Knowledge Sharing Scotland

Impact of the 2014 budget on DB pension schemes

Stephen Yates, Andrew Hornell & Stuart Cook

26 February 2015

TOWERS WATSON

Agenda

- Summary of changes
- Key DB issues
- Actuarial Factors
- Breakout discussion on factors
- Communications
- Funding
- Conclusion

Stephen Yates
Fellow of the Institute and Faculty of Actuaries

Andrew Hornell
Fellow of the Institute and Faculty of Actuaries

Stuart Cook
Fellow of the Institute and Faculty of Actuaries

Towers Watson Limited
2 Lochrin Square
96 Fountainbridge
Edinburgh EH3 9QA
UK

T +44 131 228 8181
F +44 131 228 9106

26 February 2015









The 18th Camel









The problem…

- Father has 17 camels
- When he passed away he leaves them to his 3 sons in his will
  - 1/2 to the eldest
  - 1/3rd to the middle son
  - 1/9th to the youngest
- Sons couldn't divide in line with father's wishes so started to fight
- The three sons decided to go to a wise man (actuary)

- The actuary listened patiently
- Brought along a camel of his own to make 18
- Then read the will again…

- When confronted with a challenging problem try to come up with an innovative solution!

Summary of changes

New framework to be in place from 6 April 2015

A new tax framework for retirement

- Under the new tax rules, individuals **will not be required to purchase an annuity** and will be able to draw down 100% of the value of their DC savings pot; the first 25% will be tax free
- DC schemes will be able to **choose** whether to override their scheme rules with the new tax rules
- **Transfers** between DC schemes to be permitted up to normal pension age
- **Anti-avoidance** measures will be introduced to prevent unintended tax advantages
- Tax rules for retirement income products will change to enable **innovation**
- **Minimum pension age** to rise from 55 to 57 in 2028, and then remain ten years below State pension age

Supporting choice in DC

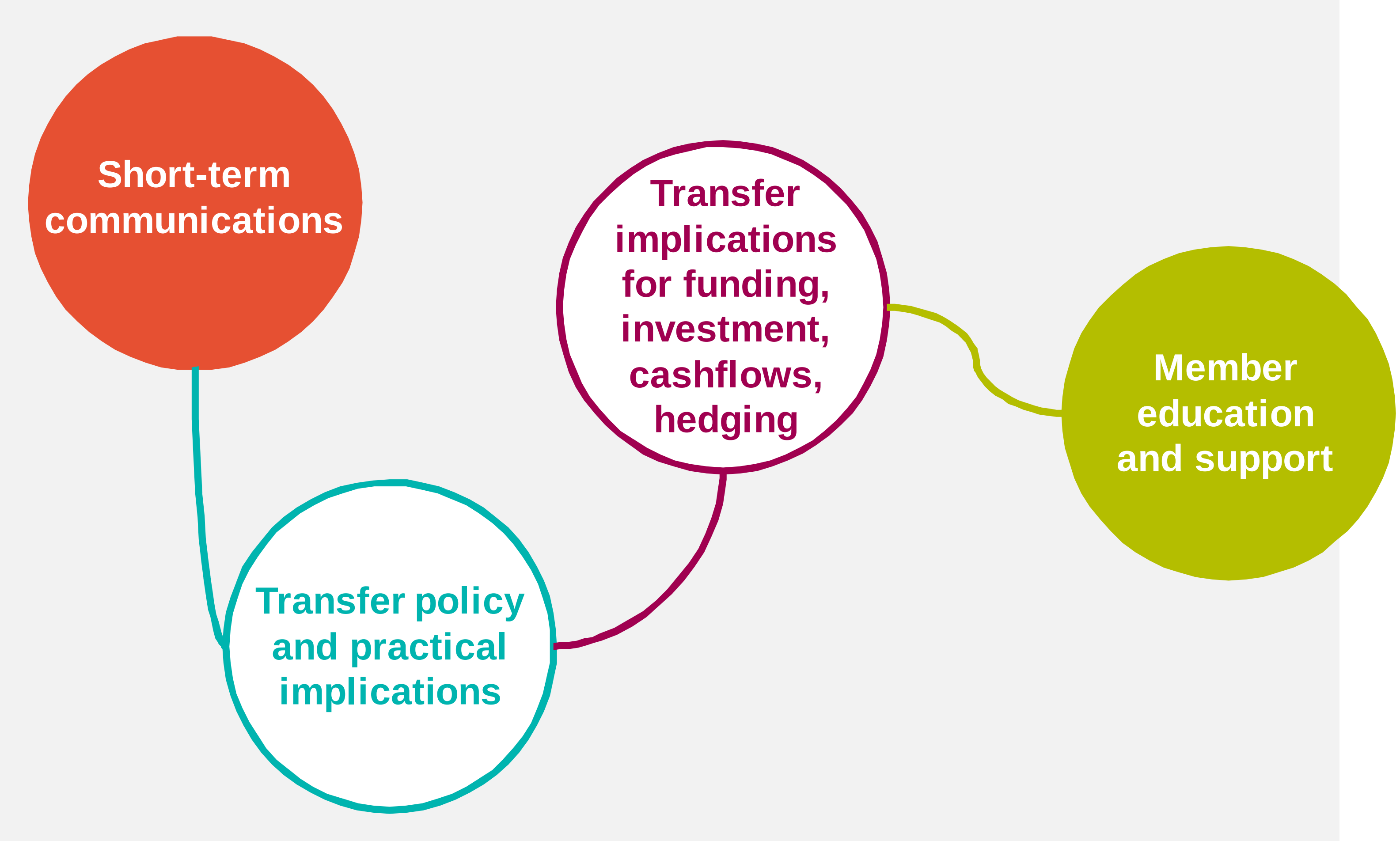
- **'Guidance guarantee'** for all DC retirements from 6 April 2015, for contract and trust-based schemes
- Delivered by **independent** organisations, e.g. TPAS, MAS
- **Funded by levy** on FCA regulated firms

Defined benefit schemes

- **DB transfers to continue** for private sector and funded public sector schemes, subject to two new safeguards
- Small lump sums from **age 55**

Key DB issues …

… in light of the government's response to consultation on its 'Freedom and choice in pensions' proposals on 21 July 2014



Factors: CETV / Commutation comparison

NOW

A.

Increasing pension

DB pension: £10,000 a year

OR

B.

Lower pension

DB pension: £6,923 a year

plus

Tax free!

£

Cash lump sum of £46,154

NEW OPTIONS

1.

£ Transfer value

Transfer value of £250,000

USE TRANSFER VALUE TO PROVIDE

2.

£ Tax free! Lump sum of £62,500

plus

£ Taxed lump sum of £187,500

OR

3.

£ Tax free! Lump sum of £62,500

plus

Invest £187,500 and draw when needed

OR

4.

£ Tax free! Lump sum of £62,500

plus

DB pension: £9,250 a year

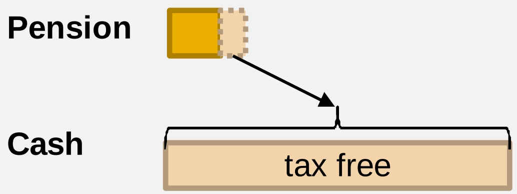
Single-life level annuity

In this example commutation factor (CF) is 15, cash equivalent transfer value (CETV) factor 25.

Factors: Comparison under partial transfer

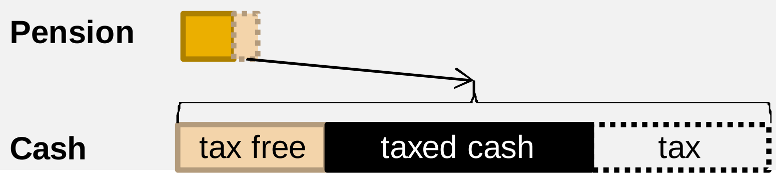
Current approach

- Exchange pension of £3,077 pa (30.8% of total) for cash
- Cash = **£46,154** (all tax free)
- Residual pension = £6,923 pa



Alternative approach

- Transfer pension of £3,077 pa (30.8% of total) into DC
- Cash = £76,925 (25% tax free)
- Cash after tax = £76,925 x (25% + 75% x 0.6) = **£53,848** (at 40% tax rate)
- Residual pension = £6,923 pa



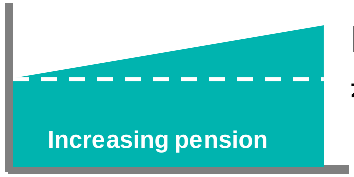
Member is better off under the alternative approach

- **c20% more** cash
- **Same** residual pension (although spouse gets 30.8% less…)

CETV / Commutation / Trivial commutation comparison

NOW

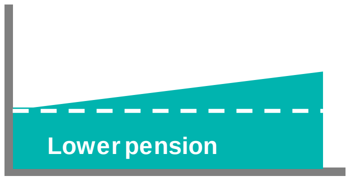
A.



DB pension:
£1,000 a year

OR

B.



DB pension:
£692 a year

plus

Tax free!

£

Cash lump sum of £4,615

NEW OPTIONS

1.

£
Transfer value

Transfer value
of £25,000

USE TRANSFER VALUE TO PROVIDE

2.

£
Tax free!
Lump sum
of £6,250

plus

£
Taxed lump
sum of
£18,750

Pre-tax total: £25,000

OR

NEW Trivial commutation

3.

£
Tax free!
Lump sum
of £4,000

plus

£
Taxed lump
sum of
£12,000

Pre-tax total: £16,000

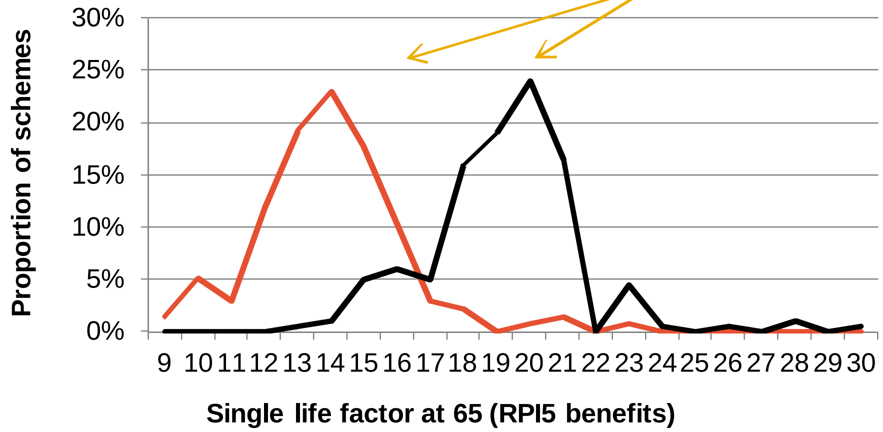
Trivial commutation directly comparable

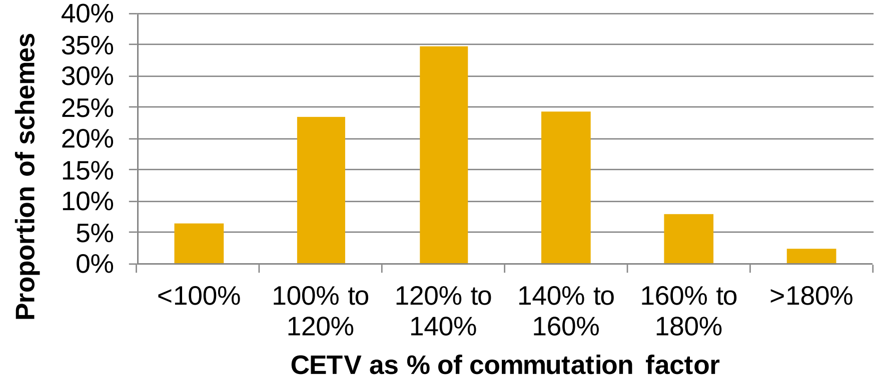
Factors
Commutation factor: 15
CETV factor: 25 (includes spouse's benefits)
Trivial commutation factor: 16

Factors: CF vs TV – where are we now?

Average CETV factor much higher than commutation factor

- Regulations
- Take-up
- Power to determine
- Benchmarking
- Market related





CETV factors (pre MVA) frequently 30% to 40% higher than commutation factors at age 65

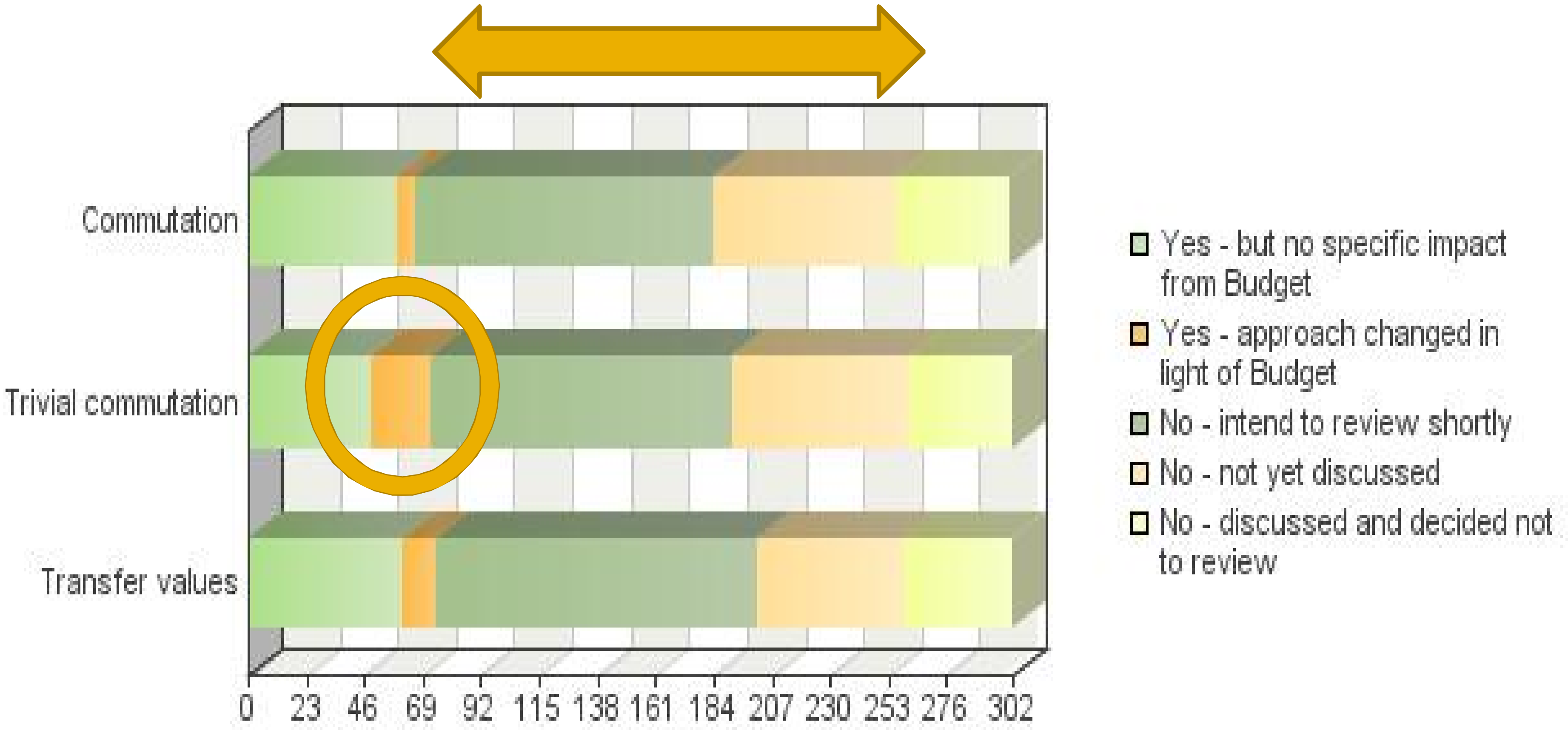
Factors: TV regulatory framework

- Transfer regulations (and the Pensions Regulator’s guidance) overlay constraints on bases used for statutory transfers:

Constraints	• **Member options:** no allowance if value would reduce (tPR guidance) • **Selection:** trustees to “have regard to the *main* characteristics of the members of the scheme” • **At least “best estimate” (overall)**
Flexibilities	• **Investment strategy:** trustees must “have regard to” the investment strategy, but what does this mean? Dual or single discounts rates, allowing or not allowing for future de-risking, might be acceptable • **Discretionary benefits:** identify and consider allowance • **Underfunding:** can reduce, subject to insufficiency report • **Other rating factors** (gender, marital status, income, health etc)**:** could be allowed for as can group members (tPR guidance), subject to legal advice on discrimination issues. For example, should we move to allowing for actual marital status going forward? • **Can pay more**

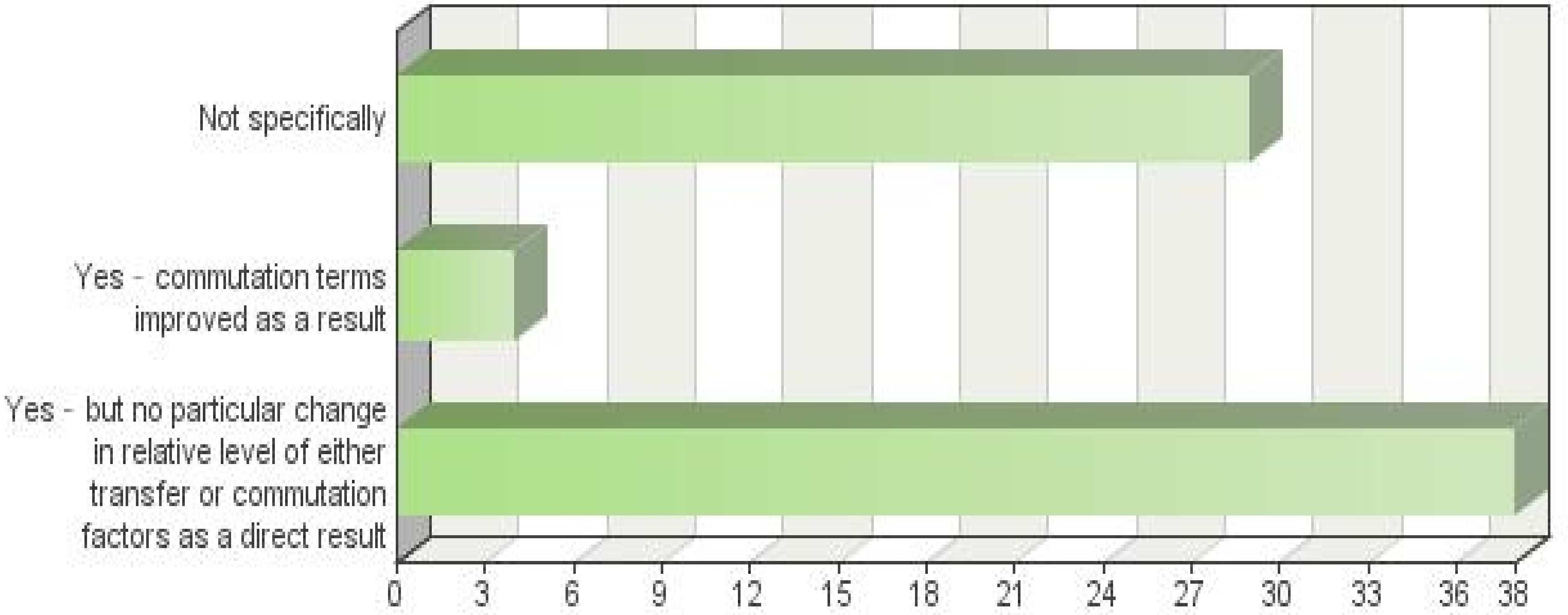
Factors: CF vs TV – where are we going?

Have factors in any of the following areas been reviewed since the Budget announcement?



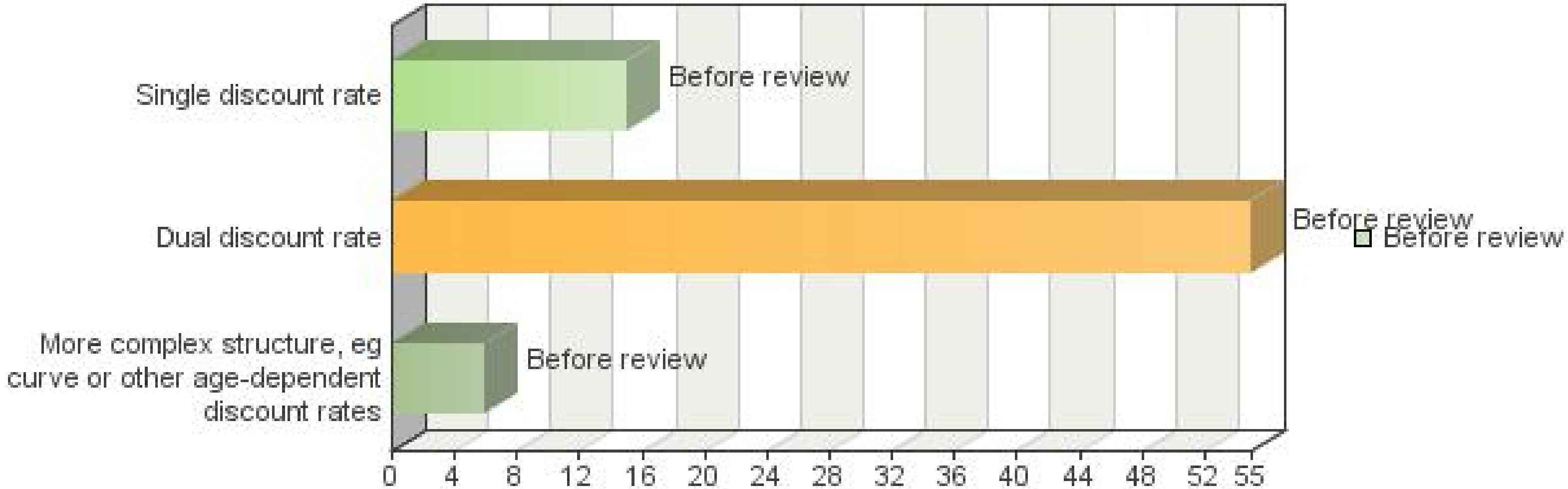
Factors: CF vs TV – where are we going?

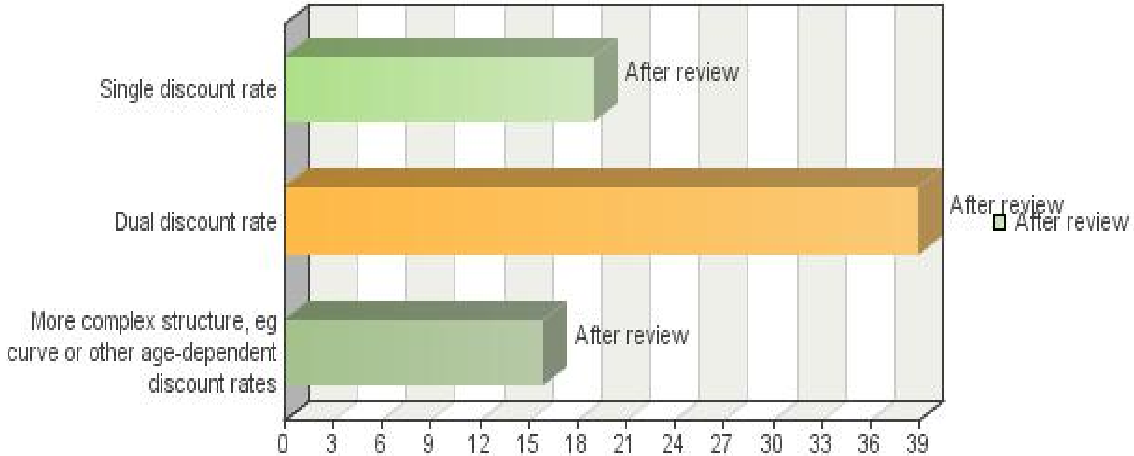
Was the comparison between commutation factors and transfer values considered in setting the revised basis?



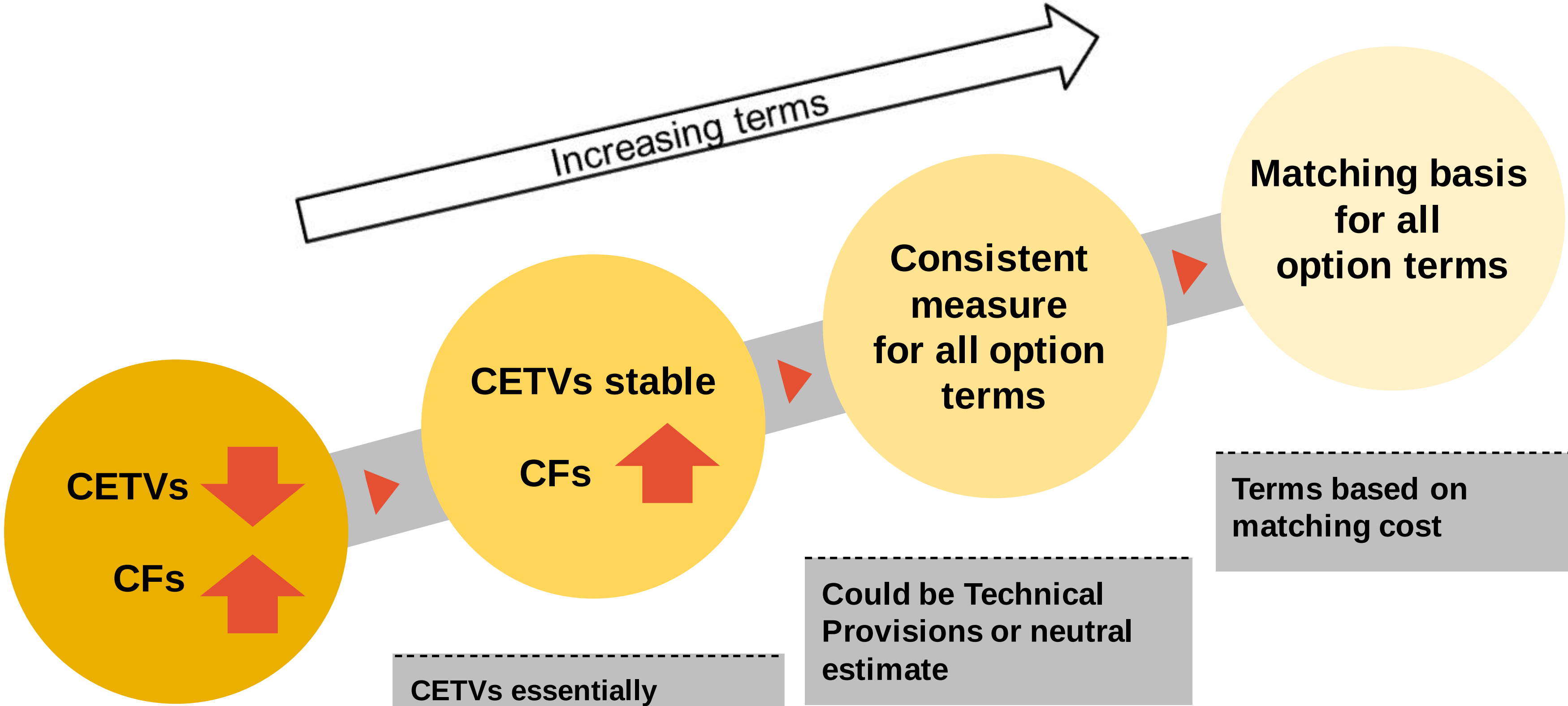
Factors: CF vs TV – where are we going?

Which of the following best describes the transfer basis before and after the review?





Factors: Possible approaches to achieving greater consistency between TVs and CFs (if desired)



CETV basis used for CFs but CETVs revised down

CETVs essentially unchanged, but CFs improved to be broadly consistent (but possibly with some differentiation)

Could be Technical Provisions or neutral estimate

Terms based on matching cost

Factors: Breakout discussion - Questions

1. Will members desire / demand consistency?
2. Do Trustees want consistency?
3. Should all factors be set using consistent assumptions at NRA?
4. Where is the 18th camel?

5. Supplementary question:

   The (Transfer Values) Regulations 1996 (SI 1996/1847) state that: "…trustees must have regard to the scheme's investment strategy when deciding what assumptions will be included in calculating the discount rates…"

   To what extent should this constrain transfer values?

Factors: Breakout discussion

- CETVs
- Commutation
- Trivial commutation
- AVC conversion

Issues that may be relevant:

- ➢ Single discount rate / Dual discount rate / Yield curve?
- ➢ Best estimate / Prudent?
- ➢ Market related?
- ➢ Allowance for future changes in investment strategy?
- ➢ Constraints eg legal / scheme specific

Communications

Level 1 - Reactive

Make minimal changes to retirement communications and process

Wait for members to request transfers

Level 2 - Communicate

Amend retirement communications to include a guide to all options

Provide transfer values in retirement quotations

Level 3 – Member support

Provide financial advice

As well as adding transfer values to retirement quotations and improving retirement packs

Funding and investment strategy

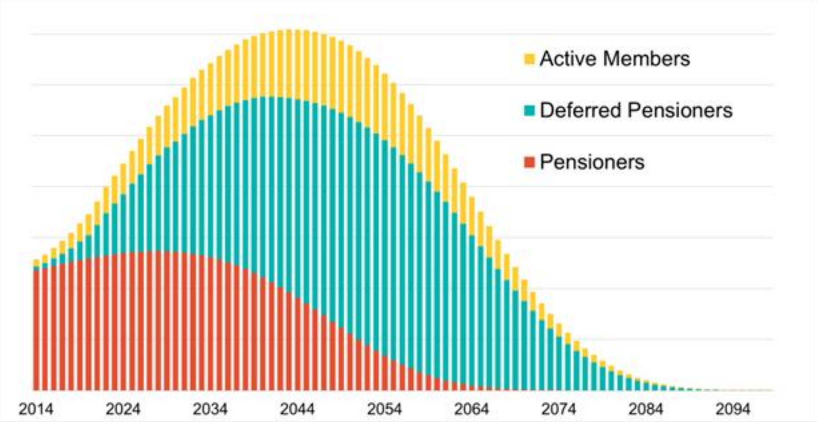
Funding – should an allowance be made for transfers in Technical Provisions?

PPF – crystallising benefits not compensated by PPF (e.g. pre 1997 increases)

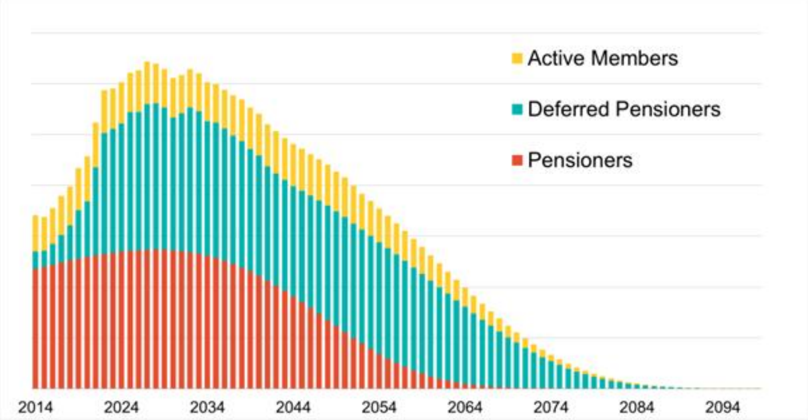
CETVs will typically be lower than Technical Provisions → If this is true for members transferring, margins for prudence will be released → Should we make allowance for this in funding?

Investment – greater uncertainty for cashflows will impact on hedging and investment strategies

With no allowance for DB transfers



With transfer of 50% of non-pensioner DB liabilities



Conclusion

?