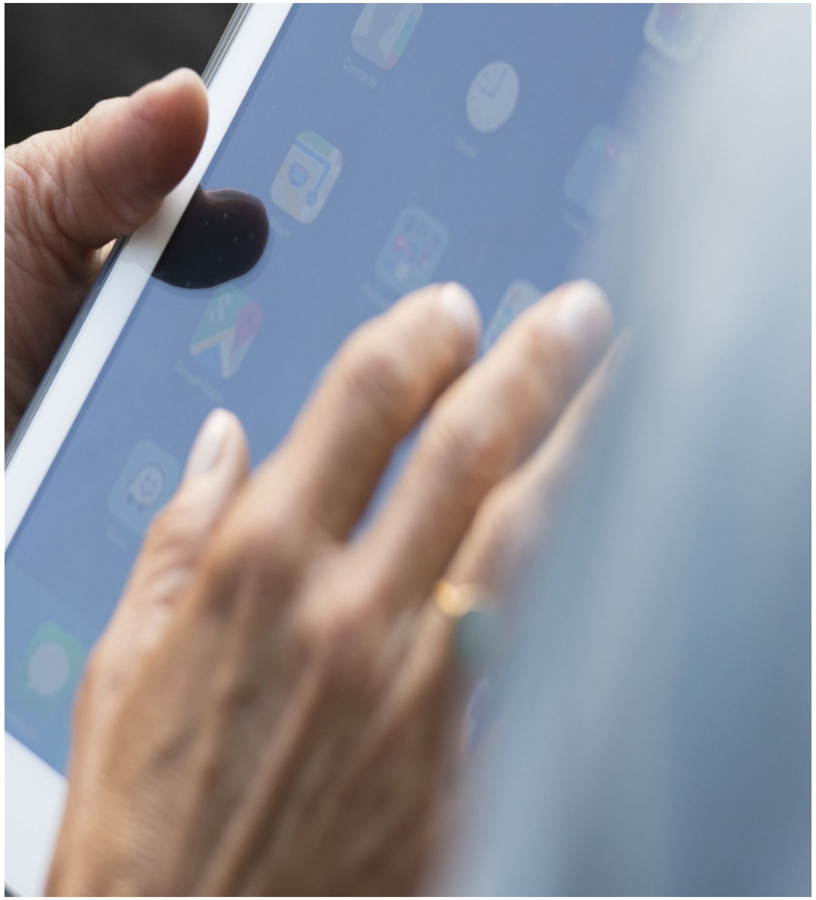
Are DB transfer values too high or too low?

WORK CAN WORK BETTER™

xerox®

Contents

What is a transfer value?



Expected cost of providing the member's benefits **within the scheme**

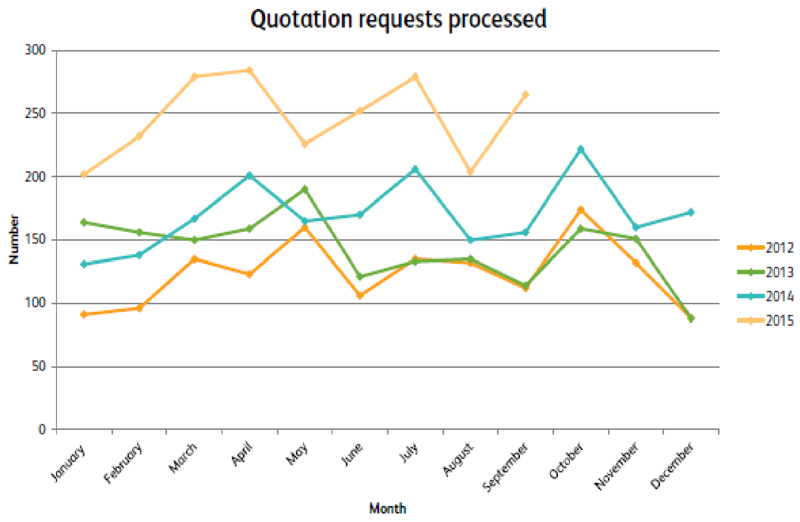
Determined on actuarial principles

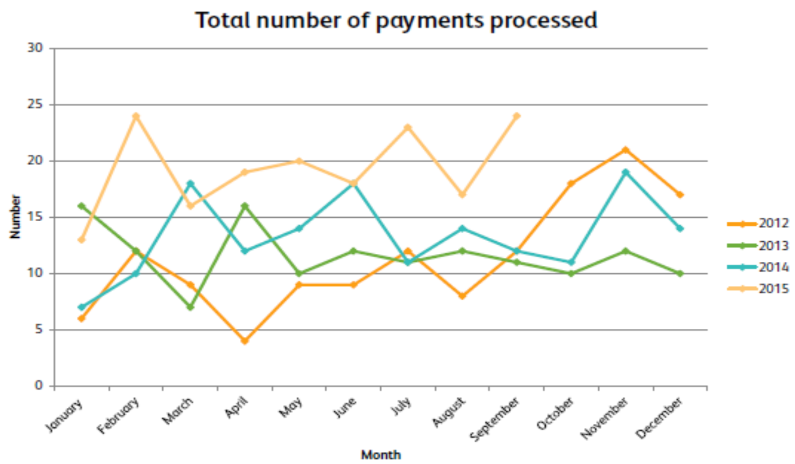
Best estimate **or above**

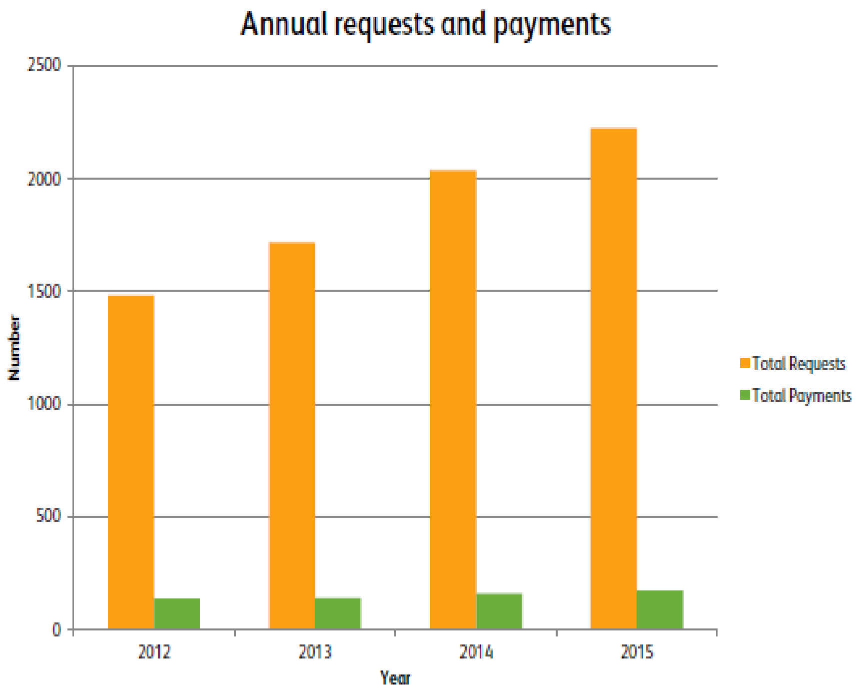
Scheme's transaction price…..

'Should I transfer out of my final salary scheme? If you belong to a final salary pension scheme, it's usually best to leave your money there'

How popular are transfer values?







The psychology behind transfer values

Potential demand for taking transfer values

Take up very low compared to trivial commutation or cash commutation. Decision based on:

- Selection against the scheme
- Unlock DB savings
- View of employer (viability)
- Control / consolidation

Other factors generally override:

- DB considered as ‘gold plated’
- Reliance for main income in retirement
- Value for money given transfer of risk?

Key aspects of transfer value guidance

'Best estimate of the amount of money needed at the effective date of the calculation which, **if invested by the scheme**, would be just sufficient to provide the benefits'

Allowance for investment strategy – future strategy at current market rates?

Only those options which would increase the value of benefits may be included within the benefit for cash equivalent purposes under the best estimate method.

Can be reduced for overall scheme underfunding

Should consider relationship with technical provisions bases

What does this mean in practice?

Scheme ‘cost’ rather than member or sponsor ‘value’

A lot of subjectivity. Different transfer values from different schemes

While ‘expected cost’, transfer value influenced by other members ‘being left behind’

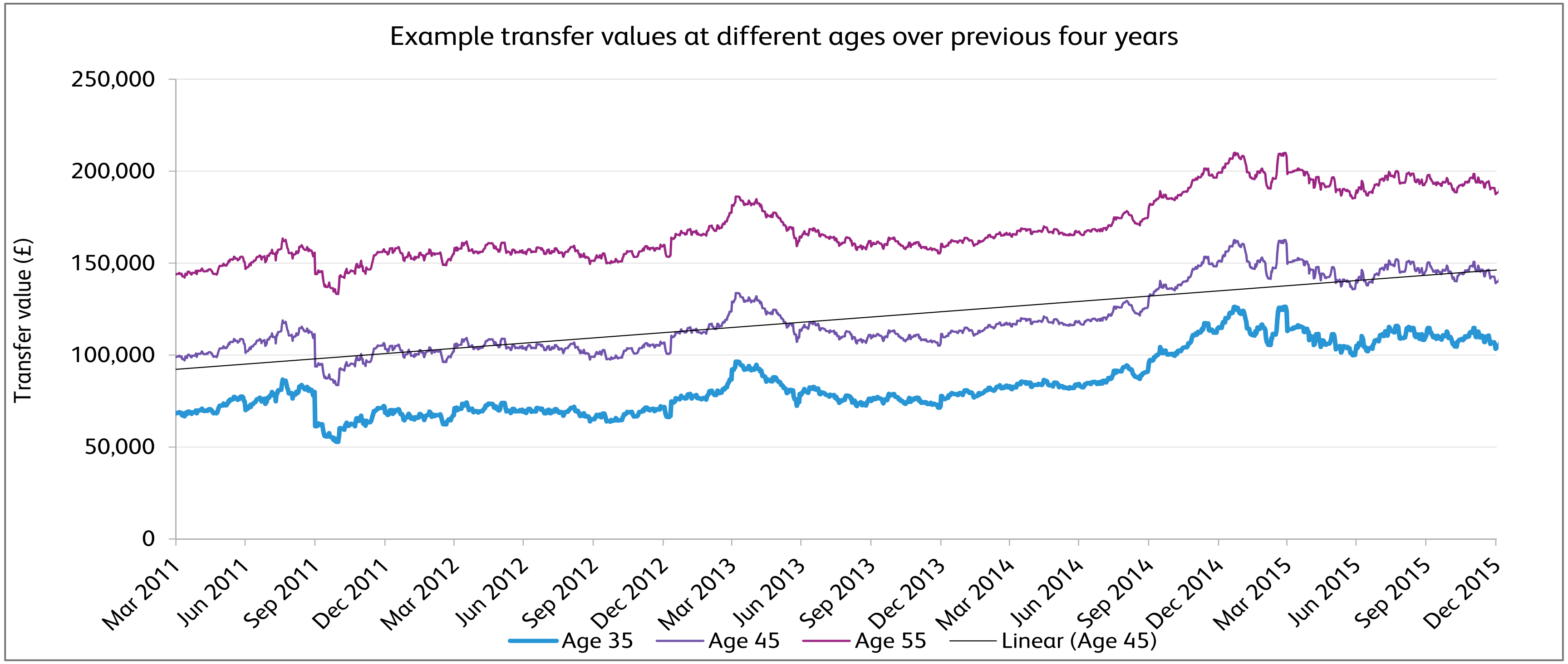
Different methods:

- Current vs future (de-risked) investment strategy
- Dual rate vs single rate
- Sliding discount rates across ages
- Options / discretionary benefits

Reductions – only ‘strong covenant’ example in guidance

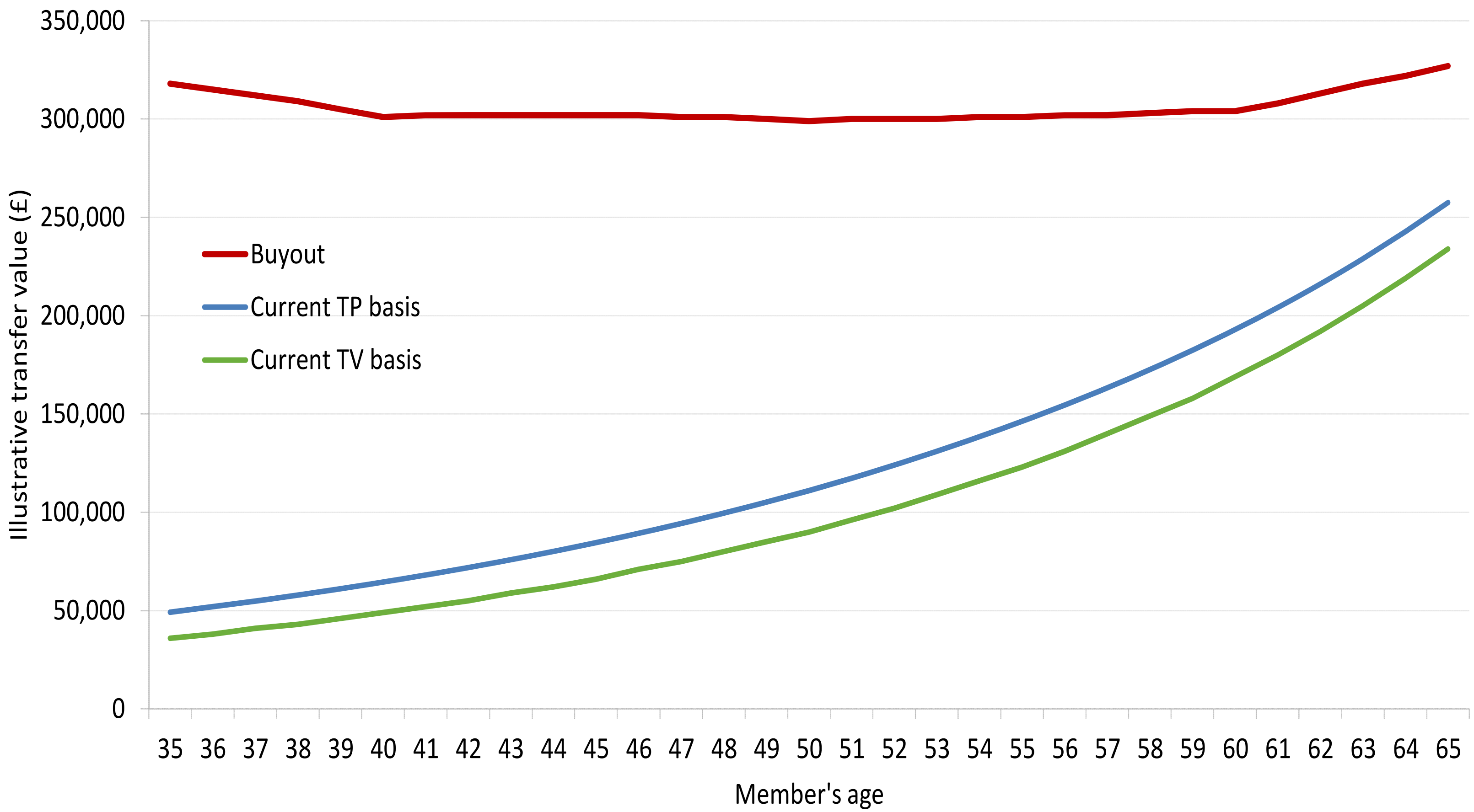
Funding regime impact

Recent levels of transfer values



- Continued upward trend over the last four years
- How many schemes reduce transfer values
- How many schemes use dual/single rate
- How many schemes allow for future strategy

Comparisons with cash funding and buyout



Concerns that transfer values are too high

Actual pension received within the scheme depends mainly on cash commutation decision, future inflation and longevity

So what do we mean by too high – giving away too much value given the benefit promise

- Expecting them to live too long?
- Expecting future inflation to be higher than will be?

Discount rates and security of members' benefits dominate calculation

High transfer values are a particular concern if the covenant is questionable. But reduction should be in place

Not so much if the covenant is strong

Areas where transfer values may be too high:

- No allowance for cash commutation
- Likelihood of transacting at current yields
- Drawdown investment strategy
- Sharp moves in markets

Challenging whether transfer values are too low

Why stop at best estimate? Premium for removing risk?

Especially where covenant strong?

Currently are trustees acting in all members interests - only a minority see transfers as attractive?

We are supposed to be in an environment of more (reasonable) choice and flexibility

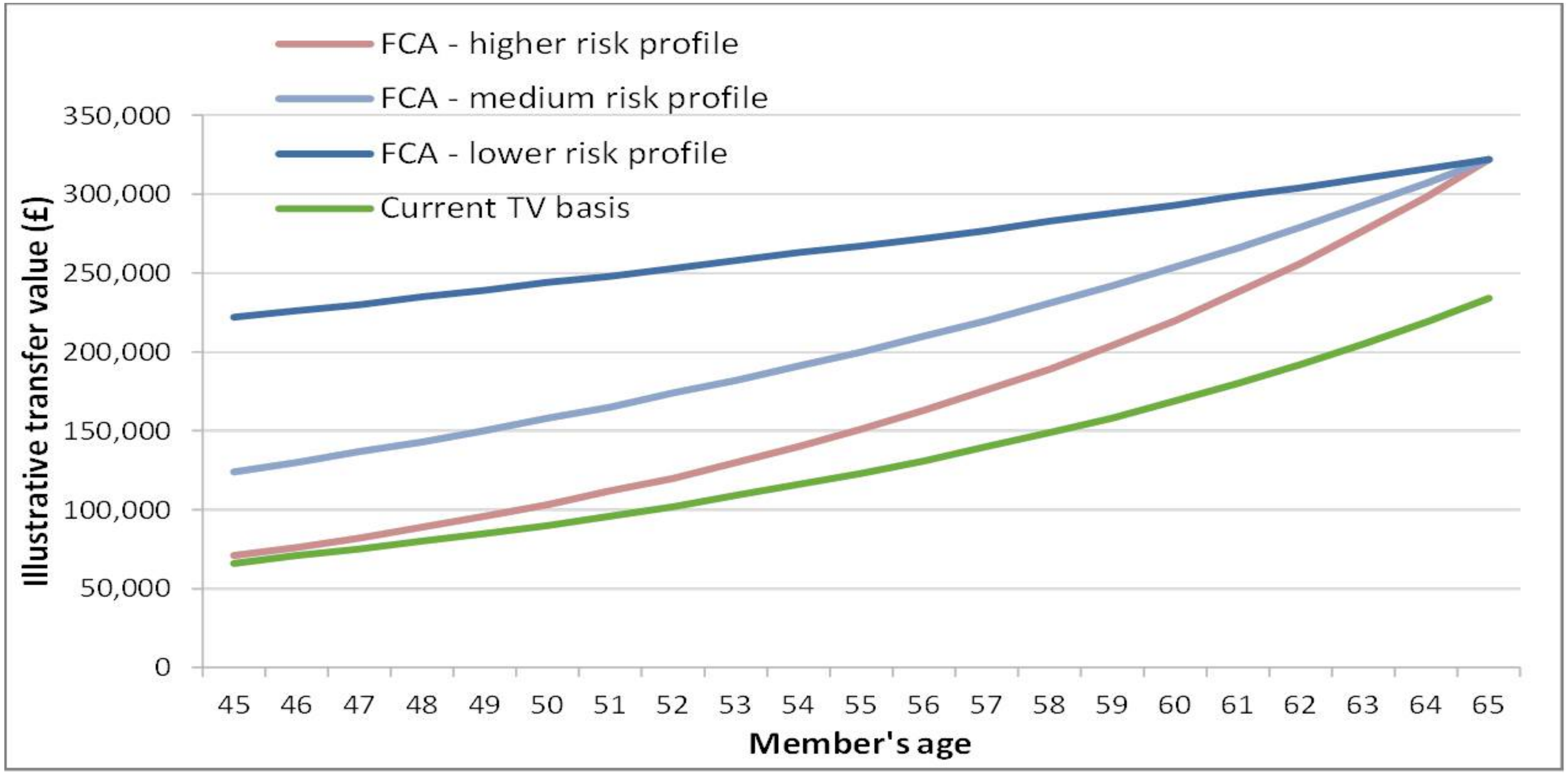
Increase transfer values to increase the likelihood of a positive recommendation to transfer?

Knock on impacts:

- TPs may need to increase so more cash needed sooner (or push out recovery plan?).
- More security or increased monitoring of covenant

xerox®

Challenging whether transfer values are too low



xerox®

Critical yields and suitability reports

Advice has historically centered on the ‘critical yield’.

Shouldn’t be viewed as a trigger to transfer. This is also the position of the Regulator.

For advice to be considered ‘suitable’ must consider full range of options – not limited to specific options.

Often possible to note advantages of transferring, but fall short of the ‘hurdle’ of demonstrating that the transfer is clearly in the member’s best interests.

Suitability report will include:

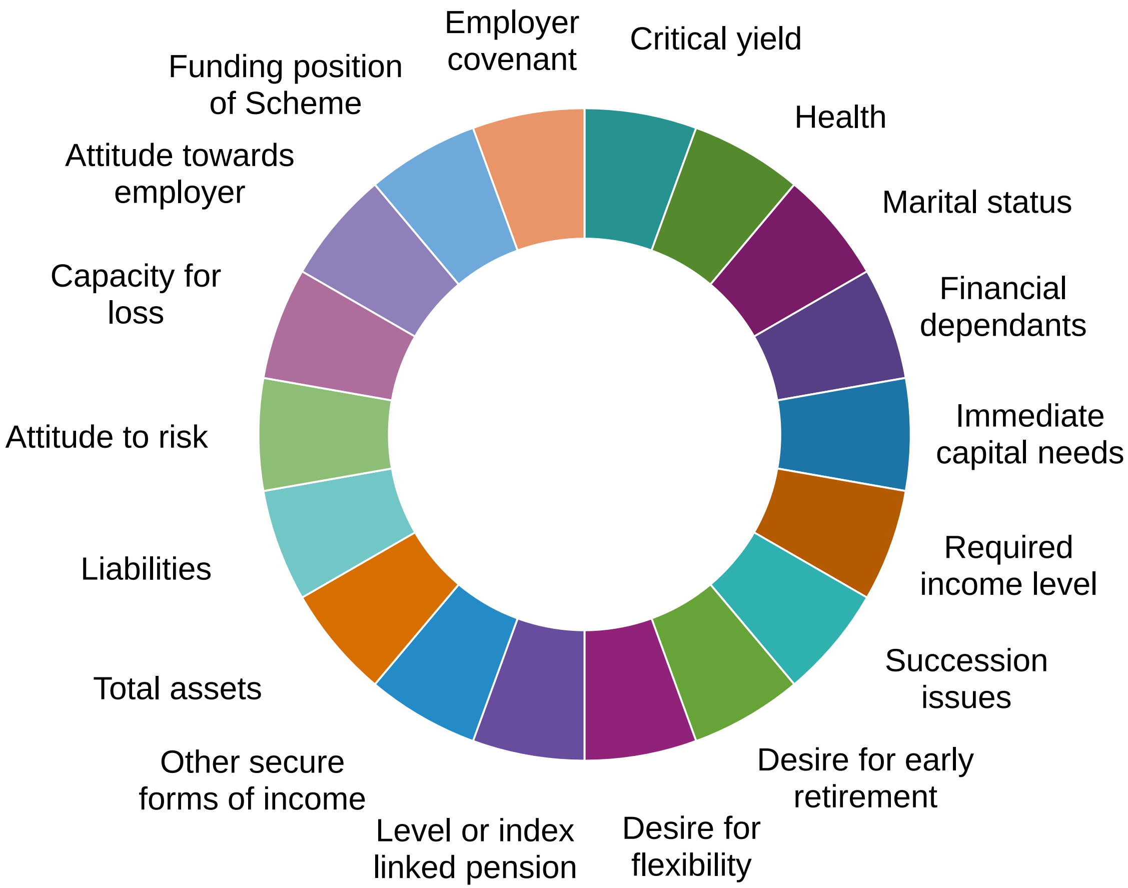
- Details of the offer, the advice process, information about the scheme, their benefits, financial position, objectives, risk tolerance, risk capacity, Transfer Value Analysis Report (TVAR), details of all the options available, advantages & disadvantages of each, the recommendation and supporting rationale.

Each report is bespoke to the client (limited templating).

Hence reports are necessarily very long, TVAR 25+ pages, full report with enclosures 80+ pages.

TVAR in particular difficult for the average member to understand

Advice must consider a number of different factors



Conclusions

Views on transfer value levels depends on stakeholder:

- Member: generally too low
- Trustees: incentive/scared to offer more than best estimate?
- Sponsor: depends

DB benefits seen as vehicle for majority of pension savings

Transfer values have had a bad press

Schemes currently exposed to challenge that they are offering poor value when compared with alternative

Schemes could change mind-set. Consider the need to offer more and get over short term cash funding focus

Thank you

Mark van den Berghen FIA

Xerox HR Services

Buck Consultants, A Xerox Company

20 Tudor Road

Reading

RG1 1NH

T: 0118 955 7791

Email: mark.vandenberghen@xerox.com

www.xerox.co.uk/hrservices

James Smith CFA, FRM, FPFS, CFP[CM]

Xerox HR Services

Buck Consultants, A Xerox Company

160 Queen Victoria Street

London

EC4V 4AN

T: 0207 429 1096

Email: james.smith2@xerox.com

www.xerox.co.uk/hrservices

WORK CAN WORK BETTER™

xerox ®