The Actuarial Profession
making financial sense of the future

Transfer Values
- Just another option?

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Introduction

- Part 1: The Past
  - Modern history of transfer values
  - The MFR
  - EXD54
- Part 2: First Principles?
- Appendix: EXD54 Details

Part 1: The Past

Modern history of transfer values

- Statutory right
  - Introduced by Social Security Act 1975
  - Currently PSA93 & PA95 and 1996 TV Regs
  - Also, 5 other Acts, 7 other Regs & 3 tertiary legislation apply to or use TVs!
- Trust Deed and Rules?
  - Member option
  - Part of the benefit structure?
  - Often as determined reasonable, by actuary or trustees

GN11 Purpose

- GN11 v1.0 (1/12/1985):

  "It is a fundamental requirement, stemming from the legislation, that a transfer value should represent the actuarial value of the benefits that would otherwise have been preserved."
- GN11 v9.1 (1/3/2004):

  "It is a fundamental requirement, stemming from the legislation, that a cash equivalent should represent the actuarial value of the corresponding accrued benefits."

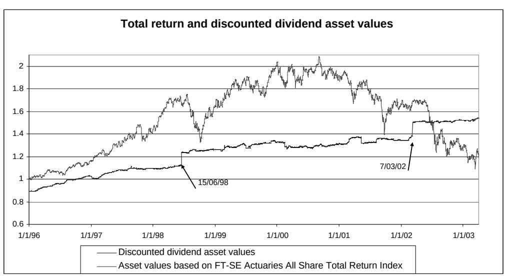
Complications & complexities

- Contracting out
- Preservation
- Divorce & pension sharing
- Reductions for under-funding
- Directors' disclosures

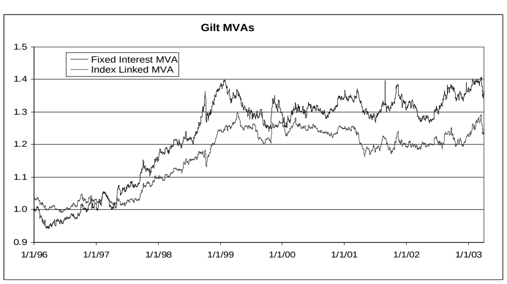
MFR and transfer values

- MFR objectives
  - Retirees can expect pensions to be paid in full
  - Others can have reasonable expectation of receiving value of their pension rights when they retire

MFR and transfer values - Equities



MFR and transfer values - Bonds



MFR and transfer values - Mortality

Standard Table	Sample annuity at 65*	Uplift relative to MFR mortality
PA90 -2	12.8	100%
PMA92 YOB	14.6	114%
PMA92 YOB SC	15.1	118%
PMA92 YOB LC	15.9	124%

*Currently age 50, LPI increases, 50% spouse's pension, 5 year guarantee, MFR basis

MFR and transfer values

- Underpin became standard basis
- Under-funding cut backs common
- Pensions Board advised members this was "close to untenable" in September 2002
- Replaced by Scheme Specific Funding from 23 September 2005

Present day environment

- 11 June 2003
- Pensions Act 2004
  - PPF
  - SFP
  - TPR
- FSA Handbook
- Different actuaries could put a different value on the same entitlement

…Transfer traffic at a virtual standstill

EXD54 to the rescue?

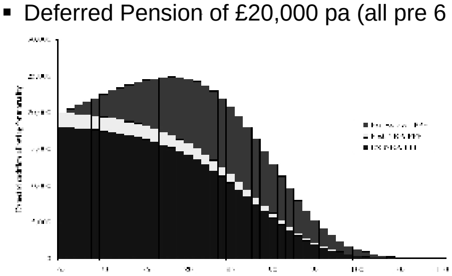
- "Marked to market" value
- Discounting using bond rates reflecting default risk
- "Best estimate" for demographic assumptions
- Actuary use judgement (can use broad brush)
- Can reduce transfer values
  - Government to decide on policy

EXD54 Details

- Discount rate & default risk
  - Actuary use judgement
  - Take instruction from trustees (not instructed: use gilts)
  - Max of yield on appropriate debt of employer
- Actuary to draw implications to trustees' attention
  - Circumstances in which certificate may cease to be valid
  - If immediate security of other members' benefits reduced

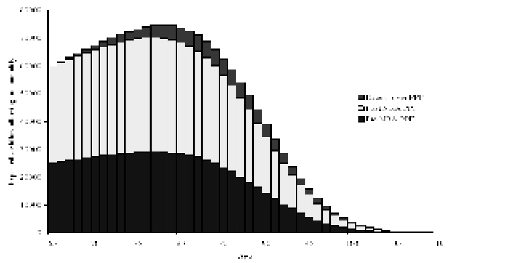
EXD54 Theory

- Deferred Pension of £20,000 pa (all pre 6 Apr 97)



EXD54 Theory

- Deferred Pension of £60,000 pa (all post 6 Apr 97)



EXD54 – Sample discount rates?

	Low Sponsor Risk		High Sponsor Risk	
	Strong Funding	Weak Funding	Strong Funding	Weak Funding
PPF Benefits	4.9%	5.0%	4.9%	5.0%
Excess over PPF Benefits, for members of different ages				
Aged 40	5.2%	5.7%	6.6%	7.8%
Aged 60	5.0%	5.3%	5.7%	6.3%

Current status of EXD54

- Unprecedented consultation response
- EXD54 with Pensions Board
- Main charges against EXD54:
  - Didn't consult widely enough
  - Too complex
  - Too prescriptive
  - Trustees unable to instruct on default risk
  - Large increase in TVs with impact on scheme costs
  - TVs potentially stronger than funding basis
  - Complex to communicate to members
  - Actuaries shouldn't be setting tertiary legislation
  - What's wrong with an expected cost approach?

Part 2: First Principles

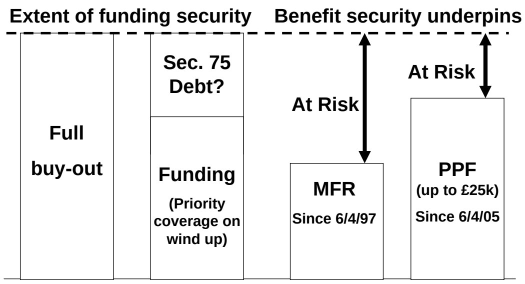
An option or a broken contract?

- Why offer transfer values?
- Is the member breaking a contract?
  - Mobile phone contacts
  - Insurance policies
  - Old age pension

Asymmetric occupational pension risks

Investment risk	→ sponsor
Longevity risk	→ sponsor
Interest rate risk	→ sponsor
Inflation/Salary risk	→ sponsor/member
Default risk	→ member

Extent of default



Allow for default risk?

- Would you rather be owed £100 by:

The government

A well resourced private institution

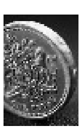
A thriving modern enterprise

An unlisted sole trader

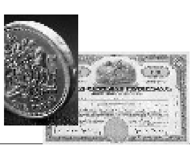
- Is a £1,000pa Civil Service pension worth the same as £1,000pa of pension from an under-funded private sector pension scheme with a B rated sponsoring company?

Allow for equity returns?

- Sponsor's perspective on equity risk?
  - Required to fund any under-performance
  - Why should member be able to "lock in" to risk free (…and then potentially invest in equities!)
- Members' perspective on expected equity return?
  - I owe you £100 would you prefer:



£100 cash?



£50 cash
& £40 equities?

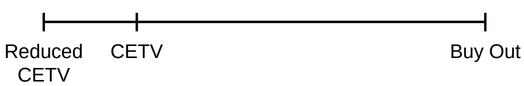
100 lottery tickets?

Practicalities

- Integration with funding strategy
- Communication with public
- Where does TV traffic go?
  - PPP\SHP\GPP – need to meet IFA critical yield criteria
  - Occupational DC benefits
  - Government sponsored DB schemes

Top-ups?

- Incentivised TVs may become more common
  - Employer tops up TVs or pays a separate cash amount?



How big a top up would you want?

15 Years from Normal Retirement Age

Pension: £10,000 pa (full RPI increases pre and post 97)

TV: £70,000 (MFR min, Full TV reduced by 30%)

60% FRS17 funded with a B rated sponsor

Brave New World

- Profession’s role in setting tertiary legislation?
- Prescription vs judgement?
- Public interest
  - Clarity
  - Fairness
  - Opportunity
- Communication and disclosure should be key

Discussion

Appendix: EXD54 Details

Appendix 1: EXD54 detail

1.2 "default risk" means the likelihood of the accrued benefits not being paid in full and is analogous to the assessment of debt for credit rating purposes

1.3 "marked to market" basis means discounting using appropriately derived bond discount rate which reflect the default risk of the relevant benefits. If considered appropriate, different discount rates must be applied to different tranches of benefits where the default risk differs

3.1 The general principle is that cash equivalents must be no less than the value of the relevant benefits calculated on a marked-to-market basis.

Appendix 1: EXD54 detail

- Discount rates
  - Actuary use judgement in assessing default risk and consider:
    - funding level & winding-up priorities
    - financial strength of the employer
    - covenants which affect default risk
    - investment strategy
    - funding target/policy
    - other contingent risks
  - Actuary takes instruction from trustees on default risk
  - If instructed not to account for then use gilt yields
  - Maximum discount rate = yield on appropriate employer debt

Appendix 1: EXD54 detail

- Demographic assumptions
  - Variations from best estimate must increase amount
  - include allowance for future changes in longevity
  - by reference to characteristics of groups or individual
  - Demographic assumptions
- Allow for options & discretionary benefits
  - Must agree allowance with trustees
- May use judgement to produce and certify appropriate and pragmatic procedures

Appendix 1: EXD54 detail

Reductions in cash equivalents

- Trustees direct the actuary to prepare report
- Report to make clear that scope limited to reductions permitted by regulations
- Need not be based on formal valuation, audited accounts or full membership data
- Actuary to determine subdivision into priority classes and allowance for expenses
- Report to compare assets available to liabilities for each subdivision