



Institute  
and Faculty  
of Actuaries

# Thematic Review Report

Pensions: actuarial factors used to calculate  
benefits in UK pension schemes

by David Gordon

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# Foreword

Neil Buckley, Lay Chair of the IFoA Regulation Board



I welcome the publication of the Actuarial Monitoring Scheme's (AMS) first Thematic Review Report: *Actuarial factors used to calculate benefits in UK pension schemes*. This represents a significant milestone for the AMS, which was launched in September 2019. This is the first time the Institute and Faculty of Actuaries (IFoA) has been able to review independently, in a regulatory context, the standard of work being carried out in practice by actuaries. I would like to thank all the IFoA Members and organisations that took part.

The Regulation Board was delighted to receive this engaging and thought-provoking report and, in particular, the finding that the overall standard of advice was very high.

Our key role as a Board is to protect the public interest. While we welcome the overall findings, we are concerned that the quality of actuarial advice in some instances may be contributing to commutation rates being well below transfer values, which may lead to poor value to members. There are of course many reasons for this, including the role of trustees and sponsors, and the impact on funding. However, the actuary's advice is critical and needs to follow all existing standards, in particular to explain why these actuarial factors differ and the implications of this difference for scheme members.

We therefore endorse the Review recommendations: for actuaries to improve the quality of their advice by following actuarial standards fully; for regulators to clarify these standards; and for further research to be carried out.

**Neil Buckley**

Lay Chair of the IFoA Regulation Board



# Introduction

## David Gordon, IFoA Senior Review Actuary



I am delighted to launch the results of this first Thematic Review, which looked at the actuarial advice given by scheme actuaries to UK pension scheme trustees in setting transfer values and commutation rates.

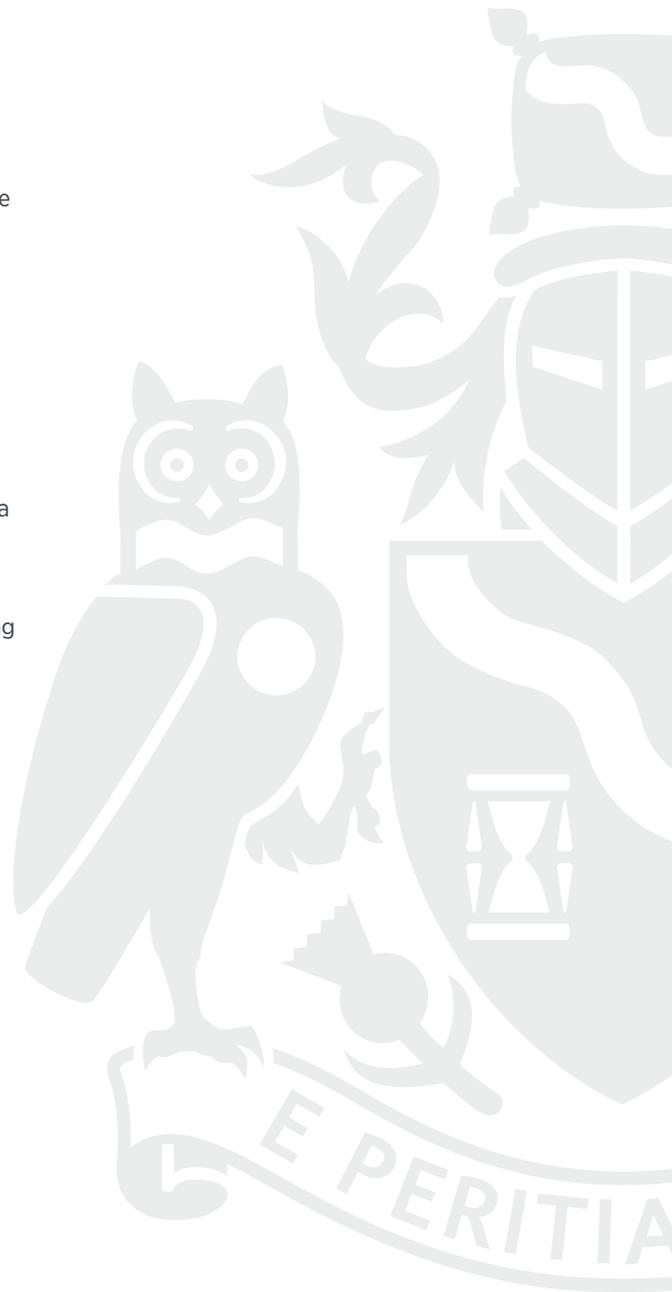
I would like to thank the 63 individual scheme actuaries from 19 organisations of all sizes who agreed to have their work scrutinised as part of this review. We were particularly pleased to receive a wide range of types of advice, ensuring that we were able to conduct a comprehensive and meaningful review.

The key recommendations are set out in the Executive Summary. The report also contains a detailed summary of the examples of advice and benchmarking that we have reviewed.

The difference between transfer values and commutation rates is not new but this review shines a spotlight on how wide the gap can be. Setting these factors is an area where actuaries directly influence member benefits. Although the ultimate decision often rests with the trustees, the advice provided by the actuary is critical. The recommendations in this review directly address this difference and are designed to inform the work of scheme actuaries. We hope that Members will use our findings to improve further the quality and clarity of their work.

I look forward to discussing this report and its recommendations with pensions industry stakeholders.

**David A Gordon**  
Senior Review Actuary



# Executive summary

The overall standard of the examples we reviewed was very high. Advice on transfer values was consistently in line with the relevant regulations and regulatory guidance. Advice on commutation factors, however, which is subject to less regulation, depending instead on each pension scheme's rules, was more variable, with clear evidence of more reliance on scheme actuary judgement.

These headline recommendations aim to improve the quality of the advice given by actuaries in this key area of public interest:

## **Actuaries should explain why transfer values and commutation rates differ**

Actuaries should explain to trustees the reasons for differences between assumptions used for different factors and the implications on scheme members making choices about their benefits. This is particularly important where commutation rates are materially below an equivalent best estimate transfer value, which may result in poor value to the scheme member taking the commutation option.

We found that the median transfer value at age 65 for £1 per annum pension is £29; the equivalent median commutation rate at the same age is £18. Although commutation rates do not typically allow for a spouse's pension, these rates are otherwise comparable in being a lump sum in exchange for a lifetime pension. There are reasons why these factors may differ at an individual scheme level: transfer values must be at least 'best estimate' according to regulations, while commutation rates are set in line with each scheme's rules, and are often seen as part of the scheme design. Actuaries need to explain the rationale for this, in line with technical actuarial standards.

## **Actuaries should review commutation rates regularly**

We recommend that three years should be seen as the 'maximum' time between reviews, rather than the default, unless a scheme's commutation rates (like transfer values) vary with market conditions. This is crucial to ensure that the basis underlying the latest advice does not become out of date and lead to poor outcomes for members.

We found that, rather than providing advice in response to changes in market conditions, actuaries have generally provided commutation rate advice on a three-year cycle aligned to triennial actuarial valuations. The result is that commutation rates are normally fixed between formal reviews for a period of three years or more, while transfer values vary each month based on market conditions.

The IFoA's 2016 Risk Alert called for actuaries to consider the frequency of providing advice about commutation rates and for actuaries to be aware of trends in market conditions.

## **Actuaries should certify commutation rates where required**

Where scheme rules require the actuary to 'certify' that the commutation rates set by the trustees are reasonable, the actuary should explicitly make such a certification. Where a report contains a range of potential outcomes the actuary should make clear which can be certified. This ensures that the safeguards written into scheme rules are followed, which is consistent with the Compliance principle of the Actuaries' Code.

## **Actuaries should improve how they communicate assumptions and results**

Actuaries should answer the trustees' typical questions "What changes are being proposed, and why?" and "How do the changes affect members and funding?"

We saw a wide range of advice, varying in style and the way the actuary complied with standards. The best examples set out the reasons why assumptions and the resulting factors had changed compared to previous advice, as required by the technical actuarial standards TAS 100 and TAS 300. They were also clear on the financial impact of the recommended factors on member benefits, by giving numerical examples.

Areas of the technical actuarial standards where a significant proportion of actuaries were not clear included:

- Stating assumptions used in deriving commutation rates
- Explaining changes to assumptions used for transfer values and commutation rates
- Explaining differences in the resulting transfer values or commutation rates
- Showing the member impact of the updated transfer values or commutation rates.

Actuaries should always follow the provisions of TAS 100 and TAS 300, in particular those listed above, relevant to actuarial factor reviews.

### **Further research should be conducted on the way commutation rates are set**

We call on research to be conducted on the appropriate adjustments to make for selection risk, market volatility, and other common criteria used to set commutation rates.

In most cases, actuaries advised trustees to set commutation rates below best estimate rates. There was a wide range of actuarial and non-actuarial reasons cited for the approaches adopted. These included selection risk and market volatility, in particular that commutation rates should not be increased to reflect recent lower yields in full as it might be difficult to reduce them again in future should yields rise. It was not always clear that reasons stated were backed by robust analysis, or could be shown to justify material differences to an equivalent best estimate.

### **Industry-wide benchmarking should be compiled**

We recommend that a central pensions industry body collates information on transfer values and commutation rates to provide an authoritative source of benchmarking.

We obtained simple benchmarking on transfer values and commutation rates currently in use covering around 800 and 1,800 pension schemes respectively. This showed significant differences between transfer values and commutation rates. It also revealed apparent differences between the rates set when advised by actuaries from different organisations. Actuaries often cite benchmarking compiled by their own firm as part of their advice to trustees. Although actuaries often explained the limitations of the quoted benchmarking, there remains a risk that this might give a misleading picture of actuarial factors generally in use, as each firm only has access to a subset of the market.

The Office for National Statistics, which has published high-level information on commutation rates as part of its annual pension schemes survey, is shortly ceasing this data series, which reinforces the need for central benchmarking.

# Report structure

## How this report should be read

We have set out in this report the detailed findings of our Thematic Review. We have provided separate comments relating to the transfer value and commutation rate advice. There is inevitably some repetition when similar comments apply to both types of advice. Although the executive summary sets out our key recommendations, a full list is set out on **page 28**.

### Recommendations

We have made a number of recommendations, which fall into three categories:



#### Member recommendations

These highlight areas of existing regulations, legal requirements or standards that are not always being met. Scheme actuaries (and the organisations employing them) should reflect upon these recommendations and make appropriate adjustments to their future advice and advice templates in relation to actuarial factors.



#### Regulator recommendations

These suggest adjustments to standards or regulations with the aim of improving the quality of future actuarial work in this area. We anticipate that these recommendations will be discussed by the IFoA with other relevant regulators, in particular the Financial Reporting Council (FRC) and The Pensions Regulator (TPR). Scheme actuaries should also consider whether to comply with this type of recommendation now, although they are under no obligation to do so.



#### Research recommendations

These call for further research activity, including the collation of independent benchmarking, to assist scheme actuaries with this type of advice. Like the regulator recommendations, we anticipate these research recommendations will be discussed by the IFoA with other relevant regulators.

### Good practice examples



#### Good practice examples

These illustrate a number of our recommendations which are intended to help actuaries comply with particular provisions of TAS 100 or 300. Each good practice example is based on one or more of the examples of advice we reviewed. Note, the appropriate wording will depend on the specific context and the same wording may therefore not be appropriate in all scenarios. There may also be other ways of meeting a particular provision.

### References

A list of documents referenced in this report is set out in Appendix 4 on **page 35**.

### Status of report

This report is non-mandatory guidance material; it imposes no obligation upon members over and above those embodied in the Actuaries' Code or the IFoA Standards Framework, which includes the enforcement of the Technical Actuarial Standards (TASs) set by the FRC. It has been prepared by the Actuarial Review Team and is issued by the Regulation Board of the IFoA. Its purpose is to report on findings of the Thematic Review: *Actuarial factors used to calculate benefits in UK pension schemes*.

This report does not constitute legal advice. While care has been taken to ensure that it is accurate, up to date and useful, the IFoA does not accept any legal liability in relation to its content.

### Questions about this report

We welcome questions about this report which should be sent to [reviews@actuaries.org.uk](mailto:reviews@actuaries.org.uk) or to:

Actuarial Monitoring Scheme  
Institute and Faculty of Actuaries  
Level 2, Exchange Crescent  
7 Conference Square  
Edinburgh EH3 8RA

# Scope and approach

## How we carried out this review

This Thematic Review was announced in September 2019 as:

### **Pensions: actuarial factors used to calculate member benefits**

The actuarial factors used to calculate scheme benefits are one of the ways in which the work of the actuary affects the benefit amounts received by scheme members, rather than simply how they are financed. The review will look at current practices adopted by actuaries in this area, including how factors such as commutation at retirement are determined for schemes, and how frequently these factors are reviewed.

In March 2020 we commenced our review by asking scheme actuaries to submit examples of actuarial advice on two key actuarial factors: transfer values and commutation rates. We focused on these actuarial factors as they are often compared with one another, and looking at only two factors enabled the Review Team to analyse a larger volume of reports. Further details of the Thematic Review Programme and background on these actuarial factors are set out in **Appendices 1 and 2** of this report.

### **Submissions**

We invited all organisations employing scheme actuary practising certificate holders to take part in the review. We asked organisations to submit examples of actuarial advice on the setting of transfer values and commutation rates. The number of examples requested was based on the number of scheme actuaries employed, according to the table:

<b>Number of Scheme Actuary PC Holders</b>	<b>Number of examples requested</b>
50 and over	7
20 – 49	4
10 – 19	3
5 – 9	2
4 and fewer	1

For organisations submitting more than one example, we asked for a range in terms of client size, level of actuarial factor and balance of powers. We also requested a summary of recent benchmarking carried out on these actuarial factors. The IFoA provided a Confidentiality Undertaking to each participating organisation.

### **Participation level**

A total of 19 organisations of all sizes took part in the review submitting 63 examples of actuarial advice – these organisations are listed below:

#### **Participating organisations:**

- Aon
- Atkin
- Barnett Waddingham
- Buck
- Capita
- Cartwright
- Censeo
- Deloitte
- Exactval
- First Actuarial
- Government Actuary's Department
- Hymans Robertson
- LCP
- Mercer
- Quantum
- Quattro
- Spence
- Willis Towers Watson
- XPS

Over 85% of scheme actuary practising certificate holders work for an organisation taking part in the Review. Of the examples that were submitted, over 70% of the authors indicated that they were prepared to discuss their work with the IFoA Review Team; we held discussions with 15 scheme actuaries. We also received benchmarking summaries from 12 organisations.

### **Review methodology**

The first phase was to review the content of each example of advice received. We looked at the criteria used by the scheme actuary to provide advice on each actuarial factor, and how important it was to the overall advice. We also tested each report against the relevant provisions of TAS 100, TAS 300 and the Actuaries' Code. Although most of the examples of actuarial advice that we received contained advice relating to other actuarial factors, for example early and late retirement factors, we did not review advice in these out-of-scope areas.

In the second phase of the review we conducted a series of discussions with a subset of 15 scheme actuaries who had prepared the advice. The purpose of these discussions was to understand their organisation's overall approach to setting these actuarial factors and to understand how the trustees had subsequently determined the factors to adopt.

We have provided individual feedback in relation to each of the examples we received, drawing attention to areas of good practice, areas where we recommend improvements could be made, and listing any TAS provisions that appeared not to have been met.

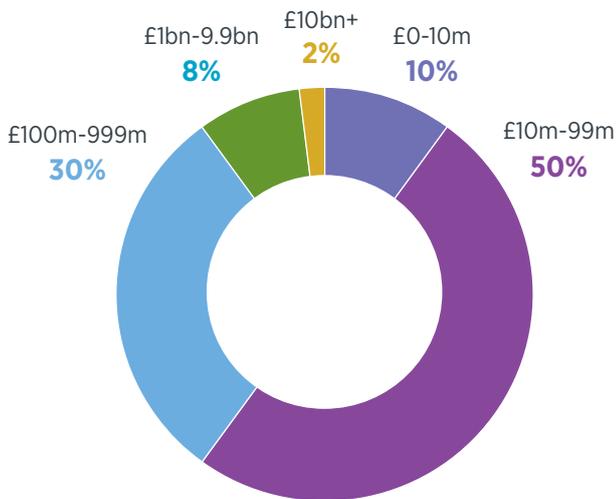
### About the examples

We asked organisations to provide a range of examples.

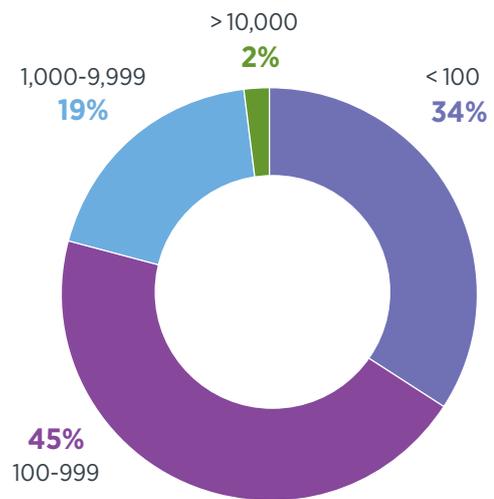
The charts shows the features of the schemes covered by the examples that we received.

Although our review was not designed to be statistically representative, it appears from the charts below that we have obtained a reasonable range across a wide variety of scheme types.

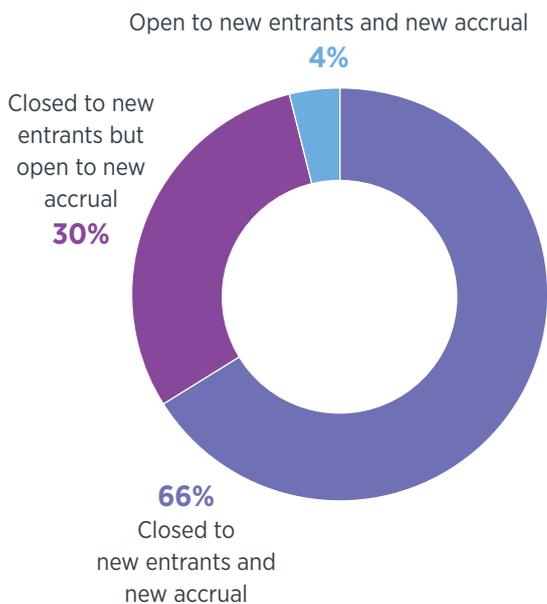
#### Scheme size: assets



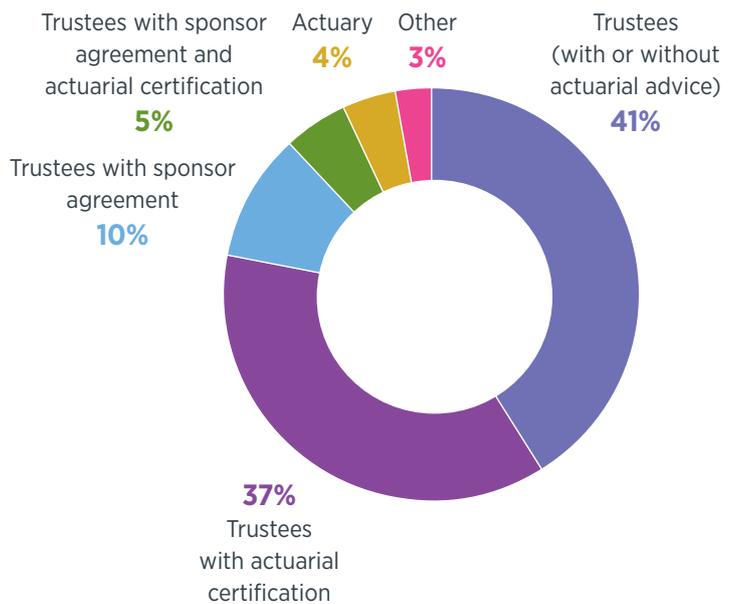
#### Scheme size: number of non-pensioners



#### Scheme status



#### Who sets the commutation rates?



# Transfer values – how actuaries advise

## Criteria used in transfer value advice

### Analysis of advice

Trustees are required to set transfer values in line with regulations and regulatory guidance. We analysed the way that the actuarial advice was structured and how clearly each point in the regulations and guidance was addressed within the reports provided. This is set out in the table below.

We are pleased to report that the examples we reviewed covered the requirements of the regulations very well. Adherence to the Regulator's guidance was less universal, although certain aspects will only be relevant for some schemes

### How often were different aspects mentioned in transfer value advice?

In over 90% of examples	Between 50% and 90% of examples	Less than 50% of examples
Assumptions, on the whole, to be best estimate	Demographic assumptions to have regard to main characteristics of scheme members or of a wider population having similar characteristics (mentioned in 86% of examples)	Reference to future de-risking in deriving the discount rate (46%)
Discount rate to have regard to investment strategy	Reference to de-risking pre-retirement in deriving the discount rate (70%)	Consideration of deriving demographic assumptions on a unisex basis (41%)
Consistency with Scheme's funding plan	Consideration of GMP Equalisation impact (60%)	Reasons why alternative method for calculating transfer values might be considered (41%)
Reference to ability to reduce transfer values to reflect under-funding	Consideration of rules, history, intentions etc in relation to discretionary benefits (60%)	Consideration of covenant (41%)
Make provision for options that increase the value	Consideration of admin expenses (59%)	Discussion of GMP Equalisation methods (22%)
Consideration of discretionary benefits	Reference to insufficiency reports (52%)	Consideration of views of investment adviser (17%)
		Investment returns being net of expenses (19%)
		Consideration of potential for allowing for commutation rates to reduce transfer values (6%)
		Consideration of existence of the PPF (5%)

	Regulation
	Guidance
	Other areas

In the remainder of this section we comment on some of these aspects in more detail, along with other general points on transfer value advice.

## Demographic assumptions

In the advice we reviewed there was less discussion on demographic than economic assumptions. While economic assumptions and other key requirements of the regulations were covered in over 95% of cases, discussion on demographic assumptions, which should be set *“to have regard to main characteristics of scheme members or of a wider population having similar characteristics”* was contained in a slightly lower proportion (86%) of examples. Relatively few examples of advice were explicit on whether, or how, scheme-specific demographic assumptions were set for transfer values.

We believe this is explained by the frequent cross-referencing, without further comment, to the derivation of the best estimate assumptions used in the latest actuarial valuation. This valuation had often been recently completed when the transfer value advice was given (see below). Scheme actuaries should, however, explain clearly why the proposed approach to selecting demographic assumptions complies with the transfer value regulations.



### Member recommendation 1

Actuaries should derive the proposed demographic assumptions to be clearly in line with the transfer value regulations, beyond simply cross-referencing to recent valuation documentation

[TPR guidance para 20]

## Investment de-risking

The transfer value regulations require the trustees to *“have regard to the scheme’s investment strategy”* in setting the discount rate. In recent years, many schemes have established a long-term funding target, or objective, based on moving towards a lower-risk investment strategy. Fewer than half of the examples we reviewed made explicit reference to potential future investment de-risking in the context of setting the discount rate (beyond implicitly through the use of a dual discount rate).

The IFoA’s 2019 Current Pensions Review Working Party found that nearly half of the actuaries surveyed thought that transfer values should be set *“allowing for future changes to investment strategy”* (the most popular response to that question). The Working Party acknowledged that this may not be straightforward to achieve – if, for example, the investment strategy is contingent on certain events, such as reaching a given funding level. However, if a scheme has a definite plan to

de-risk in future, even if the exact investment allocation has not yet been decided, we believe the actuary should raise this in their transfer value advice. This would ensure trustees consider allowing for planned de-risking in setting the discount rate. This may also involve working with the investment adviser, as envisaged in TPR’s transfer value guidance.



### Good practice example

#### Discount rate

There is no stated policy of de-risking the investments as members reach retirement. It does not seem unreasonable to adopt a single discount rate (as opposed to the current dual discount rate for funding) to better reflect the trustees’ future investment strategy.

I am suggesting an assumption of gilts +2.5% is appropriate since it is very likely there will be some de-risking at some future date, even though this date is currently not known. The Scheme’s current expected return above a gilt risk free rate is 2.9% pa.



### Member recommendation 2

Actuaries should consider planned investment de-risking in their transfer value advice on discount rates if it forms part of the trustees’ investment strategy

[TPR guidance para 21]

## Transfers above the minimum level

As well as setting a ‘best estimate’ floor on transfer values, the legislation provides a basis for paying higher amounts. Trustees might set transfer values at the higher level for a number of reasons, including to allow for lower investment returns, or for a very strong funding position. However, only 41% of examples made any reference to the possibility of paying above the minimum, and only 10% gave any more than a passing reference to this point. This contrasts with the potential for ‘reducing’ transfer values for underfunding, which was covered in virtually all examples we reviewed even though reductions were rarely applied in practice.

Although in many cases the trustees will be content to pay transfer values at the minimum best estimate level, we believe the actuary should set out reasons why they might consider paying higher amounts.



### Good practice example

#### The alternative (higher) method

- The trustees are able to pay CETVs in excess of the best estimate method if it feels this is in the best interest of the Scheme membership. The trustees may wish to engage with the company in order to determine the company's views on the level of CETVs to be paid.
- The precise way of determining the alternative, higher, CETV is a matter for the trustees. The trustees will need to discuss it with the Scheme actuary and company. One possible method is to use one or more assumptions on the prudent side of best estimate.



### Member recommendation 3

As trustees must decide whether to offer a minimum 'best estimate' transfer value, or an alternative higher amount, actuaries should provide more advice on which is the more appropriate approach

[TPR guidance para 30]

## GMP equalisation impact

Most of the examples of advice that we reviewed were prepared after the Lloyds judgment in October 2018, which ruled on the need to equalise for the effects of Guaranteed Minimum Pensions (GMPs). It is perhaps surprising therefore that only 60% mentioned the need to equalise GMPs and only 22% considered how such equalisation may be achieved. We did not collect information on whether the scheme provided GMPs and advice in this area may have been provided in other documents. We are therefore unable to provide further comments on this point.

## Unisex transfer values

In 85% of cases, the transfer values were to be derived using sex-specific demographic assumptions, with 15% using unisex. In most examples we reviewed, we found there was simply a statement of the respective male and female mortality assumptions, with little or no discussion on whether transfers should be calculated on a unisex basis. In just 5% of cases the advice was to move to unisex assumptions. By contrast, in one example, the advice was to revert to sex-specific assumptions having previously used a unisex approach.

As noted in the Benchmarking section on **page 25**, transfer values for men and women for a given level of benefit are very similar (often differing by only 1-2%). However, we believe that actuaries should advise trustees on the appropriateness of using sex-specific assumptions for deriving transfer values rather than the same assumptions for men and women. Once the scheme benefits are equalised between men and women following the Lloyd's judgment on GMP equalisation, we may see a greater incidence of unisex demographic assumptions being adopted.



### Member recommendation 4

Actuaries should advise on the appropriateness of using sex-specific assumptions for deriving transfer values

[TPR guidance para 20]

## Covenant and PPF

The sponsor covenant was mentioned in 41% of cases, mainly in the context of considering whether to reduce transfer values for under-funding. The existence of the PPF, which is also relevant in this context, was mentioned in only 5% of examples.

## Allowing for commutation rates in the calculation of transfer values

There has been some discussion in recent years as to whether it is ever appropriate to assume a proportion of members commute their pensions at retirement at rates which would 'reduce' transfer values. The Current Pensions Review Working Party found that around two thirds of respondents either agreed or strongly agreed that allowance for commutation should be permitted. This is an area where the legislation is silent (it only refers to member options that would 'increase' transfer values) but the Regulator's guidance is clear – commutation rates should 'not' be allowed for unless this would result in a higher transfer value.

We found no evidence that actuaries were advising trustees to do this in practice. The potential for paying lower transfer values allowing for commutation rates was only contemplated in 6% of cases and not recommended in any. This finding is therefore consistent with the Regulatory guidance.

## Expenses

We did not see any examples where administration expenses were taken into account in the calculation of transfer values, although this was only clearly stated in 59% of cases. Likewise, the stated discount rate always appeared to be net of investment expenses, although this was only stated in 19% of cases.



### Member recommendation 5

Actuaries should be explicit on the recommended treatment of administration and investment expenses in their transfer value advice

[TPR guidance paras 22, 63]

## Reducing transfer values for underfunding

This aspect of the regulations was well covered in the reports we reviewed (although there was less coverage of the need for an insufficiency report if transfer values are to be reduced). There were, however, some examples where the main advice was to reduce transfer values (as a result of assumption changes) and then the underfunding section of advice stated that 'no reduction' was required. Although this could be seen as a presentational issue, the repeated use of the phrase "*reduction in transfer values*" could lead to confusion among trustees. Scheme actuaries should ensure the different context of the main assumption review, and consideration of underfunding, is clear from their reports, possibly by amending templates.



### Member recommendation 6

Actuaries should clearly label their advice on reducing transfer values "to allow for under-funding" as such, to avoid any confusion with reductions "due to changes in assumptions or market yields"

[TPR guidance para 34]

## Reasons for transfer value review and frequency

We reviewed the advice to check the stated reason for the review of actuarial factors. For transfer values, in 85% of cases the review was carried out following the completion of the latest actuarial valuation. In 7% of cases the review was carried out during the valuation process. The remainder of cases were in relation to a change to investment strategy (including buy-in), or no reason was stated. We also found that the previous review of factors had been carried out around three years previously in around two-thirds of the cases, which is consistent with the normal triennial actuarial valuation cycle.

Note, this may not be wholly representative of all actuarial factor reviews as we specifically requested examples where both transfer values and commutation rates had been reviewed "*at around the same time*", which may over-estimate the proportion of examples carried out during and/or after the valuation, rather than out-of-cycle reviews which may relate to only one or other factor.

See further comments on this issue in the commentary of commutation rate advice.

## Best practices

As well as reviewing examples to identify adherence to regulations and standards, we reviewed the quality of the communications. The clearest examples had one or more of these features:

- An opening executive summary summarising the key changes being recommended to each actuarial factor.
- A clear list of decisions required by the trustees when considering the actuarial advice.
- Sign-off sheets for trustees to indicate their acceptance of the recommended assumptions and/or factors.

Each of the above helps reinforce the respective roles of the actuary and the trustees, and for the trustees to navigate the decisions they need to take to amend their actuarial factors.



### Member recommendation 7

Actuaries should highlight to the trustees the decisions that they are being asked to make, in terms of the regulatory requirements. This may take a number of forms, including an executive summary or a list of decisions.

[Code principle 6]

# Transfer values – compliance

## TAS and Code compliance

We also tested each advice example against the relevant provisions of TAS 100, TAS 300 and the Actuaries' Code and are pleased to report very high compliance levels, particularly with the Code.

See Appendix 3 for a full list of provisions we tested. We have defined 'very high' where a particular provision appears to have been met in over 95% of the cases we reviewed, and 'high' where the provision was met in over 80% of cases. The table below shows the particular TAS provisions where we did not score 'very high':

Ref	Provision (edited)	TV rating
TAS 100: principles for technical actuarial work		
3.4	Give a comparison with assumptions used last time ...	● ●
3.4	... and explain differences and changes	● ●
5.4	Explain any differences in actuarial factor compared to previous advice	●
5.5	Indicate uncertainties inherent in the actuarial information, and describe risks and uncertainties faced by the relevant entity and the approach taken to such risks	●
TAS 300: Pensions		
5	Explain any known uncertainty in benefit definition due to legislation or scheme documentation, and how this uncertainty has been treated	●
17	Communications sufficient for user to understand the financial implications of adopting the factors, including:	
(a)	• financial impact on the benefits of members exercising options	● ●
(b)	• rationale for differences between assumptions used for different actuarial factors	●
(e)	• the circumstances in which the actuarial factors should be reviewed	● ●

● ● High compliance    ● Lower compliance

We comment below on each of the provisions.

### Give a comparison with assumptions used last time and explain differences and changes. Explain any difference in actuarial factor compared to previous advice

Actuaries almost always set out clearly the assumptions being proposed for calculating transfer values and showed how the proposed transfer values differ from those currently in place. However, key explanations to help trustees in their decision-making were not present in too many cases:

- Showing a comparison of assumptions with those currently in use
- Explaining the differences in assumptions
- Explaining differences in transfer values

These are key to answering the typical trustee's simple question – "What has changed and why?"

Advice on transfer values was generally better than for commutation rates in this area – see **page 21** for more details.



#### Good practice example

The chart shows that transfer values on the proposed basis were significantly higher than on the current basis. The difference is primarily due to:

- The lower expected return on the LDI portfolio following the switch of reference interest rate from LIBOR to SONIA, and corresponding reduction to the discount rates
- The reduction to the scheme's equity holdings since the previous review (from 70% to 60%), which have also reduced the expected return on assets
- Changes to the CPI assumptions outlined above.

These effects are offset to some extent by the updates to the mortality assumptions.



#### Good practice example

Alongside the chart comparing the existing and recommended transfer values, examples are shown, including:

A member aged 55, with 40%/60% pre/post 6 April 1997 service with a £1,000 revalued pension at the date of this paper:

- Current CETV basis: £19,500
- Proposed CETV basis: £23,000 (ie an 18% increase)



#### Member recommendation 8

Actuaries should explain differences in the assumptions being proposed and in the resulting calculated transfer values

[TAS 100: 3.4, 5.4]



#### Member recommendation 9

Actuaries should explain the impact on the benefits of members exercising the transfer option, perhaps by way of illustrative examples

[TAS 300: 17(a)]

### Explain the rationale for differences between assumptions used for different actuarial factors

We comment on this point in the commentary on commutation rates on **page 22**.

### Explain the financial impact on the benefits of members exercising options

In most cases, actuaries illustrated how the amount of transfer value at sample ages would change as a result of their advice. However, this explanation was often given from the scheme rather than the member perspective.

The best examples showed transfer values available to sample members for a given level of pension – say £1,000 per annum – providing a clear explanation of the impact on typical scheme members of requesting a transfer value quotation.

### Explain the circumstances in which the actuarial factors should be reviewed

While a large majority of examples contained a statement of when the actuarial factors should next be reviewed, a minority of around 15% did not. In addition, as stated on **page 11**, our examples were dominated by reviews being carried out either shortly after a valuation had been completed, or while it was in progress. There is perhaps less need for transfer values to be reviewed outside the valuation cycle, since individual transfer values are usually calculated based on prevailing market yields (unlike commutation rates which are often fixed between reviews). However, it may still be worth carrying out a review in light of certain scheme events, such as a change to investment strategy or material market moves.



#### Member recommendation 10

Actuaries should explain the circumstances in which transfer values should be reviewed

[TAS 300: 17(e)]

## Indicate material uncertainties inherent in the actuarial information, and describe risks and uncertainties faced by the relevant entity and the approach taken to such risks

Nearly half of the examples made no reference to the risks and uncertainties inherent in the advice or facing the trustees in relation to the review of actuarial factors. Some actuaries provided illustrations of the sensitivity of key assumptions; while this may be helpful in providing some indication of the significance of varying particular assumptions, it does not appear to us to meet this particular provision in full.

This TAS provision is perhaps less relevant to advice in relation to transfer values than, say, funding advice. However, a reasonable number of actuaries did provide a useful summary of risks, which we believe should assist the trustees in their decision-making. The main risks highlighted included selection risk, cashflow risk and reputational risk.



### Good practice example

#### Key risks in setting member option terms

When setting terms for transfer values, there is a risk that those terms will be too generous and allow a member to select against the scheme. This could lead to a worsening of the funding position and additional contributions being required. On the other hand, there is a risk that the terms will fail to meet legislative minima or be judged unfair or penal in the future. These risks also apply when setting terms for members to exchange pension for cash or retire earlier or later than normal pension age.

The advice that follows aims to strike a balance between these risks, ie to provide terms that are neither over generous nor excessively penal, taking into account the requirements of relevant legislation and the Scheme's trust deed and rules.



### Member recommendation 11

Actuaries should indicate risks and uncertainties inherent in the advice or facing the trustees in relation to the review of actuarial factors

[TAS 100: 5.5]

## Explain any known uncertainty in benefit definition due to legislation or scheme documentation, and how this uncertainty has been treated

Clearly we do not know if there is any uncertainty in a particular scheme's documentation unless it is stated. A small number of examples did highlight issues, for example with pension increases or historic changes to retirement ages, and how they should be addressed.

However, more than 1 in 4 examples failed to mention the widespread potential need to allow for GMP equalisation in transfer value calculations, even those dated after the Lloyd's judgment in November 2018.



### Member recommendation 12

Where relevant, actuaries should highlight whether or not the recommended transfer values will allow for GMP equalisation, and if so outline the proposed approach

[TAS 300: 5]

# Commutation rates – how actuaries advise

## Criteria used in commutation rate advice

We now turn to the advice given on commutation rates. Actuaries have more freedom in setting these than they do transfer values as there are no specific regulations or regulatory guidance to follow. We reviewed the criteria used in the actuary's advice and assessed how important each was to the overall advice. This is illustrated in the box below:

### How often were different criteria used in commutation rate advice?

In over 80% of examples	Between 40% and 80% of examples	Less than 40% of examples
Balance of powers – how commutation rates are set under the scheme rules	Discussion of selection risk	Comments that commutation rates are part of overall benefit structure, on basis they have been communicated to members
Consideration of best estimate rates / comparison with transfer values	Link to investment strategy	Observation that commutation is a member option, to justify paying a lower rate
Funding impact of proposed rates	Discussion on timing relative to actuarial valuation	Consideration of 'inter-generational fairness' to avoid step-increase to factors
Discussion on whether rates should be market related or fixed for a period	Discussion of varying rates of pension increase	Observation that commutation is generally tax-free to member, to justify paying a lower rate
Member impact of proposed rates	Comparison with benchmarking	Impact of commutation on overall scheme expenses
Discussion on unisex rates	Consideration of Technical Provisions (funding) rates	Reference to covenant
	Consideration of mortality assumptions	Reference to potential buy-out
	Comments that commutation rates are generally always increased so may be 'harder' to reduce	Reference to future de-risking
	Consideration of take-up rates	Comparison with annuity rates
		Comparison with self-sufficiency rates
		Comparison with PPF's own factors

Actuarial considerations
Comparators
Other 'non-actuarial' considerations

We have separated each criteria of the advice subjectively into three broad categories:

- **Actuarial considerations:** actuarial justification for following a particular approach
- **Comparators:** alternative measures of 'value' that can be compared directly with the proposed commutation rates
- **Other non-actuarial considerations:** other matters raised by the actuary for the trustees to consider, which may not be considered to be strictly actuarial.

### Actuarial considerations – balance of powers

The actuary invariably quoted the relevant scheme rule for setting commutation rates at the start of their advice. The exact wording used in the rules is scheme-specific, but among the examples we reviewed, the way commutation rates were to be set fell in the following ways:

- By the trustees, normally having received actuarial advice – 41%
- By the trustees, but certified as reasonable by the actuary – 37%
- By the trustees, but subject to the agreement of the sponsoring employer – 10%
- By the trustees, but subject to the agreement of the sponsoring employer and certified as reasonable by the actuary – 5%
- By the actuary – 3%
- By the trustees, but subject to the agreement of the actuary – 2%
- By the sponsor, but certified as reasonable by the actuary – 2%

We do not have any statistics to verify whether the above distribution is representative of pension schemes in general. We reviewed each example by reference to the quoted rules.

In a very small number of cases, the actuary highlighted (consistently with the requirements of TAS 300) that legal advice should be sought on the interpretation of the rules as they were not clear.

### Certification/confirmation as reasonable

As can be seen above, just under half of our examples related to schemes where the rules specified that the actuary should certify that the basis or the rates themselves are reasonable. The wording varied by scheme – for example, where 'confirm' or 'consider' is used instead of 'certify' – although the principle appeared to be similar: that the rules require a statement by the actuary that the rates that are determined by the trustees are, in the actuary's view, reasonable. In practice, the approach followed by the actuary in these situations mostly seemed to be the same as for cases where the trustees determined the rates having simply received actuarial advice.

In particular, in almost all of these examples, we found no language certifying or confirming that the factors are reasonable or even a discussion on what the actuary considers to be 'reasonable', which we acknowledge may be challenging.

We accept that the actuary's recommendation is their view of the factors that should be put in place by the trustees in the prevailing circumstances. However, in these situations, the actuary should explicitly follow the provisions of the scheme rules and make a specific certification/confirmation using the wording required under the rules.



#### Good practice example

We did see this point addressed in three examples:

In one case, the actuary stated *"as required under the Rules, I certify that the proposed factors overleaf are reasonable"*

In another, the actuary stated *"I suggest it is reasonable to retain the current cash commutation factors at the present time"*, having considered the meaning of 'reasonable' in an earlier section of their advice.

In a third example, the actuary stated at the outset what they considered to be reasonable. The advice concluded by setting out a table of possible new commutation rates. Below the table, the actuary stated *"I confirm I would be willing to certify as reasonable factors equal to or greater than those set out in the fourth column above"*.



#### Member recommendation 13

Actuaries should follow the scheme rules, and make a certification/confirmation of the reasonableness of the factors when required

[Code principle 4]

### Actuary's decision

We only reviewed two examples where the actuary had the sole power to determine the commutation rates. In both cases, however, the style of the advice was very similar to the more usual situation where the trustees had the power and the actuary was recommending a rate, or a range of rates, for discussion with the trustees. In these two cases, the Review Team expected the advice to make clear that this was, strictly speaking, a consultative process by the actuary to obtain the trustees' views before determining the rates. As we only had two cases of this type, we are unable to comment whether this approach is widespread.

In contrast, we reviewed a number of examples where the actuary suggested that the trustees might consult the employer before taking the decision over commutation rates, when the employer did not have a formal role in the decision under the rules. In each case, this appeared to be consistent with the rules, as the advice made clear that it was still the trustees' decision.

### Other actuarial considerations

As summarised in the table above, most examples started in a similar way, quoting the factor-setting power from the scheme rules, then:

- Considering how the rates compare with other measures, in particular those derived using best estimate assumptions
- Looking at any funding impact of the proposed rates; and
- Comparing where the proposals sit within the range of factors seen by the actuary's firm (where the firm collates such information).

In most cases, the proposed rates were explicitly set relative to, but below, the best estimates for a wide variety of reasons, sometimes in combination:

- By applying an explicit discount, for example 10% or 20%, to the best estimate or technical provisions rates
- By using market conditions averaged over up to six years and, as a result, not capturing more recent lower yields, on the grounds that these may not persist
- By an explicit addition to the best estimate discount rate
- By using a discount rate based on a notional more equity-based investment portfolio
- By simply increasing the commutation rates currently in place by a specific margin or percentage.

There was a wide range of actuarial and non-actuarial reasons cited for the approaches adopted, as outlined in the table on **page 15**.

We did not review the appropriateness of the specific assumptions adopted in each example and have not commented on the reasons cited. We do, however, call for further debate among actuaries, led by research, as to how appropriate each criterion is for justifying a particular approach.

For example, selection risk was often quoted as a reason to pay out lower lump sums due to the risk that retirees in poorer health are more likely to commute part of their lifetime pension for an immediate lump sum. No specific research or evidence was cited to justify a particular deduction to the best estimate rate – of 10% or 20% in some examples – due to selection risk, particularly when many examples stated that a very high proportion of members typically take up the lump sum option, so diluting any selection impact.

Another reason often cited was that commutation rates should not be increased to reflect recent lower yields in full as it might be difficult to reduce them again in future should yields rise. While the long-term trend of improved life expectancies and reducing discount rates has led to commutation rates in many schemes that have consistently increased, we are not aware of any scheme rules or other requirements that prevent commutation rates from reducing. The justification often given is that members may see their lump sums as part of the overall benefit design and they should therefore not reduce, or that different generations of members may see different lump sums depending on their exact retirement date.

In contrast, we did see a handful of examples where the recommendation was to reduce commutation rates.



#### Research recommendation 1

We call on research to be carried out on the appropriate adjustments to make for selection risk, market volatility, and other common criteria in use in the determination of commutation rates



#### Member recommendation 14

Actuaries should test and validate their statements on the appropriate adjustments to make for selection risk, market volatility, and other common criteria used in the determination of commutation rates

[TAS 100: 3.3 / TAS 300: 4]

This is linked to the frequency of review – see comments below.

### Fixed or market related and timing of reviews

A very high proportion of the examples we reviewed advised on commutation rates that were to be fixed for the period up to the next review, which may be up to three years away. The reasons given for this were typically administrative simplicity and member understanding.

We also saw some examples which stated these advantages, but acknowledged market volatility and therefore suggested annual reviews should be undertaken. Finally, we saw a small number of examples where the commutation rates were to be adjusted according to monthly or quarterly market conditions, which is similar to the way transfer values are calculated.

Linked to this is the frequency of reviews which, as discussed above, we typically found to be three years. Unlike transfer values, which are calculated based on prevailing market yields, commutation rates are normally fixed between reviews.

The IFoA's 2016 Risk Alert stated that *“the continuing improvements in longevity and falls in yields over the last decade have emphasised the importance to trustees, sponsors and particularly members of keeping commutation rates current.”* It called for actuaries to consider the frequency of providing advice about commutation rates and to be aware of trends in market conditions. While the point about improvements in longevity may not currently be so relevant, the remainder of the 2016 Risk Alert remains appropriate and we believe should be reiterated.

We found that actuaries have generally provided commutation rate advice on a three-year cycle aligned to triennial actuarial valuations, rather than in response to changes in market conditions. We recommend that three years should be seen as the ‘maximum’ time between reviews, rather than the default, unless a scheme’s commutation rates (like transfer values) vary with market conditions. This is important to ensure that the basis underlying the latest advice does not become out of date and lead to poor outcomes for the member.



### Good practice example

#### Annual review framework

I would encourage the trustees to consider light touch annual reviews of the commutation rates.

- If the trustees are concerned with fixing the actuarial factors for a year based on current conditions, the trustees could introduce a monitoring framework whereby commutation factors are considered each quarter based on the agreed approach and updated if they fall outside of a given tolerance at any point in the quarter, for example +/- 10%.
- A combination of an annual review and a monitoring framework ensure the factors remain both market appropriate and protect the funding position against ‘spikes’ caused by changing market conditions that subsequently revert.



### Research recommendation 2

We call on ‘frequency of review’ to be included in any research on the criteria used in the determination of commutation rates



### Regulator recommendation 1

Actuarial guidance/standards should make clear that three years is seen as the ‘maximum’ time between commutation rate reviews, rather than the default, unless a scheme’s commutation rates are linked directly to market conditions

For cases that continue to be based around the actuarial valuation, and where commutation rates have a funding impact, the Risk Alert also called for actuaries to consider providing commutation rate advice ‘during’ the valuation process, rather than once it had been completed. We found that commutation rate advice was given during the valuation process in less than 20% of cases.



### Regulator recommendation 2

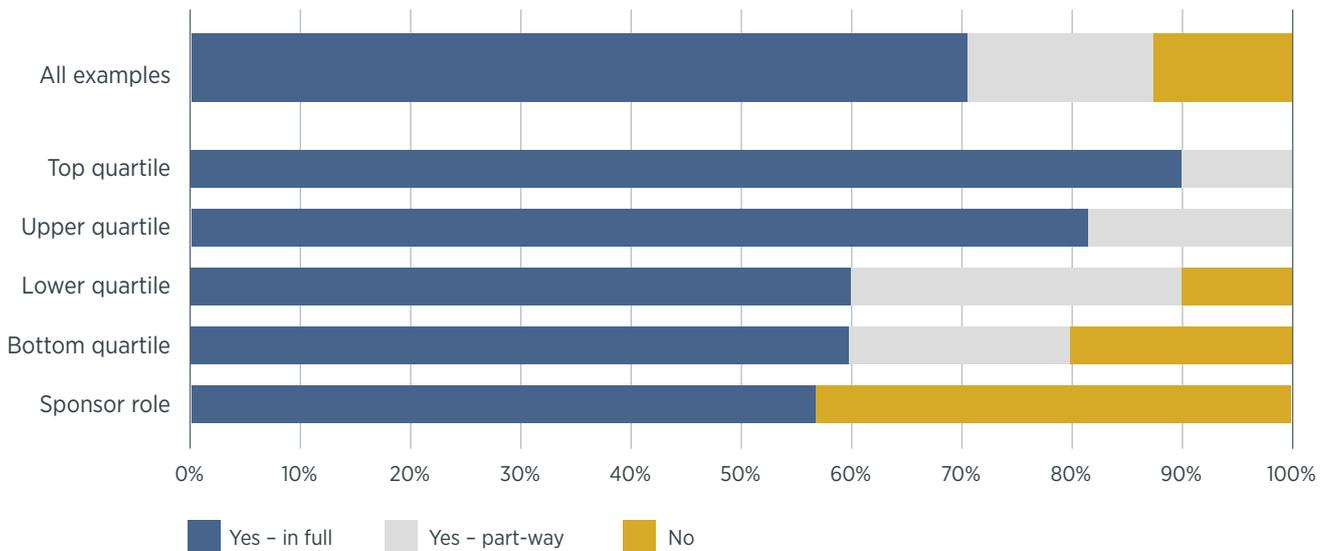
Actuarial guidance/standards should make clear that actuaries should consider providing advice on commutation rates during the valuation process, rather than once it has been completed

### Acting on advice

We asked actuaries to confirm whether the trustees had implemented the commutation rates in line with recommendations. Of the cases where the outcome was known and there was a clear recommendation, over 70% of commutation rates were implemented in line with the recommendation. The equivalent figure for transfer values was nearly 90%.

There was some evidence that where existing commutation rates were low, the trustees were more reluctant to act on the actuary’s advice, as shown in the following chart:

## Did trustees act on actuary's advice commutation rates advice?



In the bottom quartile of existing rates, the trustees made the recommended changes in only 60% of the cases; the trustees made no changes in 20% of cases and only a partial change in the remaining 20%. In contrast, for the top quartile of existing rates, the trustees made the recommended change in 90% of cases. These quartile figures excluded cases where the sponsor needed to agree the rates. In these cases the recommended changes were made in 57% of cases, with no changes in the remaining 43%.

We saw a range of ways that the actuary presented their recommendations, beyond explanations required under TAS 100 / 300, which may have increased the chance that the trustees accepted them. These included:

- Delivering the advice during the valuation process, rather than after its completion (see above)
- Presenting a range of recommended rates
- Recommending a series of small increases, rather than a single step-increase that might not otherwise be accepted.



### Research recommendation 3

We call on 'presentation of recommendations' to be included in any research on commutation rates

## Comparator rates

As noted above, the actuary usually compares the existing and proposed rates with equivalent figures derived on a best estimate basis and a funding basis. In around half of the examples, roughly equating to organisations that appear to carry out benchmarking, the rates were also shown in the context of benchmarking. Only 10% of examples made any reference to the equivalent cost of an annuity to replace the lifetime pension being commuted, and just 5% compared the rates to the scheme's 'self-sufficiency' or long-term target measure. This is perhaps surprising given the increased focus on these measures for many schemes in recent years.



### Regulator recommendation 3

Actuarial guidance/standards should make clear that actuaries should compare the proposed commutation rates with annuity costs or long-term funding targets if these measures are relevant to the scheme

# Commutation rates – compliance

## TAS and Code compliance

We also tested each example of commutation rate advice against the relevant provisions of TAS 100, TAS 300 and the Actuaries' Code and again are pleased to report high compliance levels, particularly with the Code.

Note the compliance scores for commutation rates were lower than for transfer value advice.

See Appendix 3 for a full list of provisions we tested. We have defined 'very high' where a particular provision appears to have been met in over 95% of the cases we reviewed and 'high' in over 80%. Some provisions have also been adjusted subjectively depending on the prominence of the statements in the advice. The table below shows the particular TAS provisions where we did not score 'very high':

Ref	Provision (edited)	Comm Rate rating
TAS 100: principles for technical actuarial work		
3.3	State material assumptions and their rationale	●
3.4	Give a comparison with assumptions used last time ...	●
3.4	... and explain differences and changes	●
5.4	Explain any differences in actuarial factor compared to previous advice	●
5.5	Indicate uncertainties inherent in the actuarial information, and describe risks and uncertainties faced by the relevant entity and the approach taken to such risks	●
TAS 300: Pensions		
4	Explain any known uncertainty in benefit definition due to legislation or scheme documentation, and how this uncertainty has been treated	●
17	Communications sufficient for user to understand the financial implications of adopting the factors, including:	
(a)	• financial impact on the benefits of members exercising options	● ●
(b)	• rationale for differences between assumptions used for different actuarial factors	●
(c)	• rationale for using different assumptions for factors and funding	● ●
(d)	• implications of changes in market conditions	● ●
(e)	• the circumstances in which the actuarial factors should be reviewed	● ●

● ● High compliance      ● Lower compliance

We comment below on each of the provisions where we did not score 'very high'.

### State material assumptions used to calculate commutation rates give derivation of material assumptions and any limitation in the data used to derive them

The commutation rate advice was sometimes framed around the specific rates being proposed (for example, 18:1 at age 65) or, as referenced above, by increasing the existing rates by an explicit percentage (for example, an increase of 5% across the age range). In these cases there were no stated set of actuarial assumptions underlying the proposed rates.

This style of advice appears to be very clear to the trustees as the direct impact of the proposed commutation rates is typically being shown. However, this clarity is at the expense of not showing the assumptions used. Consequently, this lack of assumptions makes it more challenging to explain in terms of TAS 100 / 300 changes in assumptions compared to the existing commutation rates and the rationale for differences in assumptions between commutation rates and transfer values.

The Review Team considered whether this type of advice, which did not quote assumptions, complied with the TAS communications provisions relating to assumptions. Principle 3 of TAS 100 refers to the assumptions 'used' in technical actuarial work. If the advice is simply to increase existing commutation rates by, say, 5%, then arguably no assumption has been 'used' to derive the new rates. In addition, departures from the communications provisions are "*permitted where they are unlikely to have a material effect on the decision of the [trustees]*". So, even if it is concluded that assumptions 'have' been used under this scenario, some might argue that the clarity of the overall recommendation ("to increase rates by 5%", say) means that it is not necessary to the trustees' decision-making to quote the underlying assumptions. Note that in many examples of this type, even if the proposed commutation rates themselves were not derived from stated assumptions, the advice was supported by best estimate comparator rates, where the assumptions 'were' summarised.

For these reasons, we concluded that this type of example did not appear to breach the TAS requirements. However, the Review Team believes there would be greater clarity in the advice if an identifiable basis was nevertheless derived for the recommended rates, even if this was done by 'back-solving' the assumptions (for example by deriving a discount rate from an otherwise best estimate basis at sample ages). This approach would then enable a comparison to be made with the assumptions underlying the existing commutation rates, and to show clearly the rationale for differences in assumptions between commutation rates and transfer values.



#### Regulator recommendation 4

Actuarial guidance/standards should make clear that the underlying assumptions should always be shown in commutation rate advice, even if these are implied assumptions, to enable relevant comparisons to be made

### Give a comparison with assumptions used last time and explain differences and changes Explain any differences in actuarial factor compared to previous advice

The level of adherence to these provisions was lower for commutation rates than for transfer values. This is partly explained by the number of cases (above) where assumptions were simply not stated.

The key TAS-related recommendation for transfer value advice applies equally to advice on commutation rates: that actuaries should be reminded of the importance of explaining differences in the assumptions being proposed and in the resulting actuarial factors.



#### Good practice example

Adopting these factors would result in higher cash lump sums and residual pensions. The increase is due to updated market conditions, predominantly being lower interest rates and higher inflation expectations. These effects have been offset by the lower life expectancy resulting from the updated mortality assumptions.

We would expect these factors to still be lower than those that an insurer would offer to members.



#### Member recommendation 15

Actuaries should explain differences in the assumptions being proposed and in the resulting commutation rates [TAS 100: 3.4, 5.4]

## Explain the rationale for differences between assumptions used for different actuarial factors

Many actuaries did not make an explicit comparison between the assumptions used for the proposed commutation rates and transfer values. Although the derivation of each factor was normally clear in its own right, we did not see many examples directly explaining the rationale for differences in assumptions. This is again partly explained by the number of cases (above) where commutation rate assumptions were simply not stated.

We saw general statements in many examples that certain actuarial factors are derived using best estimate assumptions and others using funding assumptions. However, even where both transfer values and commutation rates use best estimate assumptions as a start point, there should be further explanation about why the assumptions underlying the recommended rates differ. This is particularly important since our benchmarking shows that there are meaningful differences between assumptions used for these two actuarial factors.



### Good practice example 1

There are reasons why the commutation terms may justifiably be less generous than those implied by the best estimate assumptions. For example:

- By commuting pension for cash, a member is exercising an option. Where factors are overly generous or a member felt that the cash was more valuable to them in their specific circumstances (such as reduced life expectancy), they may be able to exercise this option to gain a financial advantage at the expense of the scheme.
- The trustees may consider it important to be consistent between generations of members. Members who have retired recently in the scheme will have exchanged pension for cash using the current factors. Consistency is arguably particularly important when considering commutation factors because, unlike other retirement factors or transfer values, a lump sum option is often perceived to be part of the scheme's benefit design.
- It is also common practice for commutation factors to be fixed for a period of time rather than regularly reviewed and therefore it is prudent to have a margin to ensure that the factors are not detrimental to the funding of the scheme. For example, a common approach is to use factors that are a proportion of the best estimate factors to include a margin against selection and adverse experience.



### Good practice example 2

The chart shows that at DATE the terms implied by the assumptions consistent with those that I have proposed for transfer values (no smoothing) are about 10% higher than the proposed commutation factors. Consequently, in current market conditions, members would receive lower value from commuting pension than if they took a transfer value.

A similar difference in terms exists in many schemes for a number of reasons, including:

- Trustees should have regard to the legislation. In broad terms, transfer values should reflect the amount that would be required (on a 'best estimate' basis) to provide the benefits from the scheme and are calculated by reference to current financial conditions.
- By contrast, commutation terms are governed solely by the scheme's rules, which give greater flexibility.
- Many schemes have smoothed out improvements in commutation factors over time to reduce the risk of having to reduce the factors in future. It is also common for commutation terms not to change frequently in order to help members to plan for retirement.

Given these considerations, you should be comfortable in explaining any material difference in the terms to members.



### Member recommendation 16

Actuaries should explain the rationale for differences between assumptions used for different actuarial factors [TAS 300: 17(b)]

## Explain the financial impact on the benefits of members exercising options

In most cases, actuaries illustrated how the amount of the commutation factor at sample ages would change as a result of their advice. However, this explanation was often given from the scheme rather than the member perspective.

The best examples showed the pension / lump sum options available to sample members, thus providing a clear explanation of the impact on typical scheme members of applying each factor.



### Good practice example

A simplified example might help to illustrate the impact of changing the terms. Consider a scheme member retiring at age 60 with a pension of £10,000 pa who takes the maximum cash sum by commuting part of their pension:

	Current factor	Possible new factor	Difference
Pre-commutation pension	£10,000 pa	£10,000 pa	-
Commutation factor	16.3	22.2	5.9
Maximum cash sum	£47,315	£51,270	£3,955
Residual pension	£7,097 pa	£7,691 pa	£594 pa



### Member recommendation 17

Actuaries should explain the impact on the benefits of members commuting some of their pension, perhaps by way of illustrative examples

[TAS 300: 17(a)]

### Explain the rationale for using different assumptions for factors and funding

Although virtually all the examples explained clearly the funding implications of adopting a particular commutation rate, the actuary was not always clear on the rationale for using different assumptions for commutation rates and funding. This contrasts with a very high score in this area for transfer values advice. As with some of the observations above, this is linked to the relatively high proportion of cases where no assumptions were stated for the commutation rates.



### Member recommendation 18

Actuaries should explain the rationale for using different assumptions for commutation rates and funding

[TAS 300: 17(c)]

# Other findings

## Non-technical comments

As well as assessing standards, we have also identified a number of other non-technical aspects of advice in this review which we believe will be helpful to organisations in assessing how to approach this type of actuarial advice.

### Work review

We asked organisations to tell us how each example of actuarial advice had been reviewed in terms of APS X2 (Actuarial Professional Standard on Review of Actuarial Work) before it had originally been issued to the client. We were told that 'Independent Peer Review' had been carried out in 62% of cases and 'Work Review' in 27% of cases. For the remainder, the form of review appeared to fall between the two definitions.

In discussions with organisations we were told about different approaches to independent peer review, which included:

- Review carried out by an appropriate individual nominated to carry out reviews that day for that (relatively small) organisation
- Review carried out by an appropriate individual in another office
- Review carried out by an appropriate individual in the client team, but not otherwise involved in the work.

### Trivial commutation

The setting of trivial commutation rates was not a direct subject of this review. However the advice examples we received almost invariably also covered the subject of trivial commutation. In over 80% of examples, the rates were set to be in line with transfer values, or a simplified approach based on transfer value assumptions. The rationale for this approach tended to be seeking consistency for members, particularly around retirement age, where transfer values and trivial commutation lump sums are directly comparable. The remainder were consistent with regular commutation rates.

### Non-statutory transfers

Trustees are not obliged to provide members within a year of normal pension age with a transfer value quotation and any such quotation is not covered by the transfer value regulations. These types of quote are known as 'non-statutory' transfer values.

In 70% of the examples we reviewed, the advice also covered the calculation of non-statutory transfers. Of these, the vast majority recommended calculations should be the same as

for regular cash equivalent transfer values. The other 30% of examples were not clear on whether their advice also applied to non-statutory transfers.



#### Member recommendation 19

Actuaries should be clear whether or not their transfer value advice also applies to non-statutory transfers

[TPR guidance para 51]

### Use of templates

For the organisations which submitted more than one example, 60% of the transfer value examples and 55% of the commutation rate examples appeared to be based on a template report. Such reports had significant similarities, for example the same structure, general background and format, although there was a varying amount of bespoke scheme-specific content. Perhaps surprisingly, these examples had only marginally higher levels of TAS compliance than those which did not appear to follow a template.

The majority of recommendations in this report are for stronger compliance with existing standards. We believe this can be achieved by reviewing templates including sign-posting where scheme-specific explanations are needed.

### Number of reports

In a slight majority of cases (55%) we received a single report containing advice on both types of actuarial factor. We also received a significant number (37%) of examples of two reports in which transfer values were typically considered in isolation in one, and the other actuarial factors (including commutation rates) were considered in the other issued a short time later. In the remainder of cases we received multiple documents that included follow-up advice in relation to one or other actuarial factor.

### Quality Assurance Scheme

All the organisations taking part in the review are accredited under the IFoA's Quality Assurance Scheme, although we invited all organisations employing scheme actuaries to take part. 30% of the examples included the Quality Assurance Scheme logo in their advice.

# Benchmarking

## Analysis of transfer values and commutation rates seen by organisations

We also asked organisations to share with us recent benchmarking they have compiled of their clients' commutation rates and transfer values.

### Overall summary

Chart 1 shows the overall range of transfer values and commutation rates seen at age 65 across the 12 organisations that provided information.

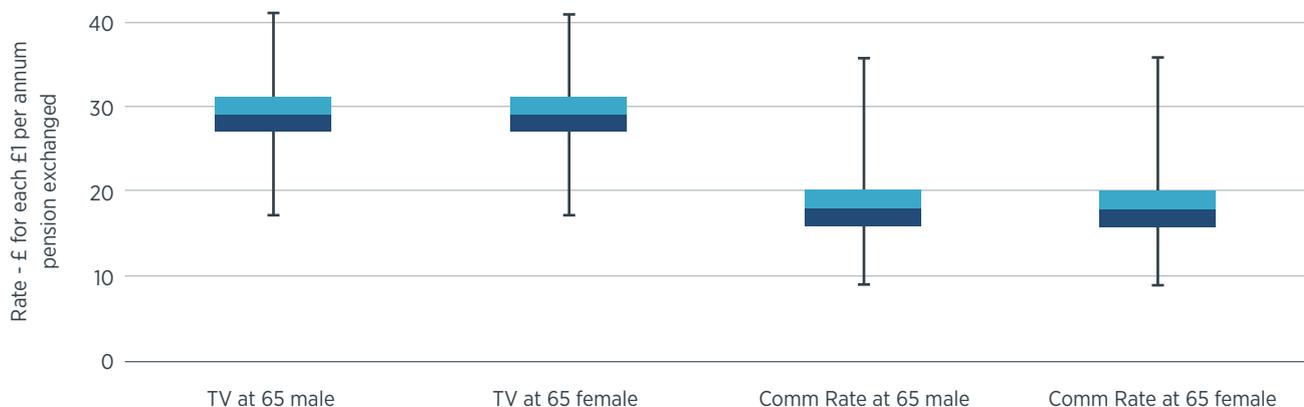
The chart shows the median transfer value at age 65 for £1 per annum pension is £29; the equivalent median commutation rate at the same age is £18. Although commutation rates do not typically allow for a spouse's pension, which may make up 10 to 15% of a transfer value, these rates are otherwise comparable in being a lump sum in exchange for a lifetime pension.

This shows that transfer values are normally being set well above commutation rates and, as we have been discussing in this report, reflects the different ways the two types of actuarial factor are determined.

The chart also shows the very wide range of rates for each factor – some schemes offer commutation rates nearly four times higher than the rates offered by other schemes; for transfer values the range is nearly two and a half times. These ranges reflect the wide variety of situations including:

- Investment strategies
- Varying discount rates, due to views on future returns
- Longevity rates for different scheme populations
- For commutation rates, who has the power to determine the rates?

**Chart 1 – overall benchmarking summary**



### Explanatory note on benchmarking charts:

The figures shown in each chart represent the overall ranges of transfer values and/or commutation rates seen by organisations. A transfer value (TV) of 18 means that the member would be offered a transfer value of £18 for each £1 a year pension transferred. Likewise a commutation rate (Comm Rate) of 18 means the member would be offered £18 for each £1 a year given up (or 'commuted').

The median figure is shown at the border of the light and dark blue bars, the lower quartile and upper quartiles are

shown at the bottom of the dark blue and the top of the light blue bars respectively. Half of the results therefore lie in the area covered by the light and dark blue bars. The minimum and maximum figures are shown at the foot and the tip of the two stems.

For organisational benchmarking, the sample size is shown in brackets for each organisation as Large (L) for more than 150, Medium (M) for 50 to 149 and Small (S) for less than 50 schemes.

A number of the examples we reviewed showed the recommended commutation rates within the context of organisational benchmarking. However, none made a comparison between transfer values and commutation rates in this way, which shows the overall outcome of using different assumptions for the two types of actuarial factor. As commented on **page 22**, we are reminding actuaries of the need to explain the rationale for differences in assumptions, as required by TAS 300.

We also believe that this benchmarking information should be collated centrally to enable these comparisons to be made objectively by all scheme actuaries and explained to their clients.



#### Research recommendation 4

We call on a central pensions industry body to collate and publish information on transfer values and commutation rates in use to provide an authoritative independent source of benchmarking

### Unisex rates

Although there is no legal requirement for either actuarial factor to be equal for men and women, the statistics show that in practice they are very similar.

For commutation rates, this reflects a high proportion of nearly 80% of rates that are unisex. Most organisational submissions noted a high proportion of 70-90% of schemes using unisex commutation rates; there was a small number of organisations, however, with a much lower proportion of less than 40%.

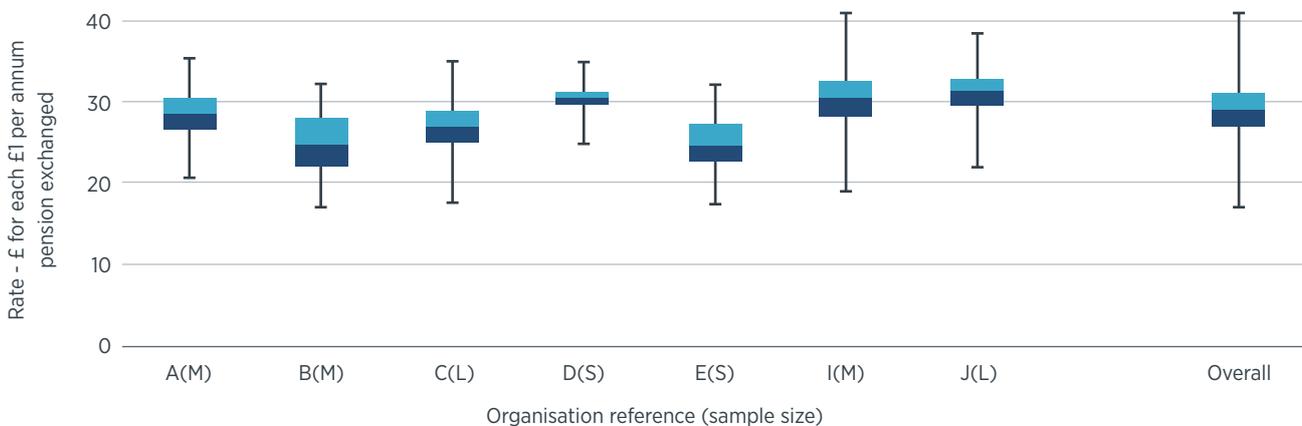
For transfer values, the proportion that are unisex is much lower, at 15%, with organisational responses ranging from 0% to 36% of schemes using unisex rates. However, note the overall transfer values are often very close for men and women as the underlying present value for a “member’s plus a dependant’s pension” are very similar.

This is consistent with the examples we reviewed, where most commutation rates were unisex but most transfer values were not.

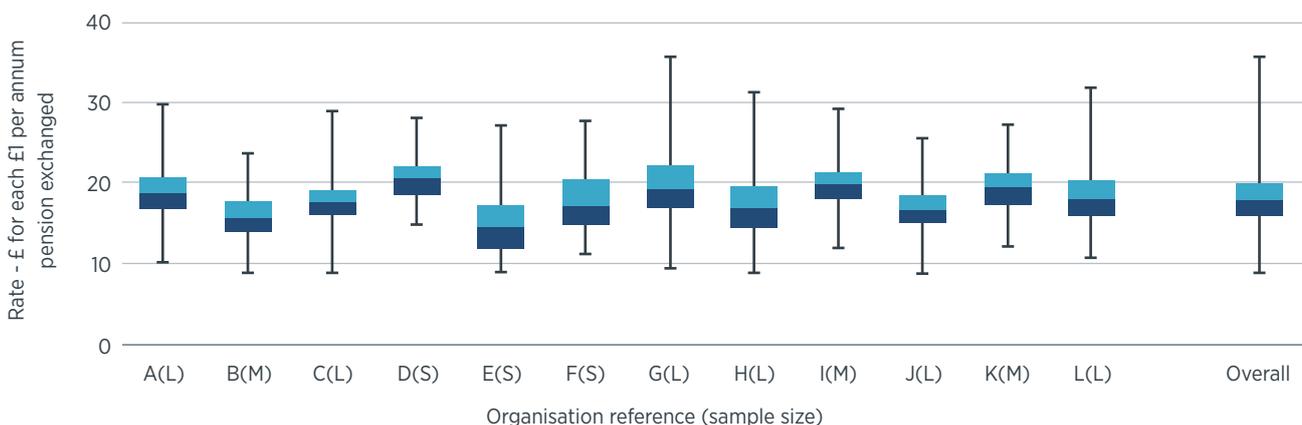
### Comparing benchmarking across organisations

Charts 2 and 3 show the range of transfer values and commutation rates seen for males at age 65 across the organisations that submitted this information:

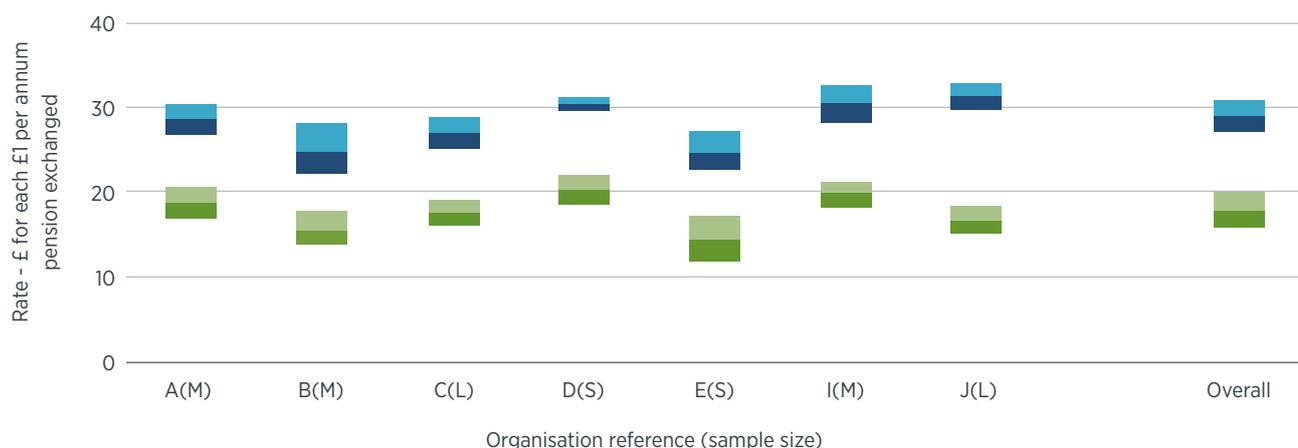
**Chart 2 – transfer value benchmarking – males at age 65**



**Chart 3 – commutation value benchmarking – males at age 65**



**Chart 4 – combined TV (blue) and Comm Rate (green) benchmarking**



As can be seen, there were seven organisations providing transfer value benchmarking and 12 providing commutation rates.

Although wide ranges can be seen for each organisation, the positioning of the benchmarking varies significantly. For transfer values the median varies from 25 to 31, and for commutation rates it varies from 14.5 to 20.5.

It is also interesting to note some evidence of a link between transfer values and commutation rates – chart 4 shows the inter-quartile range for the two actuarial factors for the seven organisations providing both.

This appears to show that, in most cases, organisations with relatively high transfer values tend to have relatively high commutation rates, and vice versa.

This could indicate that differing ‘house views’ over investment returns or to the setting of one or other factor are having an influence on outcomes. We believe this reinforces the need for benchmarking to be collated centrally to avoid actuaries and their clients being over-influenced by a single organisation’s benchmarking. We understand that the Office for National Statistics, which has in recent years published some commutation rate statistics, discontinued this data series in 2020.

### Notes on benchmarking methodology

We asked organisations to provide outputs from their latest benchmarking surveys on transfer values and commutation rates.

- For transfer values we asked for rates applying in March 2020 at ages 50 and 65, for a benefit payable at age 65, increasing in deferment in line with revaluation orders (consumer price increases up to 5% pa), and in payment with Retail Price Index up to 5% pa, and a spouse’s benefit of 50% of pension at date of death.

- For commutation rates we asked for rates applying in March 2020 at age 65, for a benefit increasing in payment with Retail Price Index up to 5% pa.
- Around 700 schemes are included in the transfer values survey and around 1,800 in the commutation rate survey.
- As we asked organisations to provide their latest information, the data will have been compiled at different times and for commutation rates, in particular, will reflect the rates in force at the date of each survey. This means commutation rates that have not been reviewed for several years will be included in the statistics.
- The commutation rates shown are all of those in force for an organisation’s clients regardless of the way the factors are set under the scheme rules (ie trustees’ power v actuary)
- The charts for female rates and for transfer values at age 50 show a similar pattern and are available from the Review Team on request.
- The transfer value survey information has been provided by fewer organisations and the sample sizes are also smaller for most organisations. Transfer values typically change each month according to varying market conditions so compiling statistics on the ranges of transfer value factor in force at a particular date is more challenging to prepare on a like-for-like basis. We requested figures based on market conditions for March 2020, where possible. Some organisations provided transfer values that they had compiled ‘as at’ a different date – we have included these unadjusted in the benchmarking.
- Finally, we combined the quartile information by taking weighted averages of each organisation’s quartile figures. This may give slightly different results than if we had access to the full data sets from each organisation.

# Recommendations

## Full list of recommendations

Although the key recommendations are set out at the start of the report, a number of detailed recommendations have been made in the text. As stated in the Report Structure section, our recommendations fall into three categories:

- Member recommendations
- Regulator recommendations
- Research recommendations.

A full list of these recommendations is given in the tables below. These are set out in the order they appear in this report.



### Member recommendations:

No.	Member recommendation	Standards/Guidance reference
1	Actuaries should derive the proposed demographic assumptions to be clearly in line with the transfer value regulations, beyond simply cross-referencing to recent valuation documentation	TPR guidance para 20
2	Actuaries should consider planned investment de-risking in their transfer value advice on discount rates if it forms part of the trustees' investment strategy	TPR guidance para 21
3	As trustees must decide whether to offer a minimum 'best estimate' transfer value, or an alternative higher amount, actuaries should provide more advice on which is the more appropriate approach	TPR guidance para 30
4	Actuaries should advise on the appropriateness of using sex-specific assumptions for deriving transfer values	TPR guidance para 20
5	Actuaries should be explicit on the recommended treatment of administration and investment expenses in their transfer value advice	TPR guidance paras 22, 63
6	Actuaries should clearly label their advice on reducing transfer values "to allow for under-funding" as such, to avoid any confusion with reductions "due to changes in assumptions or market yields"	TPR guidance para 34
7	Actuaries should highlight to the trustees the decisions that they are being asked to make, in terms of the regulatory requirements. This may take a number of forms, including an executive summary or a list of decisions.	Actuaries' Code principle 6
8	Actuaries should explain differences in the assumptions being proposed and in the resulting calculated transfer values	TAS 100: 3.4, 5.4
9	Actuaries should explain the impact on the benefits of members exercising the transfer option, perhaps by way of illustrative examples	TAS 300: 17(a)

No.	Member recommendation	Standards/Guidance reference
10	Actuaries should explain the circumstances in which transfer values should be reviewed	TAS 300: 17(e)
11	Actuaries should indicate risks and uncertainties inherent in the advice or facing the trustees in relation to the review of actuarial factors	TAS 100: 5.5
12	Actuaries should, where relevant, highlight whether or not the recommended transfer values will allow for GMP equalisation and, if so, outline the proposed approach	TAS 300: 5
13	Actuaries should follow the scheme rules, and make a certification/confirmation of the reasonableness of the factors when required	Actuaries' Code principle 4
14	Actuaries should test and validate their statements on the appropriate adjustments to make for selection risk, market volatility, and other common criteria used in the determination of commutation rates	TAS 100: 3.3 TAS 300: 4
15	Actuaries should explain differences in the assumptions being proposed and in the resulting commutation rates	TAS 100: 3.4, 5.4
16	Actuaries should explain the rationale for differences between assumptions used for different actuarial factors	TAS 300: 17(b)
17	Actuaries should explain the impact on the benefits of members commuting some of their pension, perhaps by way of illustrative examples	TAS 300: 17(a)
18	Actuaries should explain the rationale for using different assumptions for commutation rates and funding	TAS 300: 17(c)
19	Actuaries should be clear whether or not their transfer value advice also applies to non-statutory transfers	TPR guidance para 51



## Regulator recommendations

No.	Regulator recommendation
1	Actuarial guidance/standards should make clear that three years is seen as the 'maximum' time between commutation rate reviews, rather than the default, unless a scheme's commutation rates are linked directly to market conditions
2	Actuarial guidance/standards should make clear that actuaries should consider providing advice on commutation rates during the valuation process, rather than once it has been completed
3	Actuarial guidance/standards should make clear that actuaries should compare the proposed commutation rates with annuity costs or long-term funding targets if these measures are relevant to the scheme
4	Actuarial guidance/standards should make clear that the underlying assumptions should always be shown in commutation rate advice, even if these are implied assumptions, to enable relevant comparisons to be made



## Research recommendations

No.	Research recommendation
1	We call on research to be carried out on the appropriate adjustments to make for selection risk, market volatility, and other common criteria in use in the determination of commutation rates
2	We call on 'frequency of review' to be included in any research on the criteria used in the determination of commutation rates
3	We call on 'presentation of recommendations' to be included in any research on commutation rates
4	We call on a central pensions industry body to collate and publish information on transfer values and commutation rates in use to provide an authoritative independent source of benchmarking

# Appendix 1 – Thematic review programme

## Actuarial Monitoring Scheme

The Institute and Faculty of Actuaries launched the Thematic Review Programme in September 2019, as part of the Actuarial Monitoring Scheme (AMS). The AMS is designed to improve the effectiveness of actuarial regulation in the public interest, provide meaningful, credible, independent feedback to members and their employers, and promote ongoing reinforcement and continuous improvement.

The AMS forms an important part of a professionalism framework designed, through carefully balanced interventions and support, to provide evidence of the quality of actuarial work and to promote best practice. It will allow the IFoA to consider, in time, issues of relevance to members across the profession, wherever they are practising.

The IFoA's Regulation Board has initially introduced regular thematic reviews looking at particular topics, roles and/or areas of work relevant to actuaries, and data-gathering activities on a scheduled and ad hoc thematic basis.

## Thematic Reviews

The outcome of Thematic Reviews and data gathering will be used to continuously improve and, if necessary, adapt the AMS, to ensure that those forms of monitoring are working effectively.

The scheme is based on collaboration between the IFoA, its members, and the organisations for which they work. The IFoA has a devoted Actuarial Review Team in place to undertake reviews on topics identified as having the potential to provide useful insight into the work of our members.

The scheme involves review of how work is being carried out in practice by actuaries, including review of the work itself, which will allow the IFoA to share useful learning and good practice with members and their employers. The IFoA hopes that the benefits to organisations will include enhanced information about the quality of the actuarial work upon which they rely to make significant decisions.

The outputs of the reviews will be used by the IFoA to ensure that its standards, guidance, continuing professional development events, and education offerings are as effective and relevant as possible, helping it to safeguard the reputation of the profession and serve the wider public interest.

The thematic reviews will potentially apply to any area of actuarial work and themes will be identified using a range of sources, including:

- Ongoing risk analysis undertaken by the IFoA's Regulation Board
- The Risk Perspective document published by the Joint Forum on Actuarial Regulation (JFAR)
- Insights shared with the IFoA by fellow regulators including the Financial Conduct Authority (FCA), Financial Reporting Council (FRC), Prudential Regulation Authority (PRA), and The Pensions Regulator (TPR)
- The IFoA's other regulatory activities (including its disciplinary process).

A key driver of potential themes is the public interest, which in turn is a key principle in the regulatory responsibility of the IFoA through its Royal Charter. A topic such as this Thematic Review on setting actuarial factors in pension schemes, which directly affects member benefits, falls squarely into this.

# Appendix 2 – Background

## Transfer values

Pension scheme members who have not yet retired have the option to take a transfer value, in place of all future benefits that would otherwise be payable from the scheme.

Transfer values are usually calculated by the pension scheme in response to a member's request to exercise their statutory right to a 'cash equivalent transfer value' or CETV. For brevity, unless otherwise stated, 'transfer value' in this report refers to a CETV.

A transfer value should represent the expected cost of providing a member's defined benefits within the scheme, allowing appropriately for member options and trustee discretions. It is a value determined on actuarial principles, which requires assumptions to be made about the future course of events affecting the scheme and the member benefits.

The current framework for calculating transfer values dates from October 2008, with legislation setting out the requirement for trustees to determine the assumptions to be used in such calculations. The Pensions Regulator also issued guidance to trustees to assist them with the regulatory requirements.

The same assumptions and principles are also used to value pension benefits for the purpose of divorce proceedings.

A quotation requested from a member for a transfer value which falls outside the statutory framework is often known as a non-statutory transfer value. An example of this is where the member is within a year of normal pension age. Such non-statutory transfer values are often, but not always, derived using the same assumptions as above.

## Commutation rates

At retirement a member may choose to receive an immediate tax-free lump sum in exchange for part of their pension. In legislation, this is referred to as a 'Pension Commencement Lump Sum'.

In a defined benefit pension scheme, a 'commutation rate' is applied to convert a pension amount into a cash sum. For example, a commutation rate of 20 would result in a £20,000 cash lump sum being paid to the member in exchange for giving up an annual pension of £1,000. The member is exchanging a defined series of taxable future payments over the remainder of their lifetime for a single tax-free cash sum that is payable immediately.

Commutation rates are sometimes also known as commutation factors or cash commutation factors (CCFs).

The way commutation rates are determined is set out in the rules of each pension scheme (although historically the Inland Revenue also had to approve them). These rules define the roles of the trustees, the actuary and sometimes the sponsoring employer in determining the commutation rates.

# Appendix 3 – Compliance summary

The table shows the Actuaries' Code, TAS 100 and 300 provisions tested by the Review Team, which mainly relate to communications, along with an indicative rating for transfer value and commutation rate advice.

The provisions marked ● ● ● had 'very high' levels of compliance. 'High' levels of compliance are marked ● ● and those with 'lower' levels are marked ●. In each case a score is given separately for advice relating to transfer value and commutation rates.

Ref	Provision (edited)	TV rating	Comm Rate rating
The Actuaries' Code			
2.3	Members must ensure their work is appropriate to the needs and, where applicable, instructions of user(s)	● ● ●	● ● ●
6.2	Members must show clearly that they take responsibility for their work when communicating with users	● ● ●	● ● ●
TAS 100: principles for technical actuarial work			
Intro	Compliance statement is needed for reserved work, work in scope of specific TAS or work which is central to a significant decision by the user	● ● ●	● ● ●
3.3	State material assumptions and their rationale	● ● ●	●
3.4	Give a comparison with assumptions used last time ...	● ●	●
3.4	... and explain differences and changes	● ●	●
5	Communications to be clear, comprehensive and comprehensible, enabling users to make informed decisions	● ● ●	● ● ●
5.1	State the users, scope, purpose, addressee and who commissioned the work	● ● ●	● ● ●
5.2	Style, structure and content suitable for the skills and knowledge of the users	● ● ●	● ● ●
5.4	Compare results with last time ...	● ● ●	● ● ●
5.4	... explaining any differences	●	●
5.5	Indicate uncertainties inherent in the actuarial information, and describe risks and uncertainties faced by the relevant entity and the approach taken to such risks	●	●
5.8	Do not include immaterial information that obscures material information	● ● ●	● ● ●

Ref	Provision (edited)	TV rating	Comm Rate rating
TAS 300: Pensions			
4	Give derivation of material assumptions and any limitation in the data used to derive them	● ● ●	●
5	Explain any known uncertainty in benefit definition due to legislation or scheme documentation, and how this uncertainty has been treated	●	● ● ●
17	Communications sufficient for user to understand the financial implications of adopting the factors, including:		
(a)	• funding impact of different actuarial factors	● ● ●	● ● ●
(a)	• financial impact on the benefits of members exercising options	● ●	● ●
(b)	• rationale for differences between assumptions used for different actuarial factors		●
(c)	• rationale for using different assumptions for factors and funding	● ● ●	● ●
(d)	• implications of changes in market conditions	● ● ●	● ●
(e)	• the circumstances in which the actuarial factors should be reviewed	● ●	● ●

● ● ● Very high compliance    ● ● High compliance    ● Lower compliance

# Appendix 4 – References

## Documents used in this Thematic Review

Title	Author	Description
Actuaries' Code	Institute and Faculty of Actuaries	Ethical code for all actuaries
Thematic Review Programme	Institute and Faculty of Actuaries	Details of the IFoA Thematic Review Programme, along with links to submission materials for this review
TAS 100: Principles for Technical Actuarial Work	Financial Reporting Council	Technical standards for all actuaries
TAS 300: Pensions	Financial Reporting Council	Technical standard for specified actuarial work on pensions
APS X2: Review of Actuarial Work	Institute and Faculty of Actuaries	Ethical standard setting out types of review to be applied to actuarial work
Transfer Values Guidance	The Pensions Regulator	Guidance on the calculation of transfer values
The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 (SI 2008/1050)	UK Statutory Instrument	Regulations specifying how transfer values should be calculated
The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 (SI 2008/2450)	UK Statutory Instrument	Further regulations specifying how transfer values should be calculated
2016 Risk Alert	Institute and Faculty of Actuaries	Risk Alert: Commutation Factors
Report of the Member Options Working Party	IFoA Member Options Working Party	Report on Member Options
For What It's Worth	IFoA Current Pensions Review Working Party	2019 article in The Actuary summarising Working Party research on how transfer values are calculated
Occupational Pension Scheme Survey (OPSS) Consultation	Office for National Statistics	Statement that publication of the OPSS, which includes statistics on commutation rates, is to cease in 2020

Note, all links tested December 2020.



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