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Member Options

Peter Tompkins

Commutation factors

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Agenda

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- Member Options Working Party Report
- The Pension Regulator's view
- Typical factors and trends in changing factors
- Who has the power to set the factors
- Further issues to consider when setting the factors
- Allowance for cash commutation in the assumptions
- Case Study
- Going forward – questions to ask yourself

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Introduction

- Most members elect to commute pension for cash
- Do members assume that the amount of cash closely relates to the value of the forgone benefits?
- The evidence is that the cash is substantially less!
- Annuity rates and commutation factors have diverged
- Key reasons why:
  - Lower long dated interest rates
  - Expected longevity increased
  - But not fully reflected in current cash terms
- **The Sunday Times reported that pension savers may be "short changed" by up to £7bn a year**
- Post A-day cash terms are arguably even more important as many members can take more cash

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Member Options Working Party

- Early 2006, the Pensions Board established a working party
- The working party reviewed issues around setting terms for cash commutation and produced a report in December 2006
- Following that report, in February 2007, the Actuarial Profession:
  - Wrote to all members providing advice on the terms for cash
  - Sent an open letter to tPR and DWP with strong recommendations about cash commutation

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The Actuarial Profession's letter to all members

- Where an actuary has an obligation to advise trustees or company, changes in market conditions may mean it is appropriate to advise that terms are out of date and review every 2 to 3 years
- Set terms for reviewing the factors – establish a policy or trigger for future reviews
- Justify any financially inconsistent terms
- Eg defintion of 'value' – does this reflect the full cost to the member of replacing the scheme benefit?
- In relation to scheme funding:
  - The problem of hard coded factors
  - Pressures from clients to control reported costs and / or cash contributions
  - Such pressure is likely to apply to future actuarial advice in relation to cash commutation terms

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The Actuarial Profession's letter to tPR and DWP

- Alerted the problem of out of date factors
- Strongly urged:
  - Risk warnings and/or suggestion that members seek financial advice if commuting large amounts of pension

  Or
  - Disclosure of terms on member's benefit statements

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Disclosure of more information for the members

- **Pros**
  - Are member commuting pension for cash without understanding the financial impact of doing so? With more information members can make better informed decisions
  - Consistent with the stance taken in relation to the transfer values
- **Cons**
  - Additional cost burden
  - Will the information be accurate given changes in market conditions and not all members taxed the same?

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The Pension Regulator's view

- The Actuarial Profession also met with tPR
- tPR's view
  - Interested in general governance and trustee guidance rather than anything specific to cash commutation
  - Similarities between cash commutation and transfer values – both create an immediate cash impact to the scheme
  - Therefore may need consistency of approach between the two

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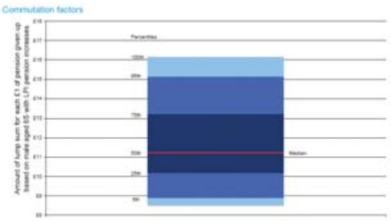
PwC 2006 Survey of actuarial assumptions



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Typical Factors

- Graph illustrates a wide variation in factors
- Sample of the PPF cash commutation factors:

Male/female factors, aged 65	Pre 97 pension	Post 97 pension
Without spouse's pension	13.64	17.78
With spouse's pension	14.55	19.29

- HMRC standard 'capitalisation' factor of 20 (stark comparison with the not uncommon factor of 9!)
- Public sector schemes = 12:1
- There is evidence that factors are improving…

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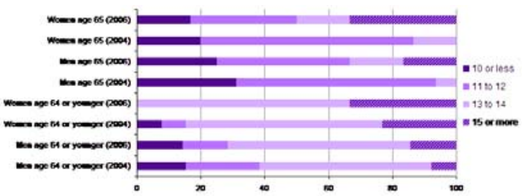
Commutation factors – trends
Source: GAD Occupational Pension Schemes Annual report 2006 edition



Proportion[1] of active members of defined benefit occupational pension schemes: by commutation rate, normal pension age and sex, 2004 and 2006

1 Percentages are calculated excluding non-responses

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Who sets the commutation factors?

- Determined by scheme rules (unlike transfer values)
- Typically set by the trustees or the sponsor
- May well be a point of negotiation between the trustees and the sponsor
- There may not even be a requirement to take actuarial advice
- Some factors are written into the rules

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Further issues to consider when setting the commutation factors

- Actuarial equivalence is only one of a number of factors!
- Financial impact of changing the factors
- The employer's viewpoint
- Allowance for the cash being tax free? Views very varied!
- Basis for the calculation: ongoing basis v best estimate
- Consistency between members retiring at different ages
- Cash commutation is only an option
- Risk of selection? Probably low
- What are other schemes doing?

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Practical issues to consider when setting the commutation factors

- Frequency of update: adjusted in line with market interest rates?
- But remember the need for member's to plan in advance for retirement
- Simplicity v fairness, eg:
  - Gender neutral or different male / female factors
  - Fixed or age related
  - Different factors for different tranches of pension
- Advantages of simplified scheme administration
- Need to communicate benefits to members effectively

No single right set of commutation factors!

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Allowance for cash commutation in the assumptions

- Historically few schemes included such an allowance in the funding basis
- Is this appropriate as it builds in an element of prudence into the basis?
- Also, given the uncertainties about the factors in the future?..
- Or, as most members take cash, a more accurate assessment of the liabilities is to allow for the amount of cash that members are likely to take?
- Based on the 2006 PwC survey, still only 36% of schemes make an explicit allowance for members taking cash
- More appropriate to include an allowance in the accounting assumptions?
- Not unusual to see cash commutation ignored and the impact offset against using a "weak" mortality basis
- Always need to consider the impact that it has on the figures…

Case study - Illustration of impact of change on members' benefits

	Before changing factors		After changing factors	
	Pre A Day	**Post A Day**	**Pre A Day**	**Post A Day**
Pension entitlement	£10,000	£10,000	£10,000	£10,000
Commutation factor	10		15	
Cash offered	£22,500	£40,000	£22,500	£46,150
Residual pension	£7,750	£6,000	£8,500	£6,900

Illustration of impact of change on balance sheet

Liabilities	**£m**	**£m**
-Actives	40	43
-Deferreds	30	32
-Pensioners	30	30
-Total	100	105
Assets	90	90
Deficit	(10)	(15)
Annual company contributions		
-Future benefits	3.8	4.1
-Deficit	1.0	1.5
	4.8	5.6

What now?

- Check factors –
  - Do they look reasonable?
  - When were they last reviewed?
  - Are there any existing trigger points/timescales for reviews? If not, should there be?
  - Expiry date on certificate
- Check deed
  - who has power to set the factors?
  - does deed encompass A-Day changes?
- What is scheme experience – do most members take tax free cash?
- How can members decide what represents good value – need more information
- Expect factors to increase in the future?...

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Enhanced Transfer Values

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The basics

- Means of reducing or de-risking defined benefit pensions obligations
- Company is concerned about size/volatility of pensions liability
- Offer made by the **Company** to the **deferred** members of the Scheme
- Members have a statutory right to transfer
- Ordinarily, the Cash Equivalent Transfer Value basis will place a lower value on members benefits than Technical Provisions/Accounting basis/buy-out basis
- Any member transferring out on the standard CETV basis improves the funding position on these other bases for those who remain
- Members are encouraged to transfer out by the offer of a cash enhancement paid in addition to their CETV
- Enhancements can be paid as a top-up to the standard CETV can be offered in the form of a cash lump sum paid direct to the member
- Company achieves a reduction in pension scheme liabilities (and probably in the deficit) at a cost of value of enhancements paid (and adviser fees)

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Structure of the enhancement

- Many different approaches
- Offer cash in hand?
- Value issues
- Same level of enhancement for everyone e.g. 20% of CETV?
- Target a critical yield?
- Where current practice is to reduce CETVs should cash be offered below the full CETV?
- Fixed Company spend – first come first served
- Exclude any members e.g. close to retirement, those with small pensions?
- Default receiving scheme?
- Contracting-out issues
- Beware discriminatory practice

Fair Value

- What is fair value?
  - Standard CETV basis (might be changed by Scheme Actuary after exercise has commenced)
  - Technical Provisions
  - FRS 17/IAS 19
  - IFA critical yield
  - Buy-out
- Obviously, value of offer has a major impact on take-up rate

Tax treatment

- Enhancement paid as top–up to transfer value
  - no tax or national insurance contributions are payable by the member or Company
  - Top-up payments paid into the Scheme classed as pension contributions. May mean that full tax relief is not immediately given
  - In a group scheme, need to ensure that correct company pays the monies to ensure corporation tax deduction
- Enhancement paid as cash in hand to member
  - Member subject to income tax and National Insurance contributions
  - NI is assessed against the weekly earnings threshold (currently earnings between £100 and £670)
  - payments ordinarily made net of basic rate tax – up to member to sort out any extra tax due
  - payments are not deductible for corporation tax and Company is liable to NI
  - If member is above SPA no NI is payable by member but still due from Company

Tax treatment

	Enhancement paid as top-up to transfer value		Enhancement paid as cash in hand to member	
	Member	Company	Member	Company
No Income Tax due	✓	N/A	✗	N/A
No National Insurance due	✓	✓	✗	✗
Deductible for Corporation Tax	N/A	✓	N/A	✓

Other Parties Involved

- Independent Financial adviser
- Trustees
- Board of directors
- Administrators
- Investment managers
- Advisers
  - Company actuary/ consultant
  - Scheme Actuary
  - Legal advisers (company and trustees)
  - Investment consultant
- DC Scheme provider (default)

IFA Involvement

- Members should be given the opportunity to take advice from an Independent Financial Adviser ('IFA')
- What level of advice should be provided
  - Generic
  - Specific recommendation
- How is the IFA remunerated? Who foots the bill?
- IFA critical yield test calculates the annual rate of return required to provide equivalent retirement benefits to those in the existing Scheme assuming the transfer value is invested in a defined contribution arrangement.
- IFA will often define different levels of risk based on critical yield and term to retirement e.g.

Term to Retirement (yrs)	Low risk (%)	Some risk (%)	Medium (%)	High (%)	Very High (%)
1	5.9	6.9	7.4	7.9	8.4
5	5.7	7.0	7.5	8.0	8.5
10	5.5	7.1	7.6	8.1	8.6
15	5.3	7.2	7.7	8.2	8.7
20	5.1	7.3	7.9	8.4	8.9
25	4.8	7.4	8.1	8.6	9.1

The Pensions Regulator's Guidance

- In January 2007 tPR issued a guidance document in connection with inducement offers setting out recommendations for the employer, trustees and scheme members
- The key points arising from the guidance document:
  - trustees and employers should give full and proper advice to enable members so that they fully understand the implications of transferring out of a DB scheme
  - trustees should carefully consider and apply a high level of scrutiny to any inducement offers
- "…we want scheme members to retain responsibility for their own financial decisions where those decisions impact their DB scheme benefits."
- Recognition that incentives can be legally made by the employer
- Motivating factors for the employer are cost saving, reduction in volatility and reduction in admin costs
- Trust law and Data Protection Act issues for the Trustees should they issue their own communication?
- Scheme Funding issues
- Communications and independent financial advice – 12 key messages that should be included

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The Pensions Regulator's Guidance

- Trustees should "…consider the impact of the use of employer resources in this way on the funding plan relative to improving the funding of the DB scheme directly."
- Members – take financial advice, check that the trustees are aware of the exercise and were consulted
- Was tPR guidance a help or hindrance?

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Communications

- Key to the success of the exercise
- Company should ensure that they comply with tPR guidance
- What form should communication take – letter, presentation, helpline etc
- Trustees should be given the opportunity to review communication material
- Trustees issue their own announcement?
- IFA communication material needs to be compliant with FSA guidelines
- End up with War and Peace!
- Legal review required?

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Factors affecting take up rate

- Level of offer
- Offer choice of cash in hand or enhancement to transfer value
- Member's perception of company strength
- Generosity of scheme benefits
- Quality of communication material (written and verbal)
- Accuracy of data (e.g. addresses)
- Indirect incentives – e.g. members who are still employees of the company may be positively affected if the company finances improve
- Quality of IFA
- Word of mouth

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Reputational Risk

- Media coverage – negative publicity provides good headlines for the press!
- Mis-selling risk – particularly if poor value offer
  - Can offer be made to actives?
- Poor relationship with the trustees
- Perceived to have done something wrong
- Mitigation:
  - Good quality communication – follow tPR guidance and beware giving advice
  - Get legal sign-off
  - Use an experienced IFA, pay for the services and strongly advise members to take advice
  - Consult the Trustees and let them vet the communication material
- Retrospective legislation

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Case studies – IFA experience

Previous level of transfer value as a proportion of full cash equivalent	Enhancement offered	Take up rate	Comments
100%	15% uplift	60% expected	High enhancement paid as concerned over buy out cost
90%	30% uplift to transfer value	100% for those > 5 years from retirement	Offer made to actives
85%	20% uplift to reduced transfer value, or cash	24%	Strong ongoing company
82%	10% uplift to reduced transfer value	Nil	Strong airline
70%	15% uplift to reduced transfer value	25%	Media company with young employees
78% of MFR	Enhanced to 100% of MFR, or cash	75%	Significantly downsized company
95% of MFR	5% uplift to transfer value, part cash option	12%	Weak company

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Case Study

- You are advising Company X in connection with an enhanced transfer exercise. Company X has a strong covenant.
- Pension Scheme X is currently paying unreduced transfer values that are 10% less than the FRS17 liability, on average.
- Company X would like to encourage members to transfer out of the Scheme in order to reduce the overall liabilities and also to reduce the FRS17 deficit.
- Company X would like to uplift transfer values by 5% to encourage members to transfer out. You have calculated that such enhanced transfer values would give a critical yield of 10% on average.

Questions:
1. What advice would you give the Company and what issues would you raise?
2. If you were the Scheme Actuary, how would you advise the Trustees if the Company proposed to increase transfer values by 5%?

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Case Study – Company Actuary Issues

- Even if the enhanced transfer leads to savings today, changes in market conditions could lead to reduced or no savings.
- According to the Regulator guidance, the Trustees are required to consider whether the offer is in the best interests of the member. As the critical yield is high and the covenant is strong, the Trustees are likely to conclude that the offer is not in the best interests of the member.
- A low enhancement is likely to lead to low take up.
- Could show the Company the potential savings on a buy out basis.
- The Company could offer different enhancement levels at different ages. The critical yield analysis could be carried out by age.
- The Company could receive bad press from making such a low offer to members and it could be accused of mis-selling.
- The communication document should reflect the fairness of the offer.
- The Company could offer a cash lump sum as an alternative to an enhancement to the transfer value.
- At the older ages, there could be a worsening of the FRS17 position as the transfer value plus 5% could be greater than the FRS17 liability.
- Has the Company got cash available to pay a reasonable level of enhancement?
- The FRS17 assumptions should be reviewed to determine how realistic they are e.g. mortality assumptions may be out of date.

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Case Study – Scheme Actuary Issues

- According to the Regulator guidance, the Trustees are required to consider whether the offer is in the best interests of the member. As the critical yield is high and the covenant is strong, the Trustees are likely to conclude that the offer is not in the best interests of the member.
- The Trustees could ask the Company to reconsider their offer.
- The Scheme Actuary may review the transfer value basis in light of these results as it indicates the transfer value is poor value.
- The Scheme Actuary should bear in mind the new regulations that are due on cash equivalent transfer values.
- If the Company are unwilling to make a higher offer, there are several options available to the Trustees:
  - They could choose not to co-operate and share the necessary data with the Company.
  - The Trustees could require a statement to be included in the communication to reflect the fact that this is not a fair offer.
  - The Trustees could send their own communication to the members to advise them against accepting the offer.

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