Pensions Convention, 5-7 June 2005, De Vere Grand Hotel, Brighton
Session F1 Individual Transfer Values: Huw Evans

1. Introduction

Thank you Ray. I'd like to start by apologising to the Powerpoint junkies among you for the lack of slides. The original intention for this session was to discuss EXD54. You can imagine that I've been busy rewriting my script after the seminar earlier today. I've tried to avoid repeating material from that session but I'm afraid that "Recent Developments" may not be the best title for what's left.

My original intention was to be provocative, or perhaps even controversial. However, it seems the Pensions Board beat me to it.

Instead I hope to use this session to inform the debate around the exposure draft. I have two sub texts:

i. First can we please avoid spurious complexity? – for example, I recently took on a scheme whose transfer value proforma runs to 30 sides of A4. There must be a better way.

ii. Secondly – I'd like to suggest that increasing transfer values from their recent levels may be good for the long-term health of our schemes even if that means, in effect, funding for cash on leaving service.
- FLY WHEEL effect
- here for cancer risk.

I am going to confine my discussion to cash equivalent transfer value from occupational DB schemes. Pensions sharing on divorce is simply too complex for a session like this and I have no experience of SSASs and SIPPs etc, except to say that they are often the most troublesome from my perspective as TPAS adviser.

Likewise, there is an interesting discussion to be had about TUPE transfers pre-June 2004, but I imagine that affects relatively few of us.

2. Historical Perspective

It seems to me that the profession last searched its soul on the subject of individual transfer values back in 1993, when the Goode Committee was investigating pensions.

At a seminar in June of that year, Roy Brimblecombe opened with a historical perspective. However, there was a lot less history in those days so my tale starts in February 2002 (not a particularly recent development I grant you). February 2002 is when the Government weakened MFR to reduce the burden on employers (my how times change).

This caused me to abandon the use of a simplified MFR-style approach to calculating the Cash Equivalent Transfer Value.

(I shall say more about my recent approach in a minute.)

6. Recent History

Of course by 2002 many schemes were underfunded and the shortcomings of the legislation on reducing transfer values had become a problem. This was addressed by the August 2003 regulations, which were a nightmare, but in the meantime the goalposts had moved again with the draft amendments to the Debt on Employer regulations issued by the DWP on 11 June 2003 which made the nature of the defined benefit guarantee much clearer.

Yesterday Harvie Brown talked about the pace of change. This year has been a bumper year: we have had further changes to the debt on the employer in February, the Pension Protection Fund got off the ground and the overriding priority order changed. Before the year is out the MFR underpin on our cash equivalents is destined to disappear.

So where does that leave us …

7. First Principles

At this point, I would like to consider individual transfer values from first principles:

By now the “member’s actuarial interest” is generally agreed to be the value of the preserved benefits.

The Ombudsman’s Pension Board’s conclusion in 1981 that “The choice between transfers and preserved benefits should be financially neutral” seems reasonable but did they mean financially neutral:

i. For the scheme, in which case an investment-based approach seems right; or

ii. For the member, in which case a liability-based approach seems appropriate; or even

iii. For the employer.

The proposed guidance seems to represent a switch from the investment-based to liability-based: are we agreed that this is the right response to recent developments?

In each case:

i. When is it appropriate to reduce for underfunding, which, in effect, is a share of fund approach to calculating the transfer value? I would argue that if we believe in a liability-based approach to calculating cash equivalents, it is inconsistent to allow for underfunding unless the underlying covenant is weak, in which case it may be inappropriate to have a long deficit recovery period.

ii. Also, how should the value of the so-called defined benefit guarantee be reflected in the transfer value especially since 11 June 2003, and even more so since the introduction of the PPF? Dare we risk an Equitable Life style challenge to our methodology. Perhaps someone in the room can tell me whether valuing the guarantee would have the effect of bringing the investment-based and liability-based approaches together. What I have in mind is that valuing the guarantee under the investment-based approach would presumably allow for the volatility of the returns on the underlying investments.

8. Current Approach

I don't have the answers to these questions so I am going to skip to my current approach and then consider what changes I might make in light of recent developments.

Only one of my schemes is currently reducing TVs for underfunding. Not surprisingly I am using an MFR-style approach for this and the assumptions follow GN27.

Otherwise, I use a bond-based approach mostly with discount rates of gilt yields + 3% pre-retirement and gilts + 1% post-retirement. This is despite knowing that an IFA is most unlikely to consider recommending transfer if his or her analysis reveals that pre-retirement investment returns of more than 6.5% p.a. are required to break even. I use higher rates because in my view the guidance and the legislation is satisfied so I can't deny the Trustees the certificate.

I think it would be better if lower rates were used, particularly if you bear in mind that to get returns of gilts + 3% from your equities would require the equivalent of dividend growth of RPI + 1% p.a. – significantly above the historic average.

You may be interested to learn that back in 1977 Pomery & Jones advocated gilt-based discount rate, but at that time gilt yields were 14% p.a. and even their proposed reinvestment rate was 8% p.a. Yesterday, the chaps from the L&G prompted us to think about a time series approach, taking account of the yield curve: I shall probably pass on this suggestion.

We heard this morning that the change in philosophy within EXD 54 was driven by the changes to the Debt on Employer legislation in 2003. Yesterday I listened with interest as Ian Sykes pointed us towards the buy out cost for M&A purposes. In a later session David McCarthy spoke about the way in which the discounts applied by members in valuing their benefits may vary. This makes the discussion around financial neutrality interesting.

As things stand, I don't feel qualified to adjust my discount rates for default risk, but perhaps I need to learn how in order to advise on scheme funding. Hopefully, the profession will be making appropriate training available. Certainly few of my clients have corporate debt that is both traded and unsecured let alone of a duration that is useful for setting discount rates for transfer values. I am sceptical about the ability even of the Finance Directors to look far enough into the future for my purposes.

Turning now to mortality, I have mostly used Year of Birth tables since the cohort effect tables became available – however, I am only doing this for clients for whom my employer provides pensions administration services: providing factors for each year of birth to a third party administrator seems excessive, but I have a concern that the best estimate requirement in EXD 54 would force my hand.

I know that some of my colleagues have some concerns about the suitability of the P92 tables for occupational schemes, but I take the view that they're OK for transfer values provided the annuity at retirement is reasonable.

I have given some thought recently to adopting lighter mortality for members with big pensions and was surprised to learn that a 25% reduction to the risks increases the duration by 5 years. Again, the best estimate provision of EXD 54 is a concern here.

I have also wondered whether I should start using proxy buy-out values for schemes that are likely to wind up within the next 10 years.

I have deferred a decision on this until the new mortality tables appear at the end of this year. In particular I hear that they are going to be stochastic – and I've no idea what this means for transfer values.

I have recently increased the commutation factors in my schemes so that they are neutral on the CETV basis as many of my schemes require me to certify them as reasonable.

I am also checking the value of Early Retirement pensions against CETVs to satisfy preservation – I anticipate that EXD 54 might be quite a significant change there too.

I have generally kept the percentage married at the rates specified for the MFR. If EXD 54 obliges me to use lower discount rates, I may revisit this as it can be quite material when discount rates are low, although I shall need to bear in mind the effect of the Civil Partnership legislation etc.

In common with the other big firms we derive our economic assumptions by reference to the yields on long gilts and index-linked gilts using option pricing formulae if necessary. I understand that it is now possible to derive the implied volatility of inflation from the LPI swaps market, which is nice.

9. <u>Allowing for PPF etc</u>

Fortunately for me, this has been addressed in part by the profession's Examination Board, which asked candidates to consider a similar scenario in Paper II Q3 of the September 2004 404 exam. Naturally the model solution gives a balanced view. For example, it allows that it could be argued that the transfer value should be the buy-out cost, but concedes that, in effect, this is allowing the life office actuary to price the option which would include profit loadings and funding for solvency margins. It also considers that there is a strong argument for ignoring underfunding, but then its hypothetical Protection Scheme protects the entire benefit and is underwritten by the Government.

10. <u>Enhancing TVs to Encourage Transfers</u>

I am aware of some companies that have succeeded in discharging pension liabilities by funding modest enhancements to transfer values. However, this was before the introduction of the PPF (although post 11 June 2003), which means that risk of the scheme winding up without full funding was a valid consideration. I have been disappointed that I can't persuade Trustees that quoting the minimum transfer values I am willing to certify doesn't save them money if they don't result in transfer **payments.**

Of course, if the inducement to transfer is made by the company and not through the pension, it may be paid as a lump sum.

If you capitalise the future expense of administration, levies etc transfer values start to become attractive when the benefit amounts are small. I shall certainly consider advising my clients to allow for the levies in this way because increasing the number of transfers may mitigate the trivial pension problem schemes will face from April 2006.

11. EXD54

I would like to conclude by welcoming EXD54 as an improvement to GN11 but enter a plea for it to be tempered with more pragmatism.