Consultation on Approaches to the Calculation of Pensions Transfer Values

A response by

The National Association of Pension Funds

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Introduction

1. The National Association of Pension Funds (NAPF) is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF Member schemes, while around 5 million pensioners are receiving valuable retirement income from such schemes. NAPF Member schemes hold assets of some £750bn, and account for over one sixth of investment in the UK stock market

2. The NAPF welcomes the opportunity to respond to the consultation by the Department for Work and Pensions on approaches to the calculation of pension transfer values. We set out our views below.

Executive Summary

- Any regulations regarding the calculation of transfer values should set out only the minimum basis which should apply; schemes should be free to adopt a more generous basis.

- Schemes should ensure that members receive adequate communication of the transfer option, the alternatives and their consequences, particularly in the light of the new protection provided to scheme benefits by the PPF.

- We strongly oppose two of the possible approaches identified in the consultation document: a basis with assumptions prescribed in detail and that set out in EXD54.

- Minimum cash equivalent transfer values should be calculated on a scheme-specific basis, similar to that applicable to the calculation of technical provisions but without the requirement to incorporate margins of prudence.

- Scheme should be permitted to reduce transfer values to reflect any underfunding.

NAPF

General comments

3. The issues relating to the calculation of pensions transfer values are of consequence only to defined benefit arrangements and our comments should be interpreted in that context. In addition, we assume that any regulation of the manner in which transfer values are to be calculated will set out a basis which represents the minimum value that must be made available and that schemes will be free to adopt any basis which produces a larger sum.

4. In general, the option to transfer the accrued rights to a deferred pension to another arrangement resides in the member; only in limited circumstances with strict controls applying can a transfer be made without a member's consent. The fact that the member is able to choose whether or not to transfer must be recognised in any requirements regarding the calculation of cash equivalent transfer values.

5. Many members are not well-equipped to make an informed choice on whether or not making a transfer is likely to be in their interests. Irrespective of the manner in which transfer values are calculated, good communication is required to members of the nature of the benefits they are foregoing in the transferring pension scheme and the impact that the existence of the PPF may have on the security of those benefits. This may be an area where guidance from the Pensions Regulator, rather than regulations, would be appropriate.

Approaches to the calculation of transfer values

6. In the consultation document, three potential approaches to the calculation of transfer values are identified. Our views on each of these are as follows.

A. Prescribed assumptions

7. As noted in the consultation document, the prescribed assumptions would have to be set towards a lowest common denominator of schemes' funding approaches if the requirements were not to weaken schemes' funding positions. It is likely that the prescribed minimum would also become the actual maximum to the detriment of transferring members from better funded schemes that could, and otherwise would, pay more. Trustees would be able to absolve themselves from responsibility for the basis and point to the government as the responsible party.

8. As well as the other disadvantages of this approach identified in the consultation document (with which we agree) there is a danger that the prescribed assumptions could become a de facto statutory funding basis or a replacement for the discredited minimum funding requirement with all the accompanying disadvantages that such an outcome would entail.

9. We therefore strongly oppose any suggestion that transfer values should be calculated on a prescribed set of assumptions.

B. Scheme specific basis

10. The use of a scheme specific basis has the overwhelming advantage of being consistent with the thrust of all the other requirements placed on schemes in relation to their funding arrangements. Trustees would have responsibility for deciding the basis in the light of the particular circumstances of their own scheme and, we suggest, should not be constrained to adopt exactly the same assumptions, particularly regarding margins of prudence, as apply to the calculation of the scheme's technical provisions.

11. The main issue with an approach along these lines is, as noted in the consultation document, how it would be applied to unfunded public sector schemes. Whilst it is clearly a matter for government to decide, we suggest for consideration an approach based on comparator funded schemes in the public sector, such as the Local Government Pension Scheme. Although that scheme is not subject to the Statutory Funding Objective, it will be paying (and receiving) transfer values and will presumably not wish to operate on a basis which is dramatically different from that applying in the private sector. The unfunded public sector schemes could thus adopt a similar basis (but without an adjustment to reflect underfunding in the scheme!).

12. We therefore support a scheme specific approach to the calculation of transfer values.

C. "EXD54" basis

13. In our response to the actuarial profession's consultation on EXD54, we expressed strong opposition to the proposed change to the actuarial guidance, particularly in the absence of a clear external mandate (ideally from government) to change fundamentally the policy underlying the calculations from one based on the cost to the scheme to one representing the cost of the benefits on a quasi-discontinuance basis. We are pleased that government has intervened to remove from the actuarial profession the responsibility for setting policy in this important area.

14. The following paragraphs from our response to the consultation on EXD54 set out our main objections to the proposed change:

- The changes contemplated in EXD54 will impact not only on the calculation of transfer values, but also in other areas where cash equivalents are involved, such as valuation of pension rights on divorce and reporting of executive remuneration in company accounts. It is not clear that that the consequences of the proposed change in these areas have been adequately explored. In addition, the change is not consistent with the Pension Act 2004 provisions for a scheme specific funding standard, the policy intention of which is stated to be to establish a liability focused, ongoing funding standard.

- Applying bond yields to the calculation of cash equivalents will lead to those values going up, in some cases quite dramatically, particularly at younger ages. This will have two consequences for a scheme funded on an ongoing basis, as most schemes currently are. Firstly, it will lead to a mismatch between transfer values and assets held in the scheme. Secondly, it will be perceived as another indication that defined benefit schemes should be funded to a bond-based standard as a matter of course. If schemes do decide to pay unreduced transfer payments on the proposed basis, there is a real possibility that actuaries will decide that the aggregate of these amounts across the whole scheme membership represents the minimum level of funding that should be targeted. The ultimate effect will be the backdoor introduction of a new, more stringent, minimum funding standard.

- Higher transfer values from defined benefit schemes are likely to lead to an increase in transfers from such schemes to individual money purchase arrangements in order to take advantage of income drawdown, greater investment freedom or inheritance planning in the new and more flexible post April 2006 environment. Such transfers may be particularly attractive to those approaching retirement. This will only serve to further undermine the long term viability of defined benefit schemes.

- The proposed method of calculation is highly prescriptive, unnecessarily complex and will add to costs. Many actuaries will initially not be well equipped to cope with the level of complexity implicit in the proposed methodology, in particular the need to derive credit ratings. At the same time trustees are going to have to become more heavily involved and give instructions to the actuary on the employer's financial strength, for example. Although this is in line with the type of decisions the trustees will be expected to make under the scheme specific funding requirements, the new guidance may force trustees into making these decisions on transfers before the first scheme specific funding valuation takes place. Once made trustees will need to have good reasons to change their position.

- For the vast majority of schemes, the funding level is insufficient to support payment of cash equivalent transfer values for all members on the proposed basis. Consequently, trustees will be faced with three possible courses of action:

    - Ask the employer to make a special contribution for each transferring employee equal to the difference between the minimum and the sum the scheme can 'afford' on the basis of its funding level

    - Pay the full amount of the minimum and trust that the employer will be able to make up the difference over future years as part of its funding arrangements

    - Reduce the transfer payment to reflect the funding position of the scheme

- Either of the first two options will result in increased cost for the employer and a potential increase in security for the transferring member compared with those that remain in the scheme (for example on the future insolvency of the employer). In addition, there will be potential for individuals who are better informed than the trustees about the employer's strength (or lack of it) to gain at the expense of others. It might also enable the transferring member to secure a benefit which is greater (in some circumstances considerably so) than the benefit being given up.

- The third option will result in members being told that the sum available by way of transfer is less (in many cases very much less) than the value which has been placed on their rights according to the standard set by the actuarial profession, currently a body of some repute. Apart from the obvious potential for creating discontent and further undermining confidence in defined benefit schemes, such a message will add to members' confusion at a time when they will be receiving increasing amounts of information about the funding of their scheme both on the new scheme specific basis and the solvency level on a buy-out basis.

- It should be remembered that a transfer value is an *option* available to the member. The legislation does not require trustees to make that option more valuable than the alternative of a preserved benefit and nor should the actuarial guidance.

15. Our opposition in relation to the EXD54 basis remains unchanged.

<u>Detailed response to questions in the consultation document</u>

1. Are there any other key stakeholders whose interests need to be addressed?

As well as the stakeholders identified, the member wanting to transfer out must also be considered from the perspective of the other side of the transaction ie as a member wanting to transfer in. Assuming that there is no intention to change the current requirement that the same assumptions and approach must be adopted by a scheme for transfers out and transfers in, the benefits being granted in the receiving scheme will be a function of the approach adopted for the calculation of transfer values.

2. What is your view about the legal rights of a member wanting to transfer out of a pension scheme?

The primary entitlement of a individual who ceases to be an active member of a pension scheme is to a deferred pension (subject to vesting requirements being satisfied). A transfer value is an option which the member may elect as an alternative to that primary entitlement and the requirements relating to the calculation of transfer values must fully recognise this.

Following the introduction of the Pensions Protection Fund (PPF) it is debatable whether schemes should continue to be required to provide this option to members with preserved rights. Removal of this requirement would represent a small, but noticeable, reduction in the administrative burden placed upon schemes.

3. Your views are sought on whether it would be reasonable to have a separate set of assumptions for the calculation of transfer values, and if so, the principles underpinning the choice of those assumptions.

Any requirements relating to the calculation of transfer values should cover only the minimum cash equivalent that must be made available. Schemes should be free to adopt a method which produces a larger figure if they so wish.

The requirements should be principle-based rather than detailed or prescriptive. The question of whether a separate set of assumptions could be used then becomes irrelevant.

4. Do you consider that private sector schemes should continue to be able to reduce transfer values because of underfunding and that the payment of a transfer value should discharge the scheme of all further liabilities for the transferring member?

The payment of a transfer value provides the transferring member with a priority call on the assets of the scheme. In the interests of the remaining members, who have no such priority claim, it should be open to schemes to reduce the cash equivalent transfer value to reflect the extent to which assets have been accumulated against the scheme liabilities.

The payment of a transfer value is an option which is exercised by the member and it is essential that the scheme is able to obtain a full discharge from all liabilities for the transferring member. To require otherwise would have enormous adverse consequences both administratively and in terms of the how the contingent scheme liabilities to transferred-out members would be assessed and reported.

5. To what extent do you think that any new rules should define the rights of <u>all</u> those involved in the scheme?

The rights of the various parties to a pension scheme are defined in the scheme documentation, pensions legislation, regulations, codes of practice issued by the Regulator, and trust law and are influenced by other legislation such as the Human Rights Act. Any temptation to add a further layer of definition, with the potential for conflicting requirements, must be resisted.

6 .Do you consider that the existence of the PPF should be factored into the calculation of transfer values and, if so, in what circumstances?

The existence of the PPF has a clear impact on the security of a member's preserved benefit entitlement. It is appropriate that the regime covering transfer payments recognises this. However, this is not to say that the calculation of transfer values should be affected by the existence of the PPF. A pension scheme does not have, as an asset, any call on the PPF. It would be irresponsible of trustees to pay an addition to a transfer value which in some way represented a sum contingently available from another totally external and unrelated entity to secure part of a member's benefits.

Rather, the prospective transferee should be made aware of the security provided by the PPF, other factors of relevance such as the amount of the protected PPF benefits and the relationship between the transfer value available and the sum required to secure the protected benefits in the PPF.

7. Views are sought on how best to provide information to individuals and on the possibility of restricting valuations to a three year cycle.

Prospective transferees should be provided with sufficient information to enable them to make an informed choice as to whether to proceed with the transfer. This might include:

- the deferred pension represented by the transfer payment and the conditions attaching to that deferred pension (increases before and after coming into payment, death benefits etc);
- the amount of the transfer payment;
- the extent to which the transfer payment has been reduced to take account of underfunding
- the PPF protected benefits (with suitable caveats regarding its amount); and
- the sum which would be required to buy the protected benefits from the PPF.

The possibility of restricting the availability of transfer value quotations to a three year cycle is, at first sight, attractive particularly as only a small minority of quotations proceed to an actual transfer. However, whether the superficial attraction converts to a real reduction in administrative burden will depend on the detail of how any change is implemented.