Linklaters

ACA Conference – New Opportunities

Choosing actuarial factors – a lawyer's view

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Benefits to be considered

1. Retirement lump sums: should factors offer “fair value” for members (and what is “fair”)?

2. Serious ill-health lump sums: should factors ignore the medical evidence (i.e. that the member is expected to die within one year)?

3. Transfer values: can Trustees take account of options which reduce the value of benefits?

4. Unisex factors?

Commutation: should factors provide “fair value”?

What do the rules say?

> The Trustees will convert pension to cash lump sum on a basis that they determine and an actuary certifies as reasonable.

Note: this rule:

1. gives the Trustees “discretion” to determine the basis
2. does not expressly require the basis to provide “equal value”
3. requires an actuary to certify the basis as “reasonable”

Commutation: how to exercise "discretion"

What does the law say?

When exercising discretion, the Trustees must:

> take account of all relevant factors

> disregard any irrelevant factors

> not act perversely

Duty is <u>not</u> simply to "act in the best interests of members"

Commutation: what are the “relevant factors”?

First “relevant factor”: the “value” of the pension to be given up

How should the Trustees value the pension?

Is this a legal or an actuarial question (or neither)?

Possible starting points

> funding basis?

> buy-out basis?

> CETV (“expected cost”) basis?

> some other basis (e.g. the current commutation basis)?

Commutation: where to start?

Arguments for buy-out basis:

> allows members to buy equivalent pension from an insurer

> but extra cost for employers and reduces funding for other members

Arguments for funding basis:

> reflects funding reserve that the scheme holds for the member (unless reserve assumes a “profit” from commutation)

> but includes “prudence” reserve as well as “expected cost”

Arguments for CETV (“expected cost”) basis:

> reflects “expected cost” of benefits to the scheme and the employer

Commutation: relevant factors to consider

1. Risk of “selection against the scheme”
   > members who expect to die young are more likely to commute
   > <u>but</u> is this realistic (or do most members commute anyway)?
2. Fact that members have a choice
   > members are happy with current rates (so why change)
   > <u>but</u> Trustees should “look after” members’ interests
3. Current funding position
   > should surplus or deficit affect lump sums (even if not pensions)?
   > analogy with CETVs (with or without an “insufficiency report”)?

Commutation: more relevant factors

4. Scheme investment strategy
   > should “low risk” investment strategy mean better factors?
   > should “high risk” strategy mean less favourable factors?
5. Consistency between generations of members
   > cliff edge when factors change (unless changes are phased in)?
   > but decisions should reflect “best available” information
6. Easier to improve than worsen factors
   > DB members have expectations as regards “amount” of benefits
   > cash seen as a “defined benefit” rather than an “actuarial value”

Commutation: even more relevant factors!

7. Size of pension
   > richer people live longer so their pensions are more valuable
   > should factors vary according to the size of the pension?
8. Tax treatment of retirement cash sum
   > lump sum is tax free (while pension is taxable)
   > should lump sum be based on the “gross” or “after tax” pension?
9. Increasing cost of pensions (longevity, etc.)
   > “unfair” for employer to bear all the increase in costs
   > why should increased costs mean increased benefits?

Commutation: role of the actuary

What do the rules say?

The Trustees will convert pension to cash lump sum on a basis that they determine and an actuary certifies as reasonable.

Does reasonable mean "equal in value" or "close to the same value"?

What is the actuary's role?

> Is the test for the actuary "purely" actuarial?

> Should the actuary use broader knowledge and experience?

Serious ill-health lump sums

Trustees must have evidence that “the member is expected to live for less than one year” (see Finance Act 2004, paragraph 4, schedule 29)

Is this medical evidence of short life expectancy a relevant factor?

Can the Trustees reasonably ignore it when exercising discretion?

> if so, are they enhancing the benefit?

> is there an extra cost to the employer?

Should all members get value based on “average” life expectancy?

More logical to pay only the value of the “pension guarantee”?

Calculating CETVs – taking account of options

Can Trustees allow for options that reduce the value of benefits (e.g. commutation)?

Transfer Value Regulations (Reg 7A):

- Reg 7A(2): "*The initial cash equivalent is the amount at the guarantee date which is required to make provision within the scheme for a member's accrued benefits, options and discretionary benefits.*"
- Reg 7A(3): "…*the Trustees must determine the extent of any options the member has which would increase the value of his benefits*…"

Calculating CETVs – taking account of options

Interpreting the regulations

Reg 7A(2) - not limited only to options that would increase the amount otherwise required to make provision for the benefits.

- In my view, this allows the Trustees to take account of the commutation option, on the basis that it is reasonable to take account of the benefits likely to be paid.

Reg 7A(3):

- Obliges Trustees to consider options which increase the value of benefits.
- But it does not require you to ignore options which reduce value.

Regulator's guidance: "*Only those options which would increase the value of benefits may be included within the benefit for CE purposes*…"

- But, TPR guidance is not law.

Unisex actuarial factors

In *Neath v Hugh Steeper* (1993), the ECJ said that:

> "The use of actuarial factors differing according to sex in funded defined-benefit occupational pension schemes does not fall within the scope of Article 119 of the EEC Treaty."

But this seems doubtful after *Lindorfer* (2007) and *Test-Achats* (2011)

Lindorfer and *Test-Achats* were based on different laws from *Neath*

But *Test-Achats* was based on the *Charter of Fundamental Rights of the European Union*, which has arguably changed the law since *Neath*

Our advice is to use unisex factors for all purposes (including CETVs)

Conclusions

If Trustees have discretion, they should:

> take account of all relevant factors

> disregard any irrelevant factors

> not act perversely

Trustees should be prepared to give reasons for their decision – so they should be prepared to disclose the factors they have considered

A decision may be “reasonable” (i.e. based on good reasons) and so “fair” even if it the outcome does not provide “actuarial equivalence”

It is not the Trustee’s role to protect members from themselves

Choosing actuarial factors – questions

Questions