The Actuarial Profession
making financial sense of the future

Member options: commutation and other choices

Member Options Working Party

October 2006

The report will be on the Profession's website

Background

Pensions Board concern over cash commutation rates
- Look obviously low
- Have actuaries advised their clients?
- Could the Actuarial Profession take the blame?

Natural extension to other options, but issues less serious

Transfer values
- some marked similarities in theory
- but already 'dealt' with

Set up working party in early 2006

Working party membership

Members
- Tim Gordon (chairman), Gordon Consulting LLP
- Richard Jones, Punter Southall
- James Saunders, PricewaterhouseCoopers
- Alan Smith, First Actuarial
- Arthur Zegleman, Watson Wyatt
- Derek Sloan, Chairman of the Association of Pension Lawyers, Allen & Overy

Consulted the Pensions Regulator—has interest

Approach adopted

Important to test state of play

- Strong suspicion that working party already had sufficient collective knowledge
- But still needed to test

Initial issues were

- The legal framework—contrast transfer values
- Approaches adopted in practice

First step: survey consultancy firms to supplement GAD and NAPF survey data

Q1 Check on the range of options

1. Principal options found in UK occupational pension schemes are:
   - Commutation of accrued pension for a cash sum paid to the member at retirement (or at any other time when the member is able to draw on the benefits).
   - Exchange of accrued deferred pension for transfer value.
   - Early retirement from pensionable service.
   - Early retirement from deferred pensioner status.
   - Commutation and retirement on grounds of incapacity or ill-health (including possibly differentiation based on severity).
   - Commutation on grounds of triviality.
   - In scheme purchase of pension using member AVCs.
   - Increase in pension to allow for 'late' retirement.
   - Exchange of accrued pension for increased dependant's pension.

Q2 Check range of legal frameworks

2. The range of legal frameworks governing setting terms for these options can be summarised as follows:
   - Either the trustees or the sponsor sets the terms unilaterally without reference to the other.
   - Either the trustees or the sponsor sets the terms but is required to consult the other.
   - The trustees and the sponsor must agree the terms (i.e. both have a veto against change).
   - The scheme deed and rules and explicit legislation set out no constraints.
   - The scheme deed and rules may require that the party or parties setting the terms takes actuarial advice.
   - The scheme deed and rules may require that the terms are certified or otherwise approved by an actuary, either at the time the terms are changed or at the time the option is exercised.
   - The scheme deed and rules may require that the terms are determined by an actuary.
   - There may be requirements in the scheme deed and rules implying that a review of terms is required following the triennial valuation.
   - The scheme deed and rules require that the terms are 'reasonable' (or similar).
   - The scheme deed and rules contain constraints referring to an external agency (e.g. commutation factors to be no more than approvable by HMRC).

Q3 Range of legal advice
Q4 Sensitivity to terms

3. The range of legal advice on interpreting these legal considerations can be summarised as follows:

- The party setting the terms is acting as a fiduciary.
- The party setting the terms is not acting as a fiduciary.
- The terms are implicitly a part of the scheme benefit design and therefore amending them (to be more or less generous) should be treated similarly to changing benefits.
- Where either the trustees or the sponsor can set the terms independently, they must still take account of the views of the other party.

4. For each of the [options], please summarise briefly how sensitive in your experience or view the exercise of the option is to the terms being offered and what evidence supports this view.

Q5 How the terms are set

5. For each [option], please summarise briefly the degree to which, and if so how, the following factors are taken into account

- Market conditions (meaning either the cost of securing the same benefit terms with an insurance company or market prices for assets that could be used to mitigate the principal financial risks (e.g. long-dated, possibly index-linked, bonds and swaps, and mortality risk mitigation products).
- Cost neutrality from the scheme's point of view (including how this is defined),
- Cost neutrality from a members' points of view (including taxation and time cost of money to the member) and, if such allowance is made, whether or how differing member circumstances are taken into account.
- Market experience about the terms currently offered to existing scheme members and the acceptance rate (or otherwise) of these terms.
- Consistency between the terms for different member options.
- The characterisation of the financial terms as part of the scheme benefit structure (e.g. on the basis that they have been set out in member communications).

Q5 How the terms are set (cont'd)

5. For each [option], please summarise briefly the degree to which, and if so how, the following factors are taken into account

- Providing members with lower values than market replacement cost on the grounds that the 'pension promise' relates to the primary benefit and members do not have to exercise the option.
- Member communication and planning, e.g. the desire to provide figures for members that are fixed for sufficiently long that members can plan financially, and any consequent the exposure of the scheme to risk arising from this.
- Risks to the scheme from the large scale exercise of a particular member option.
- Concern that it may be harder to make the terms less generous in future (if the change in financial conditions reverses) than it is to improve them now.
- Scheme funding and benefit security, including current under-funding, scheme funding and investment strategy, the sponsor covenant and future exposure of the scheme to risk in general.
- The existence of the Pension Protection Fund.

Q6 Typical range
Q7 When last reviewed

6. For [each option], please indicate a typical range for the terms as requested

- Cash commutation with and without LPI
- Early retirement from service
- Early retirement for deferred pensioner
- Late retirement

7. For each [option], please indicate when they are typically likely to have last been reviewed (by ticking the most representative box)

- Last 12 months
- Last 3 years
- Longer

Survey response

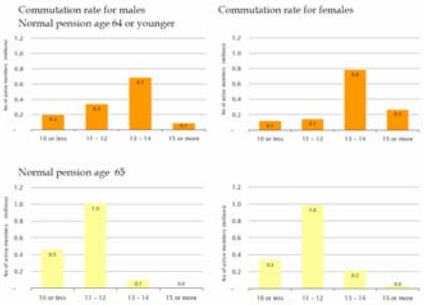
Poor response

- Not unexpected given
  - timing ('A' day), and
  - one of the concerns at outset is that this has been treated as low priority
- Consultants reluctant to provide ammunition that might be used against them

Survey findings (1)

Option	Actuarial factor X	Value of X		
		Lower value	Typical value	Higher value
Cash commutation	£X p.a. of cash per £1 p.a. of pension commuted for a male at normal retirement age 65 with no increases in payment	9	9 to 12	12 typical
	£X p.a. of cash per £1 p.a. of pension commuted for a male at normal retirement age 65 with LPI(0,5) increases in payment	Mostly 9	10 to 14	13 to 16, a few at market rates (e.g. 18 or 22)
Early retirement	£X p.a. of immediate pension per £1 p.a. of current accrued pension for an member with 5 years to normal retirement age. Assume that all pensions have LPI(0,5) increases and 50% spouses' pensions.	0.7	0.8	0.9
Late retirement	£X p.a. of immediate pension on late retirement now per £1 p.a. of pension at normal retirement age for a member retiring 5 years after normal retirement age. Assume that all pensions have LPI(0,5) increases and 50% spouses' pensions,	1.5 (tight range)		

GAD survey data



Survey findings (2)

Cash commutation rates

- substantially below market cost (of the scheme purchasing annuity)
- 9 for a male at age 65 much in evidence

Exercise sensitivity

- Consensus that cash commutation insensitive to the terms offered
- Other options, e.g. early retirement exercise may be sensitive to the terms offered (because members test affordability of retirement)

Survey findings (3)

Factors taken into account

- cost neutrality on an ‘ongoing basis’ appeared to be the most common strongest factor
- except for TVs and, possibly AVC pension purchase, where market conditions were most important

References were made to making allowance net of tax

Cost neutrality appears to refer to

- ‘ongoing basis’, i.e. capitalising ‘prudent’ future expected returns,
- although some actuaries may mean expected returns with no adjustment for prudence, i.e. weaker still

No respondent took account of the existence of the PPF

Analysis—Legal issues (1)

Legal context varies significantly by scheme *and* option:

- different wording in deeds and rules,
- different previous communications with members, and
- possibly, different legal or actuarial advice

(As informed by Derek Sloan)

- General implied duty for trustees to be reasonable in setting terms for member options *regardless of whether the rules state that the terms should be e.g. 'reasonable'*
- It *is* appropriate that the financial terms for member options take account of other factors than actuarial equivalence

Analysis—Legal issues (2)

Degree to which actuary expected to be pro-active or to monitor

- First check engagement letter—does it say anything?
- A court may in any case infer an obligation depending on the actuary's relationship with a client—obligation may be greater if she acts for the client on a frequent basis and is frequently proactive on other issues

Actuarial Profession should distinguish between the risk

- of professional negligence to its members, which may be relatively low, and
- to the general reputation of the Actuarial Profession, which is not purely a legal matter

Analysis—Member options in general

Differentiate between

- benefit conversion—sensitivity to actuarial basis is less, and
- conversion to cash—i.e. cash commutation and transfer values

Concern over consistency

- may be driven by scheme rules
- some still look odd to an external observer, e.g. LPI pension commuted at £10 per £1 p.a. but terms for purchasing the same pension from AVCs (ex spouse's) 50% (or more) higher
- some schemes changed rules to prevent members taking all AVCs as cash, which highlights the discrepancy

Analysis—Cash commutation (1)

Most scheme members take the cash

- Partly because tax free
- May also be implicit assumption that the terms are based on the value of the benefit foregone
- Data indicate cash is likely to be substantially less than the cost of replacing the pension surrendered

Cash commutation terms are typically set by the trustees or the sponsor; there may not even be a requirement to take actuarial advice.

Analysis—Cash commutation (2)

Fall in long-dated interest rates (real and nominal) plus increase in expected longevity has increased value

HMRC standard 'capitalisation' factor of 20 compared to 9 is stark (even after adjusting for dependant benefit)

Pension Protection Fund and new regime makes pensions more secure—members are giving up a more valuable right

But terms have not increased proportionately, …
… if at all

This may be explainable; the real problem is if they have not been reviewed at all

Analysis—Cash commutation (3)

Some funding valuations 'hard code' cash commutation rates (partly driven indirectly by FRS 17's best estimate requirement)

Concerned that

- possibly as a result of pressure to contain increasing reported pension scheme costs and contributions
- actuaries may be signing off valuations assuming that
  - members commute a large (25%) proportion of their pension for cash on retirement, and
  - the current cash commutation terms will continue to apply for all time

  without advising of the implications

Analysis—Cash commutation (4)

CETVs *are* different

- Driven by overriding legislation
- Used as reference values in legislation
- No direct tax benefit
- Recurring opportunity—more exposed to selection
- Much more likely to take financial advice
- Paid to pension arrangement, not member
- Different legacy—associated with the personal pension misselling scandal whereas cash commutation generally seen as positive

But underlying similarity (i.e. conversion to cash) remains

Actuarial Profession

- took stand on disclosure for TVs
- Needs to be consistent on cash commutation
- TVs under review now

Recommendations

1. Pensions Board to communicate to pensions actuaries

- Where actuary has explicit or implicit obligation to advise trustees or sponsor clients on terms for member options, changes in market conditions may make it appropriate to advise that terms are or may be out of date and should be reviewed if not taken place in the past two or three years.
- May help clarify actuary's ongoing obligation by
  - setting out terms for reviewing member options in terms of engagement, and
  - establishing a policy or trigger for future reviews.
- In any review, the actuary needs to be careful to justify any financially inconsistent terms.

Recommendations

2. Pensions Board to note hard-coding of commutation into actuarial bases and the potential distortion of trustee and company decisions on setting cash commutation terms

Took the view that

- this was a matter of actuarial conduct, and
- recommending a course of action was outside the scope of the working party.

You have been (or at least you will be) warned

Recommendations

3. The Actuarial Profession should support either

- meaningful disclosure of cash commutation terms to members consistent with its stance on member disclosure for transfer values, or
- a requirement for a risk warning and suggestion for members to take financial advice if they are considering commuting a large amount of pension to cash.

Actuarial Profession planning to raise with DWP/the Regulator

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Questions

1. Have you reviewed factors in the last 3 years?
2. Can you justify inconsistent rates in all cases?
3. How do you defend low cash commutation terms, especially where you certify or set them?
4. For cash commutation, should the Profession push for
   a) numerical disclosure,
   b) risk warning, or
   c) nothing
5. Any working party conclusions you disagree with?

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