

## **Briefing Note: Final Salary Transfer Values**

### **Foreword**

Parliamentary Ombudsman Ann Abraham's criticism of the Government in her recently published report attracted much media attention, especially since the Government is fiercely defending its case and resisting calls to grant compensation.

Her report may also lead to an often overlooked and misunderstood part of the pensions landscape – transfer values – being given, Lazarus-like, a new lease of life. It makes the important upcoming review of the way transfer values are calculated, worthy of more interest than might otherwise have been given.

Final salary transfer values – the amount of money which an individual early leaver can take out of their pension scheme – are calculated by actuaries. But few members transfer out of final salary schemes nowadays. In fact some pensions managers say that the commonest use of transfer value calculation procedures is to assess the value of an individual's pension benefits for use in divorce proceedings.

The Abraham report has drawn attention to the member's right to transfer-out of a final salary scheme. This is one of the "remedial actions" that Ms Abraham considers could have been taken by some of the members affected before their scheme collapsed, had they only been better informed. The Government disputes this conclusion, saying that "*...leaving an occupational scheme in such a way was – in any normal circumstances – a decision fraught with financial risk.*"

So what is the financial risk to which the Government refers? And why is the Pensions Board not proceeding with its proposals for change of GN11, following the consultation on its possible replacement exposed to members as EXD54?

This briefing note explains further.

### **The issues**

A key difficulty with transfer values lies in deciding exactly how a transfer value should be calculated. There are two key questions. Should the transfer value be calculated taking into account the assets which the scheme is holding to support its benefit promise? If not, should the calculation reflect a "market cost" of the benefit? The arguments for either approach take us back to the familiar "equities or bonds" issue for pension scheme discount rates.

The method of transfer value calculation which schemes typically use is the scheme asset approach. It treats future returns on equities as money already earned, thus enabling the transferring scheme to take immediate credit for such returns whenever a member elects a transfer. Therefore this method usually obliges a transferring member to take on a degree of investment risk through his or her own equity investment - more so than would be needed were the transfer value calculated using a "market cost" approach. Otherwise the member stands no chance even of matching the final salary pension given up after the transfer.

Depending on the size of the equity risk premium assumed in the discount rate for the transfer value calculation, the implications for the member of the scheme asset approach can be significant<sup>1</sup>. That might explain why few transfers actually proceed beyond the quotation stage. Some justify this by pointing out that a transfer is after all not obligatory but an option to the member. This might also be what the Government is getting at in its response to Ms Abraham.

But there is one further important development not relevant to the Abraham report, but relevant now: it affects early leaver transfers after 6 April 2005. This is the Pension Protection Fund (PPF). The PPF has implications for transfer value calculations, for within certain defined limits it will take on the pensions of insolvent employers. It therefore makes pensions in all schemes more secure, but especially those where the sponsoring employer is weak. Arguably, a transfer value paid after 5 April 2005 should reflect this improved level of security and thus be of a higher amount.

### **Other uses for transfer values**

Transfer values are also used to value pension assets when a member divorces, whether or not a transfer is to take place to another arrangement by either party. The choice of discount rate can therefore affect the division of assets between the divorcing couple. For example, a high equity-based discount rate may understate the true pension value and generally favour the party with the larger pension asset. This is to the disadvantage of the other party, typically the wife.

Another use of transfer values is to value directors' benefits for financial reporting purposes.

### **The way forward**

The issues discussed in this note are difficult to resolve, and in many ways are more to do with social policy and political intentions rather than the detail of actuarial calculation methods.

During 2005, the Actuarial Profession consulted widely on plans to change the existing basis of calculation of transfer values – our so-called “EXD54 consultation”. We suggested a move from a scheme asset approach to a new “market cost” approach, to recognise all the recent improvements in member security. We did so in the knowledge that trustees can still cut back transfer payments if they have to, to protect the other members of the scheme.

This move also followed a pre-consultation meeting held in 2004, where a consensus emerged amongst those attending from inside and outside of the actuarial profession, that a “market cost” approach was the right way to proceed.

Despite the justification for our plans and the outcome of this pre-consultation meeting, we received many strong objections during the subsequent formal consultation. Most of these objections concerned the perceived cost to schemes of our proposals. But, underpinning all of these consultation responses, was a consistent theme that the social issues we describe here need to be addressed by the Government in a new legislative framework.

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<sup>1</sup> There are also issues of expense and mortality risk arising from all transfer calculation methods, which are beyond the immediate scope of this note.

We are persuaded by this. The current pensions environment is very different from that in which the original legislation governing transfer values was set. We agree it is right that Government, rather than the Actuarial Profession, should take the lead in fundamental decisions of social policy.

The debate which the Actuarial Profession started is therefore now to be taken forward in a joint approach with the Government. This will enable a broader debate, into a wider set of related issues, than it is possible or appropriate for the Profession to effect under the current statutory framework.

### **Conclusions**

Most of the consultation responses received by the Pensions Board represented the interests of schemes as a whole, and/or the sponsoring employer. That is hardly surprising, considering the very grave cost pressures faced by those who sponsor or govern occupational pension schemes. However, the Pensions Board was struck by the almost complete lack of response from an individual member perspective.

In the foreword to this briefing note, I refer to the publication of the recent report by the Parliamentary Ombudsman. While this concerns an investigation into other matters, it does illustrate only too starkly the potential for serious problems and hardship to arise where member interests are overlooked, whether or not it is fair to say that that did happen in those cases addressed by Ms Abraham's report.

Given the tortuous history of the transfer value issue over some years now, and the standards to which the Parliamentary Ombudsman aspires, the most difficult challenge of all is perhaps how to adequately inform the member about the limitations of the transfer value. It should not be forgotten that an individual member, receiving a quotation that may also be referred to under standard pensions terminology as a "full cash equivalent", might not readily appreciate what it represents. And, where an option is given to a member, in this case the option to transfer, there is also the chance of a decision being taken that with hindsight he or she may have cause to regret.

While it is understandable that schemes will not wish to be saddled with unnecessary extra costs, the challenge of good communication with the member is one that we, the Government and the pensions industry can hardly ignore. Especially given the Parliamentary Ombudsman's clear view that, to avoid injustice, members need to be able to make fully informed choices.

The Actuarial Profession sees the provision of good, cost-effective information to the member as essential, whatever the outcome of the forthcoming wider-ranging Government consultation.

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