

## **The Actuarial Profession**

### **Ministerial Briefing Note : Actuarial Guidance on Transfer Values (GN11) October 2005**

#### **1. Relevant Legislation**

- 1.1 The primary source of legislation for transfer values is The Pension Schemes Act 1993, which consolidates earlier legislation. This Act gives members the right to a cash equivalent transfer value and requires “*cash equivalents to be calculated and verified in the prescribed manner*”. The corresponding secondary legislation provides for cash equivalents to be determined by the trustees or the actuary, but in either case for the actuary to certify that GN11 has been followed. Thus, the legislation gives no “steer” as to the method or basis by which a cash equivalent transfer value should be calculated.
- 1.2 The legislation permits trustees of private sector schemes to reduce cash equivalent transfer values where their scheme is inadequately funded, such that the payment of full transfer values in accordance with GN11 would adversely affect the security of those members remaining in the scheme. A number of safeguards are built into the process by which trustees of underfunded schemes are allowed to pay reduced transfer values. The significance of this aspect of the legislation is that it provides strong justification for GN11 to specify transfer values which are independent of the funding level of the scheme. If Parliament had wished otherwise, it could have constrained the approach on transfer values to be adopted by the Actuarial Profession in GN11 instead of enacting the additional legislation allowing transfer values to be cut back. This provision does not apply to unfunded public sector schemes, although the legislation referred to in 1.1 above does apply to them.

#### **2. Related Issues**

- 2.1 GN11 has an important role to play in what is disclosed to ‘early leavers’ as the worth of their pension benefit. All schemes, whether unfunded, funded adequately or underfunded, must disclose on request to the member the unreduced GN11 transfer value. Individual members of pension schemes do not have a good understanding of the worth of their pension benefits and the cost of providing them. Most tend to significantly underestimate the cost of saving for a given level of pension. The Government’s initiatives to encourage levels of private saving and decrease the reliance on the State will not be helped if GN11 provides a calculation of pension value that understates both its true worth and the cost of replicating a pension of similar amount. Any such understatement of pension value (exacerbated by an out-of-date GN11) is most likely to affect one of the Government’s key target audiences under these initiatives - younger members with short periods of pensionable service, especially those whose potential to accrue further benefits in an occupational pension scheme is curtailed by scheme closures or other cutbacks in employer sponsored provision.

- 2.2 GN11 is also used for other purposes. Calculations and disclosures under GN11 are applied under the divorce legislation (valuation and pension sharing orders) and for the valuation of directors' benefits in company annual reports. If these separate disclosures understate the value of the pension, there are consequences for the financial reporting of directors' benefits and the fairness or otherwise of the valuation of personal assets on divorce. Any unfairness in pension valuations on divorce due to understatement is most likely to discriminate against women, as it is women who generally have the larger claim on the pension assets earned by the divorcing couple.

### **3. Historical Background**

- 3.1 The right to have a transfer value was introduced in the mid 1980s, when early leavers were less well protected than today. At that time, there was a widely held view that final salary schemes were "unfair" because:

- membership was compulsory;
- there were cross subsidies from early leavers to stayers and from low paid to higher paid staff;
- there was no direct benefit to members from rising stock markets.

Government policy, strongly supported by the media, was to encourage membership of personal pension schemes (introduced in April 1988).

- 3.2 It was in this climate that the right for members to have a transfer value paid to another approved pension arrangement was introduced. This right could be exercised after leaving the employer's service or, under another new piece of legislation introduced at about the same time, after opting out of membership of the employer's scheme.

### **4. Transfer Values – The Basics**

- 4.1 An actuarial value of a member's benefits represents the present, or discounted, value of a stream of expected future cash payments. In the case of a transfer value, this is the discounted value of expected future payments of the member's pension from their normal retirement age (plus any attaching death benefits). The key component of the calculation of a transfer value is the rate used to discount the expected future payments to the calculation date. This discount rate represents the expected future investment returns which could be earned on the capital. If it is assumed investment is in equities, there is a higher discount rate and a lower transfer value. If investment is assumed to be in bonds, there is a lower discount rate and a higher transfer value.

## **5. Transfer Values – Changing Views**

- 5.1 There are two distinct ways of considering transfer values, which encapsulate the current debate on GN11.
- 5.1.1 One way is to consider the expected cost to the scheme of providing the benefits. Under this approach, allowance is made in the discount rate for the expected investment return from the assets held by the scheme.
- 5.1.2 The alternative way is to consider the value to the member of their future benefits. Under this approach, the transfer value represents the “intrinsic” value of the benefits, independent of the actual investment policy of the scheme. This approach is equally applicable to an unfunded scheme, where there are no assets, but where the sponsoring employer is unlikely to default.
- 5.2 Actuarial thinking has developed significantly over the last 20 years. In the 1980s, the expected cost to the scheme approach was generally accepted as the right method and one which GN11 has followed since its inception. It permits the discount rate to reflect the higher expected investment returns available from equities, since most final salary schemes hold a significant portion of their assets in equities.
- 5.3 Today, views have changed and it is the value to the member that is the better actuarial view. Moreover, because the cash flows involved in paying a pension are very similar to the interest payments on a bond investment (as opposed to an equity investment), a bond based discount rate should be used.
- 5.4 Developments in actuarial thinking take time to find universal acceptance and many outside the Actuarial Profession have found the arguments hard to understand. The attached appendix contains a simplified explanation.
- 5.5 An important additional factor in the move away from the cost to scheme was the change in legislation in June 2003, which required a solvent employer to stand behind their pension promises. This legislation fundamentally changed the employer’s obligations and meant that the value to the members of their benefits (including the transfer value) had increased.
- 5.6 The statutory term describing the transfer value is “cash equivalent”. From a member’s perspective this has resonance in a calculation of the worth of their benefits rather than a calculation that takes into account the interests of the other members of the scheme or social policy issues. Seen from a member’s perspective, the member would be likely to assume that the “cash equivalent” of his or her benefits was based on the intrinsic value of those benefits and that other factors (such as “cost to the scheme” etc.) would be irrelevant.

## **6. Consultation on Changes to GN11**

- 6.1 The Pensions Board of the UK Actuarial Profession decided to review GN11 in 2003. A policy setting consultation was held in early 2004, both within the profession and with outside bodies (including the DWP and the National Association of Pension Funds). The main policy thrust from this consultation was that transfer values should be calculated as the value to the member using discount rates based on bond yields (ie the approach described in 5.1.2 above). The specific details of how transfer values should be calculated were not, however, finalised at that time.
- 6.2 In May 2005, an exposure draft (ExD 54) of a revised version of GN11 was published for consultation. There were over 100 responses, about one third from actuarial firms or individuals, one third from trustees and one third from companies and representative organisations. Amongst the non actuaries, there was almost universal criticism of the move to bond based discount rates. Respondents considered that the new transfer values would be too high and that consequently they would be forced to go through the transfer value cut back procedures (see section 1.2) above). This would require them to explain to their members that the scheme was unable to pay full transfer values, which it was considered would destroy the fragile confidence in final salary schemes. In a climate where final salary pension provision is felt to be under attack on all sides, such respondents have felt this would be another body blow. This criticism of ExD 54 is however concerned with the possible social consequences were it to be implemented, rather than saying that the approach underpinning ExD 54 is incorrect
- 6.3 Since the legislation does not require the Actuarial Profession to take into account wider social policy issues, the primary concern for the profession is what is a fair transfer value to the member and how it should be calculated. This view is supported by Parliament which introduced safeguards for underfunded schemes (1.2 above).

## **7. Link to New Funding Regime**

- 7.1 In the context of the criticism of ExD 54 (6.2 above) the new regulatory regime on scheme specific funding will require trustees to disclose to members, on a regular basis, details of the funding level of the scheme, both on an ongoing basis and on a solvency basis. Those who have objected to the transparent approach to transfer values underpinning ExD 54, because they prefer not to expose underfunding to members, seem to have overlooked that disclosure of this information will soon be made in any case.

## **8. Role of Government to Set Policy**

- 8.1 Although the consultation showed that there was no agreement on what a transfer value should represent, both actuarial and non-actuarial respondents were unified in saying that the principle of what a cash equivalent should represent should be set by Government and not by the Actuarial Profession.

- 8.2 There is now, within the Actuarial Profession and the wider pensions industry, as a result of the consultation on ExD 54, a powerful voice that says determining social policy is the role of Parliament through legislation. It is not an appropriate role for the Actuarial Profession.

# DRAFT

## Appendix

### Alternative Approaches to Transfer Values

There are two alternative approaches to calculating transfer values. Firstly, “the expected cost to the scheme” approach involves using a discount rate that reflects expected returns on equity investments. The second approach, “the value to the member” uses a discount rate based on expected bond returns. This note sets out one argument why an individual transfer value should be calculated using bond based discount rates rather than allowing for the expected higher returns from equities.

1. Equities are expected to achieve higher long term returns than gilts but there are greater risks attached to equity investment. This is the classic risk/reward trade off in investments.
2. Suppose, for the sake of example<sup>1</sup>, that a member has a deferred pension of £1,000 pa and the transfer value calculated using a gilt based discount rate would be £10,000, whereas the transfer value calculated using a discount rate based on higher expected returns from equities would be £7,000.
3. If the member receives a transfer value of £10,000, they can either invest it in a bond portfolio and replicate the benefit of £1,000 pa with a degree of certainty. Alternatively, they can invest it in an equity portfolio, in which case they would enjoy any extra reward from investing in equities but also take all the risk attached to that investment policy.
4. If, on the other hand, the member receives only £7,000 and invests in a bond portfolio, he will only receive 70% of his expected benefits, ie £700 pa. If he invests in an equity portfolio, he may get £1,000 pa but there are risks involved and he may get less than this. In other words, to replicate the benefit of £1,000 pa the member has to take all the risks of equity investment. The exporting scheme on the other hand is £3,000 better off. The exporting scheme has “pocketed” the anticipated reward, and done so in advance, before it has been achieved. This represents the credit taken in advance for the expected higher

---

<sup>1</sup> The figures in the example are illustrative. The actual figures would depend on many features including the member's age. Some members could receive much less and others much more than the 70% illustrated.

returns from equities, which may or may not materialise.

5. In a nutshell, the argument goes that it is only fair that the rewards from equity investment should accrue to the investor who is taking the risk, not to someone else. Under 4 above, that manifestly is not the case.