to be adjusted. However, if the scheme's investment strategy is changed, the trustees should consider whether any changes are needed to the discount rates. For example if a scheme moves completely out of equities into bonds and intends that switch to apply long term, the discount rate ought to be reviewed.

The DWP's original intention was that each individual assumption should be set on a "best estimate" basis. Concern was expressed about this at the consultation stage because determining a best estimate for certain assumptions, eg certain demographic assumptions, might be a significant task. The final regulations were amended so as to require the assumptions to provide an overall best estimate of the ICE.

Regulator's Guidance:

Trustees should recognise that the "best estimate" concept is not precise and they will often need to be pragmatic and accept choices that seem reasonable to them in the light of information and advice obtained.

When determining assumptions, trustees should discuss various issues with their actuary, including:

- *whether particular assumptions are likely to be influenced by scheme-specific, industry-specific and/or member-specific factors (eg industry and geography in relation to mortality and the scheme rule on who is eligible to receive a dependant's pension for the proportion of members leaving a dependant)*
- *the main characteristics of the scheme's membership, or the characteristics of a wider population thought to be similar if the scheme's members are not a large enough group, when it comes to demographic assumptions*
- *whether it would be appropriate to sub-divide the membership into groups with shared characteristics*
- *relevant external data, such as trends in mortality rates and longevity*
- *expert opinions on past relationships (eg between bond and equity returns) remaining valid in future.*

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In relation to making assumptions about future investment returns, trustees should:

- *discuss the relevance of the scheme's funding plan with their actuary*
- *consider consulting their investment adviser about economic conditions and the implications for selecting best estimate investment returns.*

Trustees' decisions for matters that will have a material affect should be objective and based on evidence, which might include:

- *past history of investment returns from different asset classes and the relationships between them*
- *published mortality tables*
- *for larger schemes where it is statistically reliable, the scheme's own demographic experience*
- *published statistics on proportions married and the relative ages of partners*
- *the opinions of recognised experts*
- *the output from any stochastic models used by the actuary.*

Different legal requirements apply to CETV assumptions and those underlying a scheme's technical provisions. However, trustees should consider how the two bases relate to each other.

Once set, trustees should monitor and review the appropriateness of their assumptions, with the frequency of review being influenced by practicality and cost.

It would be reasonable for trustees always to review assumptions in conjunction with a scheme funding valuation, although reviews between valuations should be considered where the ICE is no longer within a reasonable margin of materiality of a best estimate. Accordingly, trustees should instruct their actuary to alert them when this is likely to be the case.

Circumstances justifying a review between valuations include:

- *a significant change in investment strategy*
- *a change in policy regarding the exercise of discretions*
- *becoming aware of significant differences between actual and expected demographic experience*
- *the publication of new mortality tables or other information in mortality.*

Even if trustees decide to incorporate some form of adjustment based on market yields in the calculation of ICEs, they should still monitor whether the assumptions remain appropriate in changing market conditions.

Allowance for members' options and discretionary benefits

The regulations require the minimum level of the ICE to be calculated as the amount needed to make provision within the scheme for a member's accrued benefits, options and discretionary benefits.

The trustees must determine the extent:

- of any options the member has that would increase the value of his benefits under the scheme
- of any adjustments they decide to make to reflect the proportion of members likely to exercise those options and
- to which any discretionary benefits should be taken into account, having regard to any established custom for awarding them and any requirement for consent before they are awarded.

One constraint imposed on trustees is that they should only make allowance for options that would increase the value of a member's benefits; this is likely to include such things as early retirement as of right on favourable terms, but exclude options such as commutation which typically reduces the value. This is because the DWP does not consider it appropriate to reduce a member's transfer value on the basis that other members had historically exercised unfavourable options, such as commutation which has often come to represent poor value for money. Although it is a new regulatory requirement, this constraint does not represent a change from what was previously imposed on the actuary by GN11.

Previously, trustees had to obtain a report from their actuary before they could decide not to allow for discretionary benefits in members' CETVs; that report had to address the implications for the scheme's funding position and had to be made available to members on request. Trustees are no longer required to obtain such a report.

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The requirements outlined above do not directly apply to any alternative calculation of ICEs the trustees may decide to adopt. Thus, for example, the trustees could decide to make an allowance for members to exercise the option to commute pension into cash, even if this is on unfavourable terms. However, the resultant ICEs must be no lower than if they had been calculated on a best estimate basis with allowance only for options that increase the value of members' benefits under the scheme.

Comment: It is of some concern that trustees must use best estimate assumptions but cannot allow for members exercising options such as commutation (even where the vast majority of members do so) if these would act to reduce ICEs. This creates a paradoxical situation where trustees might be forced to pay cash equivalents that exceed the expected cost to the scheme of providing the member's deferred pension.

Regulator's Guidance:

As only those options that would increase the value of benefits may be included when calculating a CETV, trustees will need to take advice from their actuary over which options would increase an ICE. Where an option that does increase the ICE is included, trustees should not offset that by another option that would on its own reduce that ICE.

Trustees may allow for the chance that the member will not take up such an option, based on their view of the scheme's likely future experience, informed by past experience of members taking it up.

Options that require [trustee and/or employer] consent should be treated as discretionary benefits.

When considering the extent to which discretionary benefits are to be included, trustees should:

- *make a decision in relation to each discretionary benefit they can provide under the scheme's rules*
- *understand the relevant scheme rule that provides for the award of the discretionary benefits in question, bearing in mind they may need to take legal advice*
- *usually consult any person (eg the employer) whose consent is required*
- *consider the past history and future intentions with regard to the award of the benefit, taking into account the relevant factors on which decisions are based (eg the scheme's funding position)*
- *take into account any agreed policy relating to the award of that benefit*
- *consider whether allowance for discretionary benefits is made in the scheme's funding plan (either explicitly or implicitly through margins for prudence), bearing in mind they may require the actuary's advice.*

Trustees should consider, not only all the standard benefit structures within the scheme, but also establish a process and principles for dealing with any non-standard benefits that may require separate consideration.

Allowance for administrative costs

Trustees may, but are not required to, reduce the ICE quoted to a member to take account of the administrative costs that would arise were the member to transfer his or her benefits out of the scheme. The condition for doing so is that the trustees should offset any ongoing administrative savings they will obtain if the member transfers his benefits against the cost of calculating and paying the transfer value. However, a member's ICE does not have to be increased by any "excess" ongoing savings over and above the administration costs.

Regulator's Guidance:

Trustees may reduce the ICE quoted to the member to take account of the administrative costs that would arise were the member to transfer his or her benefits out of the scheme. The administrative cost savings that must offset such costs will be the discounted value of the expected cost of:

- *administering the deferred pension up to retirement*
- *dealing with a deferred member's retirement*
- *administering the member's pension and contingent dependant's pension after retirement.*

Where a reduction is applied, it must be disclosed when providing the member's Statement of Entitlement.

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Reductions for scheme underfunding

It will continue to be possible for trustees to pay cash equivalents that are lower than the ICEs to take account of their scheme being underfunded.

Although similar to the current requirements, new conditions apply to schemes where the trustees have received an actuarial valuation under the scheme-specific funding regime (which will soon be all private-sector DB schemes). Basically, the trustees of such schemes must obtain an "insufficiency report" from their actuary with an effective date that is no earlier than the effective date of the most recent actuarial valuation.

In the insufficiency report the actuary is to compare the total of all members' (unreduced) ICEs with the market value of the scheme's assets as at the effective date. For this purpose the actuary:

- is to assume any active members left pensionable service on the effective date
- is to value all members' accrued benefits (including pensioners' benefits) on the assumptions determined by the trustees for calculating ICEs
- may divide the liabilities into one or more categories, using such approximations as he considers reasonable, provided that if he uses more than one category he must have regard to the statutory priority order that applies on winding up
- may disregard any insurance policies (and the insured benefits) from the assets and liabilities
- may value any insurance policies as he considers to be appropriate
- may deduct from the value of the assets such amount as he considers to be a reasonable estimate of the expenses associated with winding up the scheme.

In a break from the past, the actuary is not required to consider discussing the preparation of an insufficiency report with the trustees; this is left as a matter for professional judgement. Our view is that having such a discussion would be good practice and (time permitting) struggle to envisage a situation where an actuary would not do so.

The trustees may reduce, by a percentage not exceeding the relevant deficiency percentage, any part of a member's ICE that is payable in respect of a category of liability for which the insufficiency report shows the assets to be insufficient.

The regulations permit the trustees to treat the actuary's last relevant GN11 report as an insufficiency report. It is left to the trustees' discretion to determine whether it would be appropriate to use the GN11 report if the assumptions used in that report are different to those used in calculating members' ICEs. This is because the GN11 report (and indeed the insufficiency report) is intended to give a broad measure of the funding position of the scheme in order to provide a percentage by reference to which an ICE may be reduced. If the trustees are of the view that that percentage would probably not change materially as a result of the revised assumptions, it would be reasonable for them to continue to use the existing GN11 report.

Regulator's Guidance:

The preparation by the actuary an insufficiency report on the trustees' instructions should not in itself be taken as a recommendation that CETVs should be reduced.

Before deciding whether it is appropriate to reduce CETVs, the trustees should take into account:

- *the degree of underfunding*
- *their assessment of the strength of the employer's covenant - the stronger the covenant, the less likely the trustees may feel it necessary to reduce CETVs*
- *the structure of any recovery plan that has been put in place - the quicker a funding shortfall is being addressed, the less necessary reductions may be*
- *whether any contingent assets have been put in place and, if so, their form*
- *whether the employer has undertaken to make a compensatory payment into the scheme each time an unreduced CETV is paid.*

Trustees should not normally reduce CETVs where the employer's covenant is judged to be strong and any funding shortfall is being remedied over a reasonably short period of time. However, where there are concerns about the employer's covenant over the term of an agreed recovery plan, trustees should consider reductions in order to provide similar security to transferring as to remaining members.

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Trustees should, as appropriate, ask their actuary to advise them on the implications of one or both of:

- *not reducing CETVs where a reduction is permitted and/or*
- *applying a lesser reduction than would be permitted.*

An insufficiency report is not required where trustees do not wish to consider reducing CETVs.

It is likely to be appropriate for trustees to treat a GN11 report as an insufficient report where either:

- *the actuary advises any resulting maximum reductions would not be materially greater than those that would result from an insufficiency report or*
- *the trustees wish to apply a lesser reduction than the maximum permissible and the actuary advises that the GN11 report is appropriate for this purpose.*

A need to increase the degree of reduction (and hence a need for a new insufficiency report) between actuarial valuations may arise in certain circumstances, which include:

- *an apparent weakening in the strength of the employer's covenant*
- *an increase in the scheme's funding shortfall, eg due to a worsening of economic conditions.*

Where a scheme is underfunded and a recovery plan has been put in place, its funding level can generally be expected to improve over time, which would diminish the need to reduce CETVs. This means the level of reduction applied to CETVs shortly after an actuarial valuation may no longer remain appropriate throughout the entire period until the next valuation. Trustees should consider how their approach might be reviewed in such circumstances.

Although not a legal requirement, trustees should expect their actuary to discuss various aspects of the preparation of an insufficiency report. In particular, the actuary should discuss the appropriateness of including an allowance for the cost of winding up the scheme. The actuary should also discuss the nature of any approximations to be made in the calculations.

Another aspect for discussion is whether to allow for the statutory priority order on wind-up. It should usually be assumed that taking account of the priority order is the most equitable treatment, unless combining categories would not give rise to significantly different degrees of reduction in the ICE for any member.

A transfer payment for a member's former spouse following divorce can only be reduced if the former spouse (or civil partner) has been offered and refused an unreduced pension credit within the scheme.

Transitional arrangements

Any transitional arrangements would necessarily have been quite complicated. So there are none.

Quite simply, any statements of entitlement issued to members on or after 1 October 2008 must comply with the new requirements even if the request was received before that date.

In extreme cases, the trustees may be able to make use of the ability to extend the three-month deadline for issuing a statement of entitlement if they consider it appropriate; the new regulations expand the circumstances in which the deadline can be extended to cover any reasons that are beyond the control of the trustees.

Non-statutory transfers

The new regulations do not apply to circumstances where a member is able to take a transfer payment under his scheme's rules but he does not have a statutory right to a cash equivalent (eg he is within 12 months of his normal retirement date and left pensionable service more than six months ago). The trustees would be free to calculate the transfer value as they see fit, although it would make sense from an administrative perspective for the calculation to be consistent with that used for all other members.

Regulator's Guidance:

The same basis should normally be used for non-statutory transfers as for statutory transfers.

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Inward transfers

There will no longer be any restriction on the benefits to be granted by a scheme on receipt of a transfer value, because the DWP did not have the appropriate legislative power to include any regulations relating to these. It will now be for trustees to decide how to award benefits in respect of incoming transfers or the transfer value to be offered where the member had previously transferred benefits into the scheme.

Regulator's Guidance:

Where schemes are still accepting inward transfers and offering defined benefits, it will usually be appropriate to choose best estimate assumptions for the cost of providing those benefits. However, where there is potential for "selection" against the scheme (eg the offer of "added years" being attractive to members who expect their pay to increase faster than average), it would be appropriate for trustees to take this into account. Although in general assumptions should not vary between members, account may be taken of identifiable characteristics expected to affect the eventual cost of benefits.

Trustees should discuss with their actuary how to deal with any member who was granted added years and is subsequently looking to transfer out of the scheme.

Former spouses' or civil partners' pensions

Regulator's Guidance:

Trustees will need to consider the guidance in conjunction with the legislation on pension sharing on divorce. This is a specialist area where trustees should take appropriate advice.

Disclosure to members

There will be some new disclosure requirements for members considering whether to transfer out of a scheme.

The trustees will have to tell such members that the Financial Services Authority and the Pensions Regulator provide information that may assist with the transfer decision. Such members will also have to be told about the Pension Protection Fund and be advised to consider taking financial advice. However, other disclosure requirements may be relaxed as a result of the wider deregulatory review.

Regulator's Guidance:

It would be good practice for trustees to make available reasonable details of the scheme's relevant CETV basis (including underlying assumptions) on request from a member or a member's financial adviser.

Trustees should continue to ensure that the amount of any CETV relating to Guaranteed Minimum Pensions or post-97 contracted-out salary-related rights is identified.

Schemes in wind up

Regulator's Guidance:

The new regime applies to schemes in wind-up. However, such schemes cannot reduce CETVs in accordance with an insufficiency report; they should instead comply with the legislative requirements for the allocation of assets on a wind-up, which will dictate the extent to which reductions can be applied.

Schemes in a Pension Protection Fund (PPF) assessment period

Regulator's Guidance:

Although not exempt from being required to provide quotations (Statements of Entitlement), schemes being assessed for entry to the PPF are not normally allowed to pay CETVs. However, unless needed for pension sharing on divorce, it will usually be appropriate for schemes to inform inquiring members that quotations will not be issued. Where this is the case, provided members have been kept informed, the Regulator will not seek to take action.

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Comments

Trustees should note the contrast between the scheme-specific funding regime, which requires them to set prudent assumptions, and the new transfer value regulations, which will require them to set "best estimate" assumptions. This may encourage trustees to be more explicit about where they are building prudence into their funding assumptions and may lead to explicit contingency margins being introduced.

The requirement to have regard to the scheme's investment strategy when determining discount rates may not be that simple to meet in cases where the trustees' statement of investment principles does not draw an explicit link between long-term asset allocation and the profile of the scheme's liabilities. In such cases trustees may have to consider how their investment strategy is likely to develop as the membership profile of their scheme matures over time.

Any simplification of the transfer regime is to be welcomed. However, the extent to which schemes will benefit from the relaxation on how inward transfers are treated, for example, is questionable given it makes sense for there to be consistency between inward and outward transfers and few schemes still grant added years or other defined benefits on receipt of a transfer value.

This *In Focus* is based on Chapter IV of the Pension Schemes Act 1993 and The Occupational Pension Schemes (Transfer Values) Regulations 1996 (SI 1996/1847), as amended by The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 (SI 2008/1050) and The Occupational and Personal Pension Schemes (Transfer Values) (Amendment) Regulations 2008 (SI 2008/2450), the DWP's response dated April 2008 to its consultation on the draft regulations and the "Transfer values – Guidance to the trustees of private sector pension schemes providing defined benefits" issued by the Pensions Regulator on 29 September 2008.

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