Faculty and Institute of Actuaries

Re: Guidance Note GN16

O P I N I O N

I have been asked to advise the Faculty and Institute of Actuaries ("the Faculty and Institute") on various questions that are set out below.

I understand that this opinion may be published on the web site of the Faculty and Institute. I should make it clear that this opinion is written to advise the Faculty and Institute in its capacity as a body regulating its members. It is not written to advise the individual members of the Faculty and Institute. It should be made clear that publication on the web site is a means of giving members of the Faculty and Institute information on current legal thinking and is not advice to them. I assume no responsibility towards individual members of the Faculty and Institute or other persons who may see this opinion. They must be responsible for taking their own advice and should not rely on this opinion.

Question 1: Is any form of wind up test necessary when deciding whether a Certificate can be given?

1. Paragraph 12(3) of the Occupational Pension Schemes (Preservation of Benefit) Regulations (SI 1991/167) ("the Regulations") sets out the condition required to be satisfied if accrued rights are to be transferred without a member's consent. It provides:

> "The condition set out in this paragraph is that the relevant actuary certifies to the trustees or managers of the transferring scheme that –
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> (a) the transfer credits to be acquired for each member under the receiving scheme are, broadly, no less favourable than the rights to be transferred; and

> (b) where it is the established custom for discretionary benefits or increases in benefits to be awarded under the transferring scheme, there is good cause to believe that the award of discretionary benefits or increases in benefits under the receiving scheme will (making allowance for any amount by which transfer credits under the receiving scheme are more favourable than the rights to be transferred) be broadly no less favourable”

2. The Regulations are delegated legislation under the Pensions Schemes Act 1993 (see section 73(4) of that Act and The Occupational and Personal Pension Schemes (Consequential Amendments) Regulations 1994 SI 1994/1062). Accordingly, "Transfer credits" has the meaning defined in section 181(1) of that Act, that is:

> "rights allowed to an earner under the rules of an occupational pension scheme by reference to a transfer to that scheme of his accrued rights from another scheme (including any transfer credits allowed by that scheme)”.

The term “rights” is defined by section 181(1) in relation to accrued rights as including “rights to benefits and also options to have benefits paid in a particular form or at a particular time”[1]. “Accrued rights” is not a defined term.

3. Paragraph 12(3) of the Regulations is supplemented by paragraphs 12(4) and (4A) which provide:

> "(4) For the purposes of paragraph 3(a), where long service benefit in the transferring scheme is related to a member's earnings at, or in a specified period before, the time when he attains normal pension age then, in the case of a member in pensionable service at the date of transfer, the value of any rights to be transferred shall be based on pensionable service (including any transfer credits) in the transferring scheme up to that date and projected final pensionable earnings
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> “(4A) For the purposes of paragraph 3(b), the relevant actuary shall, in considering whether there is good cause, have regard to all the circumstances of the case and in particular -

[1] The relevant rights will be those contained in the scheme documentation as modified by any relevant statutory provisions.

> (a) to any established custom of the receiving scheme with regard to the provision of discretionary benefits or increases in benefits; and
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> (b) to any announcements made with regard to the provision of such benefits under the receiving scheme."

4. Paragraphs 12(3) and (4) were substituted for the previous paragraphs 12(3) and (4) in 1993 and at the same time paragraph (4A) was added (by SI 1993/1822). Those provisions should therefore be construed together.

5. A categorical answer to the question is not possible and it is up to the individual actuary to determine what is relevant. In my opinion, however, the better view by some way (and the view that a court is likely to take) is that the "broadly no less favourable" test in paragraph 12 (3)(a) requires a comparison only of the relevant rights allowed under the rules of the receiving scheme and the rights to be transferred and does not require a consideration of whether or to what extent those rights might be satisfied in practice. My reasoning is as follows.

    (1) The comparison required is of the "rights allowed under the rules" of the receiving scheme with the rights to be transferred. Paragraph 12(3)(a) does not on its face require a comparison of anything other than the rights to be acquired and the rights to be transferred.

    (2) It is clear that in order to make such a comparison, a comparison of the value of those rights might be required and the Regulations envisage this - see for example the provisions in paragraph 12(4) concerning "the value" of the rights to be transferred for the purposes of paragraph (3)(a). But such a valuation is for the purpose of comparing the "rights allowed under the rules" of the receiving scheme with the rights to be transferred. Accordingly what is to be valued are the rights as contained in the respective rules and not the benefits (if different) that might actually be delivered. Actuaries are familiar with placing values on such rights.

(3) The Regulations are plainly not envisaging a comparison of the open market value of the rights - paragraph 12(4) is describing a calculated value and an open market basis would be absurd given that there is no market in pension rights.

(4) A “purposive” interpretation that brought in wider considerations could be justified if it was required in order to allow the Regulations to meet a particular purpose that can be gathered from the legislation (or other legitimate aids to construction). The purpose of paragraph 12(3)(a) is plainly to protect members' rights but to say that the purpose goes further than ensuring that the rights contained in the rules are broadly no less favourable is simply assertion. There is no indication in the legislation (nor as far as I am aware in other relevant material admissible for the purpose of construing the regulations) that paragraph 12(3)(a) has a wider purpose.

(5) If a wider purpose were to be formulated it would have to be along the lines of ensuring that the member’s position was broadly no less favourable. This would entail construing paragraph 12(3)(a) as requiring a comparison of the relevant rights by means of valuations that took into account the risk of default in the payment of benefits having regard to all factors. That would require consideration not only of the then solvency of the scheme but also of many other factors such as the future solvency and commitment of the employers[2] and the schemes’ investment and funding policies. I do not believe that to be the correct construction for the following reasons.

First, the contrast between paragraph 12(4) and paragraph 12(4A) undermines the case for such a wider purpose. Paragraph 12(4A)

[2]Benefits would be paid in full if either (1) on a winding up in the future the scheme would then be fully funded on a buy out basis or the employer could and would (either through compulsion or otherwise) fully fund the scheme on a buy out basis; or (2) the scheme would not be wound up within the relevant time scale and the employer would continue to fund it. At the time that the Regulations were amended to take their present form (and until February 2005) employers were not necessarily obliged to contribute to a scheme on its being wound up so as to make it fully funded on a buy out basis. Thus the security of benefits would depend to an extent on both the commitment and ability of the employer to fund the scheme.

(which relates only to paragraph 12(3)(b) and not to paragraph 12(3)(a)) requires all circumstances to be considered while paragraph 12 (4) does not.

Secondly, if the risk of default is taken into account, it could not be said with certainty whether the transfer credits are broadly no less favourable than the rights to be transferred. I am aware that there are methods for calculating a value of benefits that take into account the risk of default in payment but, if the regulations were intended to require the risk of default to be taken into account, it is unlikely, given the nature of the judgment that would then be required, that they would require the actuary to certify that the transfer credits **are** broadly no less favourable than the rights to be transferred.

Thirdly, there is a telling distinction in wording between paragraphs 12(3)(a) and (b). As discussed below (see question 10) paragraph 12(3)(b) does require a judgment based on wide considerations such as funding and solvency but the actuary is then required to certify only that there is *good cause* to believe that the award of discretionary benefits or increases will be no less favourable than the established custom.[3]

[3] It is understandable that when requiring transfer credits to be compared with the rights to be transferred for the purposes of regulation 12(3)(a) (and when directing the allowance specified by paragraph 12(3)(b) for improved transfer credits), the regulations should proceed on the basis that the actuary is not concerned whether rights will be satisfied and yet require (pursuant to regulation 12(3)(b)) a judgment based on all circumstances whether and how discretions may be exercised in the future.

Question 2: Must each separate element of a member's transfer credits satisfy the 'broadly no less favourable' requirements or does the requirement apply to the credits as a whole?

Paragraph 12(3)(a) of the Regulations requires a comparison of the member's transfer credits taken as a whole with the rights to be transferred again taken as a whole.[4]

If one element of the package of rights under the receiving scheme is less favourable than the corresponding provision in the transferring scheme, a certificate could still be given if other provisions of the receiving scheme were more favourable so that overall the package was broadly no less favourable.

Question 3: Does the test in paragraph 12(3)(a) require only a comparison of the value of the transfer credits and the value of the rights to be transferred?

1. No.

2. A consideration of the separate elements of the transfer credits and rights to be transferred[5] will always be relevant to the question whether the transfer credits are broadly no less favourable than the rights being transferred.

3. If there is no difference whatsoever between the separate elements of the rights conferred by the transferring and the receiving scheme then the test in paragraph 12(3)(a) of the Regulations will be satisfied.

[4]For the reasons given in the answer to question 11 below, the cautious view is that the relevant rights include those arising from powers concerning a member's benefits (for a discussion of these see the answer to question11 below). On that basis, the comparison will require consideration of all the trusts powers and provisions governing the members' benefits as set out in the documents of each scheme (including the members' rights to benefits and powers and options relating to the benefits that they, the trustees or the employer might have as set out in those documents).

[5]See footnote 4 above

4. On the other hand, if there is any difference, the test must be answered taking into account the differences in the separate elements of the rights as well as the relative values of the transfer credits and of the rights to be transferred. This is a common sense assessment taking into account both factors, with neither factor taking primacy.

5. A consideration of the separate elements of the rights is required because there may be differences that can be seen to make the transfer credits less favourable than the rights to be transferred but which will not be adequately reflected in a valuation.

6. I do not mean by this that the magnitude of any change in any element of the rights could be a decisive factor. As mentioned in question 2 above, in principle any element of the benefits which is less favourable can be off-set by improvements in other elements.

7. Examples of the type of difference in rights that might be considered to render the transfer credits less favourable than the rights to be transferred but which might not be reflected in a valuation are:

(1) where the transferring scheme provides for a lump sum to be payable on death to such of a defined class of objects as the trustees choose and the receiving scheme contains a similar provision but with a smaller class of objects;

(2) where the transferring scheme permits an immediate early pension (reduced appropriately for early payment) to be paid in wider circumstances than permitted under the receiving scheme.

8. In cases where there are differences in the rights but where the differences cannot adequately be reflected in different values, the actuary will need to ask the question whether taking into account such differences the transfer credits are broadly no less favourable than the rights to be transferred.

Question 4: Could a change from Defined Benefits to Defined Contributions (or vice versa) ever satisfy the 'broadly no less favourable' requirements?

In general defined contribution rights will be less favourable than defined benefit rights but it is not impossible to imagine that they might not be. For example, the value of the member's defined contribution account might be enhanced in some way and so might be sufficiently more valuable than the value of the defined benefit rights being transferred. But whether the change is one way or the other, the radical change in the nature of the rights, risks and rewards would mean that great care would have to be taken before a certificate is given.

Question 5: To what extent should the rights of contingent beneficiaries be taken into account when deciding whether the test in paragraph 12(3)(a) is satisfied?

Paragraph 12(3)(a) requires a comparison of the rights (including "rights to benefits") of the member. One of those rights is to have benefits paid to dependants and other contingent beneficiaries. Thus, those rights need to be considered but only as part of the consideration of the question whether the transfer credits to be acquired are broadly no less favourable than the rights to be transferred. Relevant changes in benefits for contingent beneficiaries would include not only the amount of the benefits but also changes in the identity of the contingent beneficiaries - for example, a change from a right to have a pension payable to a spouse or dependant to a right to a pension payable only to a spouse. Since the statutory test requires a comparison of the overall package of rights a certificate could still be given even if the transfer credits include less favourable benefits in respect of contingent beneficiaries than under the transferring scheme if that was offset by better rights in respect of the member. Provided that the transfer credits are broadly no less favourable than the rights transferred, an individual contingent beneficiary would have no locus to complain if his or her benefits were reduced or even if no benefits for that particular person were provided at all. However, although the actuary may conclude that he can give the certificate he could also point out to the Trustees that specific benefits have been reduced (so that they can take that into account when deciding whether or not to transfer without members' consent).

Question 6: Is it necessary to take an individual's personal circumstances into account when deciding whether a Certificate can be given?

1. Paragraph 12(3)(a) requires that "the transfer credits to be acquired *for each member* under the receiving scheme are, broadly, no less favourable than the rights to be transferred". Thus, the test must be satisfied for each member.

2. In the cases of large groups, however, an evaluation by reference to each individual's precise personal circumstances would be impractical. Also, an assessment of the value of many of the rights of a member could only sensibly be carried out by reference to statistics for appropriate groups (e.g. the chances of a particular male member dying before normal retirement age could not generally be stated other than by using some general statistic of males dying under that age.)

3. In my view these considerations indicate that the test need not be conducted with reference to each individual's personal circumstances. On the other hand, since the test must be satisfied for each member, the actuary must consider whether a valuation of the respective rights for the group as a whole reasonably reflects the value of the respective rights for each member of the group. He must consider whether there are classes of members for whom such a valuation will not reasonably reflect the value of the relative rights. If there are such members, he should, so far as possible, value the respective rights

separately for each such type or sub-group of member using the statistics appropriate to that sub-group.

4. Such an exercise will not in general require the actuary to identify whether a particular member falls within a particular class (e.g. whether the member is married or not). The exercise identifies classes of members who should be considered separately, it is not identifying which members fall within such a class. (On the other hand in practice the actuary's personal knowledge of specific characteristics is likely to assist him in identifying the relevant classes).

5. The point may be illustrated by an example. Suppose a transfer where the benefits for spouses of a member dying in retirement provided by the receiving scheme are lower than those provided by the transferring scheme but where the receiving scheme provides some other improved benefits (not depending on marriage). One approach would be to value the transfer credits and rights to be transferred for the group of transferring members as a whole using an assumption appropriate for the whole group of transferring members of the chances of death in retirement leaving a spouse. It would have to be considered, however, whether that reasonably reflects the relative values of the respective benefits for married members, or whether that is not the case because members who are already married have a greater chance of leaving a surviving spouse than the assumption appropriate for the group as a whole. The actuary would have to consider whether the comparison required by paragraph 12(3)(a) could fairly be made using values that incorporated an assumption about the chances of death in retirement leaving a spouse and if so, what values, or whether he should address the position along the lines discussed under question 3 above. The actuary might conclude for example that he should take into account valuations assuming that every member, regardless of current marital status, will die leaving a surviving spouse.

Question 7: Is the amount of a cash equivalent a relevant consideration when deciding whether a Certificate can be given? Would solvency and

any reductions in cash equivalents need to be taken into account in this context?

In my opinion, the right to a cash equivalent is a "right" within the meaning of the Regulations. Although the relevant definition of "rights" provides that "rights" includes "rights to benefits", that definition does not confine the meaning of "rights" to rights to benefits. It also seems to me that the right to a cash equivalent under the receiving scheme is a "transfer credit" (i.e. a right under the receiving scheme allowed to an earner by reference to a transfer to that scheme of his accrued rights) and that such a right can be considered to be one of the "rights to be transferred".

On this footing the right to a cash equivalent is one of the rights to be compared for the purposes of paragraph 12(3)(a). Any differences in the rights as set out in the rules should be taken into account. On the other hand, if (as I think is correct) it is the rights allowed in the rules that are to be compared, it follows that the comparison for the purposes of paragraph 12(3)(a) does not take into account wider factors such as the way in which the cash equivalents are actually being calculated. Although the actuary might point out the position to the trustees (e.g. if cash equivalents in the receiving scheme were being calculated on a less generous basis or are being reduced to take account of underfunding), the certificate would be based on the rights set out in the rules. (However, where for example there is an established practice of allowing for discretionary benefits in transfer values then that might be relevant for the purposes of paragraph 12(3)(b). As to this see the discussion under questions 9 and 10 below.)

Question 8: Is a change in the priority of benefits upon a hypothetical wind up a relevant consideration when deciding whether the requirements

of paragraph 12(3)(a) are satisfied? Would solvency need to be taken into account in this context?

1. Paragraph 12(3)(a) requires a comparison of "the rights allowed" to the earner under the rules of the receiving scheme "by reference to a transfer to that scheme of his accrued rights" with the rights to be transferred. In my opinion, for reasons similar to those discussed in respect of rights to cash equivalents (see question 7 above), a member's rights include his right to have certain priority accorded to his benefits on a winding up.

2. The question posed raises several difficult issues: first, are rights on a winding up "accrued rights"; secondly, are the rights on a winding up of the receiving scheme rights allowed to the member *by reference to* a transfer of his accrued rights; thirdly, are the rights on a winding up *of the transferring scheme* rights "transferred" to the receiving scheme.

3. I do not think there is a clear answer to the question.

4. It is certainly arguable that priorities on a winding up are one of the rights to be compared on the footing that: (1) in the context of the relevant legislation "transfer" is used in a loose sense and includes all rights under the transferring scheme that are, as a result of a transfer payment, extinguished and replaced with rights under the receiving scheme; and (2) even if one assumes that priority rights are not "accrued rights", the priority rights accorded under the receiving scheme are "rights allowed" to the earner under the rules of the receiving scheme "by reference to a transfer to that scheme of his accrued rights".

5. On the other hand, it is arguable that the second stage of the above argument does not give proper effect to the restriction of transfer credits to rights allowed *by reference* to a transfer to that scheme of accrued rights; and that the concept of transfer credits and/or the concept of a rights transferred do not stretch to what could be seen as rights concerning the administration of a scheme.

6. The cautious approach would be to proceed on the basis that priority rules are relevant rights for the purposes of the statutory test.

7. This does not bring solvency into account, however. For the reasons given above, it is the rights allowed under the rules that are to be compared not the effect that those rights might have in practice, so that the comparison will be between the priorities as stated in the rules.

8. I would add that in my opinion when making the required comparison the actuary should take into account the effect, if any, of section 73 Pensions Act 1995 or any other statutory modification of the rights stated in the rules. It seems to me that the "rights allowed by the rules" and "the rights to be transferred" may both properly be construed as meaning the rights stated in the rules as modified by statute.

Question 9: What are the "discretionary benefits or increases" referred to in paragraph 12(3)(b)?

1. The "discretionary benefits or increases" are not difficult to describe in theory but may be more difficult to identify in practice. I shall consider some situations below but should emphasize that I am not attempting to cover all types of situation and the classification of a benefit in any particular case should be considered in the context of that case.

2. The benefits and increases provided by a scheme for a member will depend on defined conditions governing the provision and the amount of the benefits being satisfied. Such benefits and increases may in general be divided into two classes. First, those where the conditions include the consent of someone other than the member or the exercise of a power at the discretion of someone other than the member (normally the trustees and/or the employer) and, second, those where the conditions do not include such consent or exercise of a power. In my opinion the phrase "discretionary benefits or increases" refers

to benefits and increases in the first class. They stand in contrast to benefits or increases to which a member has a right on satisfying conditions that do not involve the exercise of a discretion.

3. Thus the phrase “discretionary benefits or increases” includes benefits that are an alternative to a benefit in the second class but which are provided only with the consent of the trustees and/or the employer (e.g. an early retirement pension that requires the consent of the employer).

4. The discretion may be expressed as a discretion as to grant or as to amount but a benefit is only a “discretionary benefit” where there is a true discretion as to award of the benefit. For example, a provision for the payment in defined circumstances (eg on the member’s death) of a benefit of such amount as the trustees in their discretion determine is a discretionary benefit if there is a true discretion as to the amount so that it could be zero.

5. On the other hand, benefits do not become “discretionary benefits” merely because the amount of the benefit is not defined by reference to a formula or table. There will not be a true discretion as to amount if the amount is required (either expressly or impliedly) to be fixed in a manner that produces consistency of treatment of different members so that one member (or group of members) cannot be preferred over others (contrast **Edge v Pensions Ombudsman** [2000] Ch 601, 627).

6. This is the acid test. If such consistency of treatment is required, there will not be a true discretion as to the amount of a benefit even though, because the amount depends on the exercise of judgment by the trustees, different trustees might determine its amount differently.

7. Thus, suppose that a transferring and receiving scheme have identical provisions permitting a member to commute, at his option, part of a pension at a rate to be determined by the trustees as being of equivalent value as the part commuted or alternatively suppose the rate is to be advised by the actuary.

That benefit is not a discretionary benefit[6] even though (because there is a range of rates that could reasonably be used) the rates used by the transferring scheme might well be different from the rates used by the receiving scheme. If it is the trustees who are determining the rate, they are required to determine the equivalent value and hence treat members consistently. Equally if the rate is to be advised by the actuary it is implicit that he is to advise what rate fairly reflects the value of the part commuted and so is required to treat members consistently. If it were the case that the rates used by the transferring scheme were more generous than those used in the receiving scheme, the actuary might point that out to the trustees as relevant to the decision whether to make the transfer.

8. On the other hand, if there is a discretion whether a benefit or increase is granted, that is a discretionary benefit or increase even if the amount of the benefit, if granted, is defined by reference to a formula or table (ie the benefit is a discretionary one even though there is consistency of treatment of members who are granted the benefit).

9. Increases in pension that are granted pursuant to a discretion are discretionary increases even though the trustees might feel constrained to treat certain classes of pensioner equally. The trustees are able to treat one group of members (those pensioners receiving the increase) differently from another group (non pensioners and pensioners not receiving the increase).

10. A potentially difficult question arises in respect of transfer values. Suppose that the rules of a transferring scheme provide that on a member leaving service he is to be paid his cash equivalent as determined by the relevant legislation. The Occupational Pension Schemes (Transfer Value) Regulations 1996 (SI 1996/1847) provide (see regulation 8(2)) that:

> "where it is the established custom for additional benefits to be awarded from the scheme at the discretion of the trustees or the employer, the cash equivalent shall, unless the trustees have given a

[6] However the right to commute and the right to have the Trustees determine the amount would be two of the rights to be taken into account for the purposes of paragraph 12(3)(a).

> direction that cash equivalents shall not take account of such benefits, take account of any such additional benefits as will accrue to the member in question if the custom continues unaltered."

11. If the trustees of the transferring scheme have not given a direction under regulation 8(2) of the Transfer Value Regulations, does the provision of cash equivalents taking account of additional benefits bring paragraph 12(3)(b) of the Regulations into play? This raises the question such provision can be said to include the award of discretionary benefits.

12. I do not think there is a straightforward answer to this. It is not clear whether there can be said to be an award and, if there is, whether "discretionary benefits" are being awarded.

13. The power is to give a direction that will tend to reduce the cash equivalents, but the trustees will have to consider from time to time whether such a direction should be given Accordingly, if no direction is given that will be as a result of a decision that cash equivalents should be calculated taking into account the additional benefits. That could be seen as an award.

14. It is also possible that "discretionary benefits" are being awarded. Whether to permit the additional benefits to be taken into account can be seen both as a valuation issue (i.e. whether a fair value would take account of such additional benefits) and also as a discretionary benefit (i.e. as a continuation of the discretionary award process).

15. Indeed, it is tempting to conclude that the power to direct the actuary not to take account of additional benefits is conferred on the trustees because it cannot easily be classified as a valuation issue or a discretionary matter.

16. Given this uncertainty the prudent view would be to treat an established custom of permitting cash equivalents to take account of discretionary awards as if it were an established custom for a discretionary benefit to be awarded.[7]

[7] This issue should be distinguished from reductions in cash equivalents to take account of scheme underfunding – see question 7 above.

Question 10: What is the comparison required by paragraph 12(3)(b)? Does the solvency of the schemes and the solvency and commitment of the employers have to be taken into account when deciding whether there is 'good cause to believe' for the purposes of paragraph 12(3)(b)?

1. Paragraph 12(3)(b) provides:

> "where it is the established custom for discretionary benefits or increases in benefits to be awarded under the transferring scheme, there is good cause to believe that the award of discretionary benefits or increases in benefits under the receiving scheme will (making allowance for any amount by which transfer credits under the receiving scheme are more favourable than the rights to be transferred) be broadly no less favourable"

This is supplemented by paragraph 12(4A) which provides:

> "(4A) For the purposes of paragraph 3(b), the relevant actuary shall, in considering whether there is good cause, have regard to all the circumstances of the case and in particular -
>
> > (a) to any established custom of the receiving scheme with regard to the provision of discretionary benefits or increases in benefits; and
> > (b) to any announcements made with regard to the provision of such benefits under the receiving scheme."

2. The comparison required is between future awards under the receiving scheme and the established custom under the transferring scheme.

3. As discussed above, a discretionary benefit or discretionary increase might arise where there is a true discretion either as to the grant of the benefit/increase or as to the amount of the benefit/increase or as to both. These possible variations do not affect the test required by paragraph 12(3)(b)

to be satisfied. In all cases where it is the established custom for discretionary benefits or increases in benefits to be awarded under the transferring scheme, the actuary is required to certify that there is good cause to believe that the awards under the receiving scheme will be broadly no less favourable. Regardless of whether there is a discretion as to the grant of a benefit/increase or as to the amount or as to both, this will require a consideration both of the frequency of grant and of the amounts granted. Although the difference in approach might make no significant difference in practice, it is not simply the discretionary element of a benefit/increase that comes into consideration for the purposes of paragraph 12(3)(b).

4. This test has the potential to raise some difficult issues.

5. The starting point is to identify whether there is an "established custom for discretionary benefits or increases in benefits to be awarded under the transferring scheme". I have been asked to consider some examples.

6. Suppose first that a type of discretionary benefit is rarely awarded but, if it is awarded, it is awarded on customary terms. (An example might be early retirement benefits that are rarely permitted but if they are, the pension is not reduced for early payment). In this situation there will not be (as regards those discretionary benefits) an established custom for discretionary benefits to be awarded under the transferring scheme and those awards will not bring paragraph 12(3)(b) into play (although the scheme provisions permitting the award should probably be taken into account under paragraph 12(3)(a) – see question 11).

7. Next, suppose a discretion to grant a benefit which, if granted, is to be on terms set out in the scheme documentation. If there is an established custom of granting such benefits, that would bring paragraph 12(3)(b) into play.[8] Since that requires future awards to be compared with past custom, it would

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[8] The scheme provisions permitting the benefit should probably be taken into account under paragraph 12(3)(a) in any event – see question 11.

not matter for these purposes that the relevant terms applicable under the transferring scheme might be altered in the future

8. Suppose now, that there is an established custom of granting a particular discretionary benefit, there is a discretion as to the terms on which the benefit is granted but there are some prescribed minimum terms or there is a customary minimum basis, so that when the benefit is awarded it is normally on some minimum terms. (e.g. if early retirement pensions are allowed with the employer's consent with a minimum value equivalent to the value of the pension at normal retirement date but there is a discretion to permit a higher amount that is sometimes exercised.) In that case there would be an established custom of awarding the benefit on the minimum terms and that would be the benchmark for the comparison required by paragraph 12(3)(b).

9. In theory it could be that there is a discretion to grant a benefit and an established custom of granting them but there is no established basis or custom as to the amount of the benefit. It is difficult to envisage such a custom in practice but if there is no consistency in the awards, it is hard to see that the awards will have any real relevance for the purposes of paragraph 12(3)(b). Although it would be possible to say that there was an established custom of awarding the particular benefit, if there is no consistent benchmark, it is meaningless to ask whether there is good cause to believe that the award of the relevant benefits under the receiving scheme will be no less favourable than wholly variable awards under the transferring scheme.

10. Lastly, suppose there is an established custom of making particular awards in certain circumstances. I shall call these "qualified customs" Examples might be: a custom of using a particular proportion of any surplus revealed on a valuation for awarding discretionary benefits or increases; or a custom of awarding RPI increases in pensions if the valuation reveals sufficient surplus to enable such increases to be made without further contribution from the employer. The question here is whether it can be said that there is an established custom for discretionary benefits and increases to be awarded.

11. In my opinion, although the contrary is arguable, the better view is that it can be said that there is the necessary custom. It seems to me that there can be said to be an established custom for benefits/increases to be awarded even though the custom is for them to be awarded only in particular circumstances and for the level of benefits/increases to be fixed in some way by reference to those circumstances.

12. Thus, where there is a custom of using a particular proportion of any surplus revealed on a valuation for awarding discretionary benefits, then (ignoring any other established customs and the allowance to be made for improved transfer credits) paragraph 12(3)(b) would require the actuary to certify that there is good cause to believe that the award of discretionary benefits or increases in benefits under the receiving scheme will be broadly no less favourable than the established custom of using the particular proportion of any surplus to award discretionary benefits or increases. In other words it will suffice if there is good cause to believe that under the receiving scheme the same or a broadly similar proportion of any surplus (that is the surplus in the receiving scheme as a whole) would be used to award discretionary benefits or increases.

13. Similarly in the case of an established custom of awarding RPI increases whenever a valuation reveals sufficient surplus in the scheme to allow it with no additional contribution from the employer, it will suffice if there is good cause to believe that under the receiving scheme such increases (or broadly similar increases) will be awarded whenever a valuation reveals such a surplus.[9]

14. The actuary does not, when considering this type of situation, have to consider whether there will in fact be any surplus in the future.

[9] This will normally involve considering whether there is good cause to believe that the relevant increases (or broadly similar increases) will be awarded if there is sufficient surplus in the scheme as a whole. It is possible both in relation to this and the previous example that the test in regulation 12(3)(b) could be satisfied by special arrangements relating to the transferring members and surplus referable to them.

15. Care should be taken to distinguish between what I have called qualified customs and customs where certain circumstances were merely the norm against which the custom became established or where certain conditions influenced the employer's decision to agree to certain awards. In these types of case, the established custom and the reference point for the comparison required by paragraph 12(3)(b) is simply the award of the relevant benefits. Qualified customs are different because the custom can be regarded as being defined by reference to certain circumstances, so that if those circumstances occur certain awards conventionally follow. A custom will normally only be a qualified custom if the fact that awards are conventionally made if (but only if) a certain circumstance occurs would be apparent to any reasonably well informed observer from the actions and outward communications of those involved in the decision. This does not necessarily require the condition to have been formally communicated to the members. It will, however, generally require the condition to have been clearly identified in the past so that it is understood by the parties involved in the award (i.e. normally the trustees and the employer) that, if the relevant circumstance occurs (but only if it occurs), the relevant awards conventionally follow.

16. It should be noted that the comparison required by paragraph 12(3)(b) is not between the future award of discretionary benefits or increases under the receiving scheme and the awards that could be expected under the transferring scheme were there to be no transfer. The comparison required is between future awards under the receiving scheme and established custom under the transferring scheme, irrespective of the ability of the transferring scheme to provide such awards in future.

17. Accordingly, the future funding position of the transferring scheme and the future ability or willingness of the employer of the transferring scheme to provide any necessary funding are not relevant considerations.

18. The required comparison of future awards under the receiving scheme with the established custom under the transferring scheme could produce what might be considered as odd results. After all, that custom might bear no

resemblance to what future awards could be expected under that scheme. Nevertheless, paragraph 12(3)(b) requires future awards under the receiving scheme to be compared with the customary awards under the transferring scheme and means that, if there is an established custom of making certain awards, that custom is the reference point.

19. I do not see any real alternative to that conclusion and when contrasted with what was required by the original version of the regulations, the conclusion is not altogether surprising. The original version of the regulations required in effect for past custom under the transferring scheme to be incorporated as rights under the transferring scheme. They did this by requiring the value of the transfer credits to be at least equal to the value of the rights to be transferred and providing that where there was an established custom of awarding additional benefits the actuary was to take into account the value of such benefits as would accrue if the custom continued unaltered. The value used as a benchmark did not therefore depend on future solvency or funding of the transferring scheme. The present form continues the theme of using past custom as the benchmark but relaxes the requirement that such custom is incorporated into rights.

20. As far as making the required comparison is concerned, paragraph 12(3)(b) does not contain any time limit on the future awards of discretionary benefits and increases under the receiving scheme that must be considered. Paragraph 12(3)(b) recognizes that the customary award of discretionary benefits or increases is valuable to members. Its purpose is to protect members against transfers which are likely to result to their receiving lower benefits because of less favourable awards of discretionary benefits or increases. That indicates that paragraph 12(3)(b) should be construed so as to require consideration of awards in the receiving scheme throughout the lifetime of the relevant members (and persons claiming through them).

21. Thus, the actuary will need to consider the period during which the relevant awards could affect the transferring members (and, if relevant, their contingent beneficiaries). The regulation requires there to be good cause to believe that

awards under the receiving scheme during that period will be no less favourable than the established custom under the transferring scheme.

22. The actuary is directed by paragraph 12(4A) to take into account all the circumstances when considering that issue.

23. It is up to the individual actuary to make a judgment in each case what circumstances are relevant. The judgment to be made is a pragmatic one. It is difficult and dangerous to try to say in isolation what is or is not relevant. Nevertheless, the actuary will have to consider whether there is good cause to believe that the relevant persons (normally the trustees and/or the employer) will consent or otherwise exercise their discretion so that appropriate awards are made under the receiving scheme. The particular matters specified in paragraph 12(4A)(a) and (b) (established custom under the receiving scheme and announcements made) are of great importance in such respect but where those awards have cost consequences, the impact of those costs may well be a relevant circumstance. After all a custom in the receiving scheme will be an unreliable indicator of future awards if there is insufficient in the scheme to allow it to continue and the employer cannot afford to provide the necessary funding. Thus, the funding of the receiving scheme and financial position of the employer of the receiving scheme are likely to be relevant considerations.[10]

24. This may require some consideration of what might happen were the receiving scheme to be wound up.

25. The first question will be whether there is good cause to believe that the receiving scheme will continue during the relevant period. If there is, then no specific consideration of what would happen on it being wound up is required.

[10] Contrast the position under paragraph 12(3)(a). As discussed under question 1 above I think that the difference in approach between paragraphs 12(3)(a) and (b) is understandable. The wording of paragraph 12(3)(b) (especially when read with paragraph 12(4A)) is also pretty clear that it is necessary to consider what awards might be made in the future under the receiving scheme and I cannot see a persuasive argument that paragraph 12(3)(b) requires a more restricted consideration (for example by construing it as requiring the actuary to consider merely what policy might be expected).

26. If on the other hand there is not good cause to believe that it would continue, then consideration would need to be given to what would then happen. Paragraph 12(3)(b) does not require the actuary to consider whether in such an event discretionary benefits/increases that have been awarded will be provided in full. On the other hand, the regulation requires there to be good cause to believe that awards under the receiving scheme during the relevant period will be broadly no less favourable than the established custom under the transferring scheme. If the receiving scheme were to be wound up within that period, then that condition would only be satisfied after it was wound up if the benefits secured for the relevant members contained provisions that resulted in their continuing to receive discretionary benefits/increases broadly no less favourable than the discretionary benefits/increases customarily awarded under the transferring scheme. In practice this would probably mean that the benefits secured would have to contain rights equivalent to the customary practice (e.g. if the customary practice were to increase pensions in payment by the RPI, the annuity purchased would have to escalate in line with the RPI).

27. I do not consider that the regulation requires a detailed consideration of the finances or future prospects of the employer. There are several reasons for this.

28. First, the test is whether there is *good cause to believe* that the award of discretionary benefits or increases would be broadly no less favourable – the actuary is not being asked to certify that they will be no broadly less favourable. Secondly, given that an actuary will not in general have the skills to conduct a detailed examination of the employer's finances or prospects, it is unlikely that the Regulations were intended to require him to do so. Thirdly, the time scale of the awards and increases in issue (see paragraphs 20 and 21 above) are such that a close examination of the employer's current finances and prospects would not lead to a firm answer to the question posed by paragraph 12(3)(b) of whether there is good cause to believe that the awards and increases will continue far into the future. Fourthly, the Regulations can only envisage that the actuary will give his view on the information available to him as an actuary retained by the trustees.

29. In many cases where the employer is committed to enabling relevant discretionary benefits to be provided there will be no real reason to doubt that the employer would be able to meet its commitment and the actuary will be able to give the certification required by paragraph12(3)(b). If on the other hand the actuary feels that there is too little information or too much uncertainty to say whether there is good cause so to certify, then he cannot give the certificate. In that situation it will then be up to others, for example the employer's accountants, to supply him with sufficient information and/or convince him of the prospects.

Question 11: Do scheme provisions for such benefits or increases come into account under paragraph 12(3)(a)?

1. Where a discretion is exercisable by trustees, a member has the right to be considered for a discretionary benefit if he satisfies the relevant conditions – see e.g. **re Hay's Settlement Trusts** [1982] 1 WLR 202. Where a discretion is exercisable by an employer, there is (in general) an implied limitation (under the scheme as well as contractual) that the discretion will be exercised in accordance with an implied obligation of good faith. This duty will normally mean that the employer must at least consider whether in any particular case the relevant discretion should be exercised – see **Imperial Group Pension Trust Limited v Imperial Tobacco Limited** [1991] 1 WLR 589.

2. For the purposes of the regulations, "rights" is defined as including "rights to benefits and also options to have benefits paid in a particular form at a particular time". But that definition is not exhaustive it simply says what is included. In my opinion the rights outlined in (1) above fall within the general meaning of "rights"

3. This then raises the issues discussed in the answer to question 8. For the reasons given there, the cautious approach would be that provisions in scheme

documents for discretionary benefits or increases should be taken into account under paragraph 12(3)(a).

Question 12: To what extent should the actuary consider the possibility of future events when considering whether there is 'good cause to believe' that discretionary benefits or increases will be provided?

It is difficult to be specific about this. The issue required to be considered is whether there is good cause to believe that the award of discretionary benefits or increases under the receiving scheme will be no less favourable than established custom under the transferring scheme. This will require the actuary to consider whether there is good cause to believe that the conditions necessary for that to be the case will subsist during the relevant period (see paragraphs 20 and 21 under question 10 above).

Question 13: Should the actuary advise of matters of which he is aware that he considers are relevant to a decision whether to transfer? What should the actuary do if the advice is ignored?

1. Assuming that the actuary has been retained by the trustees and the trustees have a discretion whether the transfer should take place, it would be good practice for the actuary to draw attention to any specific issues of which he is aware that (whilst not affecting his certification) are relevant to the decision whether to transfer, for example any security issues.

2. If it is the case that the employer can direct that a transfer is made, such advice will not assist the trustees. If the actuary is retained by both the trustees and the employer, it would in such a case be good practice to draw the attention of the employer to such matters. Even if retained only by the trustees the actuary

could nevertheless inform the trustees of the matters on the basis that they could be passed on to the employer as being relevant to his decision.

3. If the advice is ignored, the actuary will have to consider carefully what to do (e.g. if he has not already given a certificate he might consider whether he should do so and/or make a report to Opra[11] and/or resign).

4. If the trustees have a discretion whether to make the transfer, it may be that the circumstances indicate a wrongful refusal by the trustees to consider matters relevant to their decision to make a transfer so that their decision would be a breach of trust In circumstances where the certificate is requested at a time when the actuary believes that the trustees have wrongfully ignored or will wrongfully ignore relevant matters, the actuary would have to consider carefully whether he is willing to give a certificate when he might be assisting in a breach of trust. This might occur for example if the trustees have taken a decision to transfer if a certificate is given and the actuary knows that in making that decision they have wrongfully ignored relevant matters; or where, although a decision has not been made, it is clear that the trustees are wrongfully ignoring and intend wrongfully to ignore the relevant matters when making the decision. In this situation, an actuary who believes that the trustees are wrongfully ignoring relevant matters and intend to continue to do so, could consider that giving a certificate would be assisting a breach of trust (just as a person who drives intending robbers to the scene of a crime assists in the crime as much the person who drives them away).

5. I would emphasize two matters.

6. First, if an actuary believes that trustees are wrongfully ignoring relevant matters, the situation will raise issues of contract law as well as trust law and careful consideration and specialist advice will be required before refusing to give a certificate. Equally, if the trustees have no discretion, and it is the

[11] There may be difficulties in making a report to the Regulator at a time when a breach of trust has not been committed – a breach would not normally occur before the trustees actually resolve to make a transfer.

employer who refuses to consider the matters, the position will require specific advice.

7. Secondly, an actuary can safely give a certificate if at the time he has no reason to believe that the trustees are wrongfully ignoring relevant information. In normal circumstances the actuary would be entitled to assume and should assume that the trustees will act properly and so can safely give a certificate and at the same time draw the trustees' attention to matters that he considers relevant to their decision.

Question 14: What are the implications of including additional information in the certificate and in particular an addition stating that no account has been made for the receiving scheme defaulting on the transfer credits acquired?

1. Where a contract provides for a certificate of valuation, there is a line of authority that the certificate can only be challenged on certain grounds such as mistake or improper motive (see e.g. **Dean v Prince** [1954] Ch 409, 418; **Jones v Sherwood Computer Services plc** [1992] 1 WLR 277; **Veba Oil v Petrograde** [2002] 1 All ER 703).

2. It is possible that a similar principle would be applied in the case of a certificate required by statute.

3. Thus, if additional information is included in a certificate, that might increase the risk of attempts to have the certificate set aside on the basis of mistake or some other ground.

4. This would be a real consideration if there is a danger that the additional information might give a misleading impression that an error or mistake has occurred when in reality it has not. On the other hand, where the additional information is stating a simple fact that the actuary would want to communicate

to the trustees in any event, it is difficult to see any practical impact of including the words in the certificate.

5. There is no problem that I can see with stating in the certificate that the certificate does not give authority to make a transfer and that the decision whether to make the transfer is for the trustees to take.

6. Equally, I cannot see any real difficulty in stating on the certificate that "in giving this certificate no account has been made for the receiving scheme defaulting on the transfer credits acquired"   The actuary would normally wish to inform the trustees of that fact in any event as it is a matter of which the trustees should be aware when considering whether to make the transfer.

7. Any member or employer could enquire of the trustees whether the actuary had taken account of such default and would expect to be told what the position is. If (contrary to my view) the risk of such default should have been taken into account, the certificate could be challenged whether the omission is proved by the face of the certificate or by information given by the trustees. (Compare **Re Imperial Foods Ltd Pension Scheme** [1986] 1 WLR 717 where a valuation of the amount to be transferred between pension schemes did not reveal its basis on its face but the actuary admitted that it was made on a particular basis and so the court considered whether it should be set aside).

Christopher Tidmarsh QC
Lincoln's Inn,
March 2005

The Faculty and Institute of Actuaries

Re: Guidance Note GN16

O P I N I O N

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