

# Pensions Bulletin

## Fact Sheet 2

Autumn 2008 Issue 3

### Transfer values

#### 1 What is a transfer value?

- 1.1 Members of pension schemes accrue pension rights in their scheme. Where a member transfers from one pension scheme to another, a cash value is put on their accrued rights (the 'Cash Equivalent Transfer Value' or 'CETV') and that cash sum is paid from the transferring scheme to the receiving scheme.
- 1.2 In a defined contribution (DC) pension scheme, the value of a member's pension rights is usually just the cash value of his or her individual account at any particular point in time.
- 1.3 The conversion of defined benefit (DB) pension rights into a cash amount is more complicated and a special methodology has to be used for the calculation, based on assumptions on matters such as future investment returns and life expectancy.
- 1.4 Regulations set out the methodology for the calculation and for the verification of CETVs for both DC and DB schemes. The methodology is also used for other purposes where pension rights may need to be valued (for example, pension sharing on divorce).

#### 2 Legislative background

- 2.1 Since 1986, members of pension schemes have had a statutory right to have their CETV transferred to another pension scheme. The legislative provisions are contained in Chapter IV of Part IV of the Pension Schemes Act 1993 and in regulations made under those provisions – the Occupational Pension Schemes (Transfer Values) Regulations 1996. These are the regulations that applied prior to 1 October 2008.
- 2.2 Under those regulations, the Government delegated, to the Faculty and Institute of Actuaries ('the Actuarial Profession'), the responsibility for determining the policy on the calculation framework for CETVs. The Actuarial Profession fulfilled its obligations by issuing a mandatory guidance note to actuaries, known as 'GNII'. From April 2007, responsibility for GNII passed to the newly formed Board for Actuarial Standards.
- 2.3 In May 2005, the Actuarial Profession consulted on proposals for a major revision of GNII – in a document called Exposure Draft 54 (EXD54). However, there was substantial resistance to the proposals from many actuaries and other parties, and it was decided to refer the matter to Government.
- 2.4 The Government discussed the results of the consultation with the Actuarial Profession and it was agreed that the time was right for the Government to resume direct responsibility for setting the rules for CETVs.

- 2.5 For the Government, the starting point has been the ongoing sustainability of pension schemes. It issued its own consultation document, in June 2006, setting out three approaches to the calculation of CETVs:
- Prescribed assumptions
  - 'EXD54' basis
  - Scheme specific basis
- 2.6 Further information on these approaches can be found in the consultation paper 'Approaches to the calculation of pensions transfer values' via the following link:  
<http://www.dwp.gov.uk/publications/dwp/2006/calc-ptv.pdf>
- 2.7 Following the consultation, the Government decided to regulate on the basis of the 'scheme specific' approach. This is an approach based on the expected cost to a pension scheme if the member had decided to remain in the scheme rather than transfer to another scheme. This is the approach that also underpinned GNI I. Of the 69 responses to the consultation, most respondents favoured the scheme specific approach.
- 2.8 Draft amending regulations were issued on 6 July 2007. However, initially proposed timescales were deemed too tight. The effective date for changes was therefore deferred from 6 April to 1 October 2008.
- 2.9 Final regulations, the Occupational Pension Scheme (Transfer Values) (Amendment) Regulations 2008 were laid before Parliament in April 2008. These amendments prescribe the new way of calculating CETVs with effect from 1 October 2008. From this date, GNI I is withdrawn.
- 2.10 The intended effect is that across all pension schemes, transfer values should remain broadly at the same level as they would have done had the current actuarial guidance remained in force.

### **3 Key elements of the new transfer value regulations**

- 3.1 The 2008 Amendment Regulations establish new arrangements for the calculation and verification of CETVs and cash transfer sums (i.e. the transfer values that must be offered to members of occupational pension schemes, who leave their scheme with between 3 and 24 months pensionable service, but do not qualify for preserved benefits under the scheme).
- 3.2 The regulations are effective from 1 October 2008. The main change introduced is that from that date, scheme trustees have the responsibility, having taken actuarial advice, for setting transfer value assumptions.
- 3.3 One major feature of the new legislative requirements is that the transfer value should be at least the best estimate of the cash required to be invested in the scheme to reproduce the relevant member's benefits.
- 3.4 The new arrangements are not subject to any transitional provisions.

### **4 Calculations**

- 4.1 From 1 October 2008, CETVs must be calculated and verified by first calculating the 'initial cash equivalent' (ICE); i.e. the cash equivalent before any permitted deductions.
- 4.2 For DB pension benefits, the following provisions apply to the calculation of the ICE:
- It must be calculated on an actuarial basis.

- It must be the amount required at the date of calculation ('the guarantee date') to make provision within the scheme for a member's accrued benefits. For this purpose, the trustees must determine the extent:
  - » of any options the member has which would increase the value of their scheme benefits;
  - » 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.
- Having taken the advice of the actuary, the trustees must determine the economic, financial and demographic assumptions. In doing this the trustees must:
  - » have regard to the main characteristics of the membership of the scheme or, where the membership does not form a large enough group to allow demographic assumptions to be made, the characteristics of a wider population sharing similar characteristics;
  - » 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; and
  - » determine the assumptions with the aim that, taken as a whole, they should form the best estimate of the ICE.

#### 4.3 For DC benefits, the calculation of the ICE is much simpler:

- The ICE is the 'realisable value' of the member's benefits (the amount on the date of disinvestment).
- The trustees must calculate the realisable value in accordance with the scheme rules, and in a manner which is approved by the trustees and consistent with Chapter IV of Part IV of the Pension Schemes Act 1993.
- The realisable value must include any increases to the benefits resulting from a payment of interest made in accordance with the scheme rules.

## 5 Reducing the ICE

- 5.1 Once ascertained, an ICE can be reduced in order to reflect scheme underfunding. However, the trustees must first request an 'insufficiency report' from the actuary. Broadly, this report supersedes the 'GNII reports' that trustees may have commissioned previously.
- 5.2 For convenience, the regulations provide that trustees may treat the actuary's last relevant GNII report as an insufficiency report. However, this might not be appropriate if the assumptions used in the report are different to those used in calculating the member's ICE.
- 5.3 The Department for Work and Pensions (DWP) considers that this issue should be left to the discretion of the trustees in each individual case. If the assumptions are significantly different, the trustees should consider commissioning a new insufficiency report. However, if the differences are minor, the trustees may consider that it is still reasonable to use the GNII report.
- 5.4 Trustees may also reduce an ICE to reflect any reasonable administration costs and must offset against these costs any reasonable administrative savings.
- 5.5 Members of pension schemes have certain rights to information under the transfer value regulations and this includes the right to know whether their cash equivalent has been reduced.

## **6 Increasing the ICE**

- 6.1 If trustees wish to pay cash equivalents that are higher than the ICE, there is provision for them to do so. Cash equivalents above the ICE are subject to any requirement for consent (e.g. employer consent may be required under scheme rules).
- 6.2 Where a higher amount is to be paid, the cash equivalent is to be calculated and verified in such manner that can be approved by the trustees.

## **7 Trustees' role**

- 7.1 Under the new transfer value regulations, pension scheme trustees are responsible for calculating each CETV. In practice, they will delegate this responsibility to the actuary or administrators.
- 7.2 Assuming a member has exercised his cash equivalent right and the trustees have done what is needed to carry out his or her wishes, they are discharged from any obligation to provide benefits to which the cash equivalent related.
- 7.3 When the trustees receive an application for a cash equivalent, they must normally do what is needed to carry out what the member requires:
- in the case of a member of a salary related scheme, within six months of the guarantee date, or (if earlier) by the date on which the member attains normal pension age; or
  - in the case of a member of any other occupational pension scheme, within six months of the date on which they receive the application, or (if earlier) by the date on which the member attains normal pension age.

## **8 Employer's role**

- 8.1 There is no formal role for the employer in the payment of CETVs above the minimum amount (i.e. the ICE), in determining discretionary benefits or in setting the assumptions.

## **9 The Pensions Regulator**

- 9.1 The Regulator issued guidance on 8 August 2008 regarding the calculation of cash equivalent transfer values. This publication can be found on the Regulator's website at [www.thepensionsregulator.gov.uk](http://www.thepensionsregulator.gov.uk)
- 9.2 The guidance aims to help trustees understand the requirement for calculating transfer values. It also includes the Regulator's views on good practice and outlines its expectations of the standards trustees should adopt.

## **10 Implementation at The Pensions Trust**

- 10.1 The Trustee of The Pensions Trust has agreed the following in relation to the new regulations:
- no adjustment will be made to the ICE calculation for any benefit options;
  - no allowance will be made for any discretionary benefits in the ICE calculation, except for an allowance for discretionary pension increases for Arthritis Care and Bedford Charity;
  - the economic and demographic assumptions will be as follows:
    - » Inflation – being the difference between the yields of fixed interest and index-linked government bonds less 0.6% points.

- » Pre-retirement discount rate – being the yield on Government fixed interest bonds plus 3.5% points per annum.
  - » Post-retirement discount rate – being the yield of fixed interest government bonds plus 0.8% points per annum.
  - » Scheme specific investment strategy adjustment – pre-retirement and post-retirement rates will be reduced when schemes adopt more conservative scheme specific investment strategies.
  - » Pension revaluation in deferment – based on actual increase in RPI from date of leaving to the date of calculation plus the implied rate of inflation per annum from the date of calculation to NRD, subject to an overall maximum of 5% per annum. Guaranteed Minimum Pensions: statutory increases.
  - » Pension increases in retirement RPI capped at 5% per annum – based on the level of inflation, subject to a maximum of 5% per annum.
  - » Pension increases in retirement RPI capped at 3% per annum – based on the level of inflation, subject to a maximum of 3% per annum.
  - » Pension increases in retirement RPI capped at 2.5% per annum – based on the level of inflation, subject to a maximum of 2.5% per annum.
  - » Pre-retirement mortality assumption – in line with the standard mortality table used for 30 September 2006 valuations. To be amended to the mortality table used for 30 September 2008 valuations once this was agreed.
  - » Post retirement mortality assumption – in line with the standard mortality table used for 30 September 2006 valuations. To be amended to the mortality table used for 30 September 2008 valuations when this is agreed.
  - » Pensioner mortality assumptions – in line with the standard mortality table used for 30 September 2006 valuations. To be amended to the mortality table used for 30 September 2008 valuations when this is agreed.
  - » Family statistics – 90% proportion married. Wives assumed to be three years younger than husbands.
  - » Expenses – no allowance.
- no under funding reduction will apply, except where there is a concern over the employer's covenant;
  - transfer values will not be increased above the level of ICEs;
  - transfer-in benefits will continue to be calculated consistently with transfers-outs; and
  - previous transfers-in will continue to be given particular consideration in the ICE calculation.

10.2 The Board further agreed that these economic and demographic assumptions would be reviewed at the time of each scheme's triennial valuation. If significant changes were made to the basis in any one year, the basis for those schemes not undergoing a valuation would also be reviewed.

10.3 The Board noted that the mortality assumptions would be updated on the issue of the new 'Self-Administered Pension Scheme' (SAPS) tables. For more information about developments in the assessment of mortality trends, please refer to Fact Sheet 4.

*While every effort has been made to ensure the accuracy of the information contained in this fact sheet, it should not be treated or relied upon as a statement of law. Readers should contact their regular Account Manager at The Pensions Trust in relation to their own circumstances and/or refer to the original source material as appropriate.*

*Sections of this material were provided by HSBC Actuaries & Consultants Ltd and are reproduced with their kind permission.*