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Transfer values Post-2015 – issues/challenges to actuaries

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Disclaimer

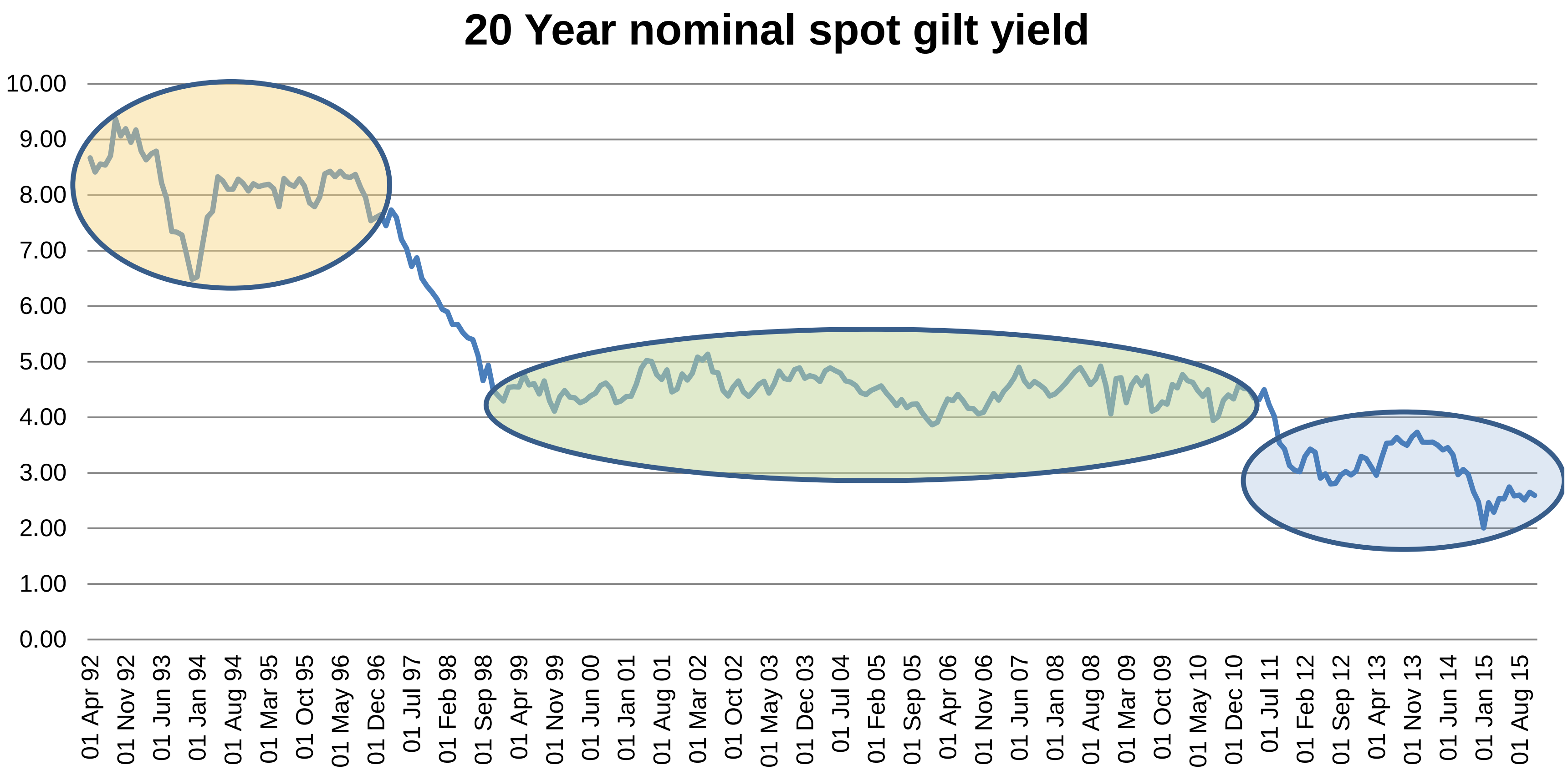
- My thoughts and experiences
- View expressed may not represent the views of my Employer
- Views of a practising Scheme Actuary

- Welcome Feedback and comments through the presentation or at the end

AGENDA

- Low interest rate environment
- Single v dual discount rate
- Other assumptions
- Consistency with other factors
- Non-statutory transfers
- Equalisation approaches
- Insufficiency reports
- AOB

Low interest rate environment



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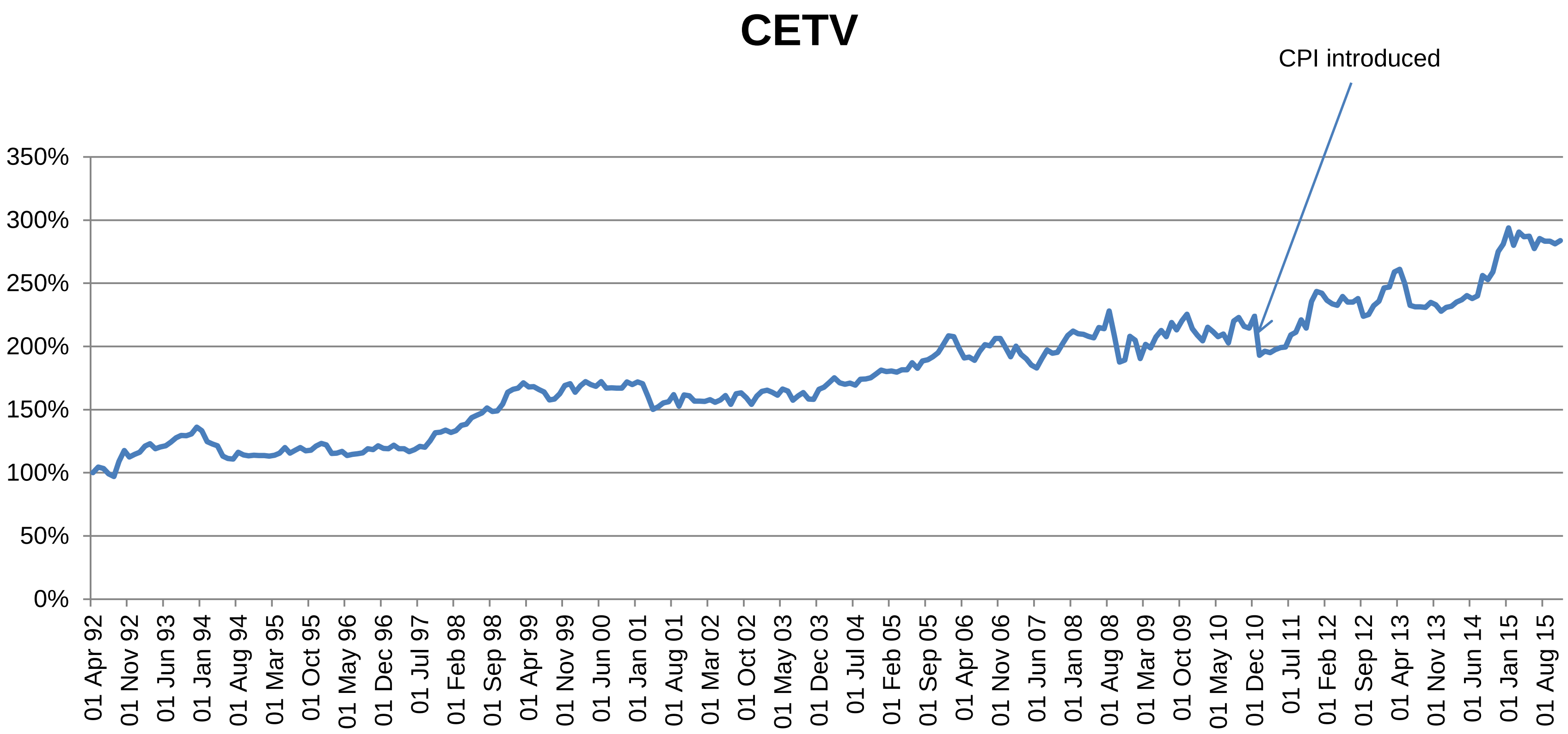
Low interest rate environment



Indicative transfer value. For comparison only. Assumes males aged 55 retiring at 65, discount rates set as G+3% pre retirement and G+1% post retirement, 20 year gilt spot yield used. RPI derived from index of consistent duration to gilt reference point allows for 0.2% IRP. CPI revaluation from 2011 with CPI = RPI – 1%. Mortality basis assumed unchanged over period.

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Low interest rate environment

- Transfer values at historically high levels
  - Perhaps over 50% higher than in 2008
  - 3x greater than 1992
  - in spite of move from RPI to CPI
- Funding levels are comparatively poor
- What should trustees be doing?
  - Pay the higher transfer values?
    - Lower than TP reserve but
    - Cash allowance may mean TVs close to NRA > TP reserve
  - Adjust basis?
  - Reduce transfer values via insufficiency report?

Legislation

- **The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008**
- "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."
- "The trustees must have regard to the scheme's investment strategy when deciding what assumptions will be included in calculating the discount rates in respect of the member."
- "The trustees must determine the assumptions under this regulation with the aim that, taken as a whole, they should lead to the best estimate of the initial cash equivalent."

Regulatory Guidance (2008)

- The assumptions must be chosen with the aim of leading to a best estimate of the ICE. This is a 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. However, trustees should recognise that 'best estimate' is not a precise concept and they will often need to be pragmatic and accept choices which seem to them reasonable in the light of the information and advice they have obtained.
- Trustees must have regard to their investment strategy when choosing assumptions. This includes the appropriate investment returns to be expected, which in turn will influence the choice of interest rates with which future expected cash flows are discounted. To inform decisions, trustees should:
  - discuss with their actuary the relevance of the scheme's funding plan as set out in the statement of funding principles (…). For example, where a scheme's funding plan implicitly assumes that investments underpinning benefits change at or approaching retirement, it might be appropriate to take this into account in deriving discount rates; and
  - consider consulting their investment adviser on the financial landscape and its implications for choosing best estimate investment returns.
- Assumptions as to investment returns which are used to derive the appropriate discount rates should be net of investment management fees and expenses.

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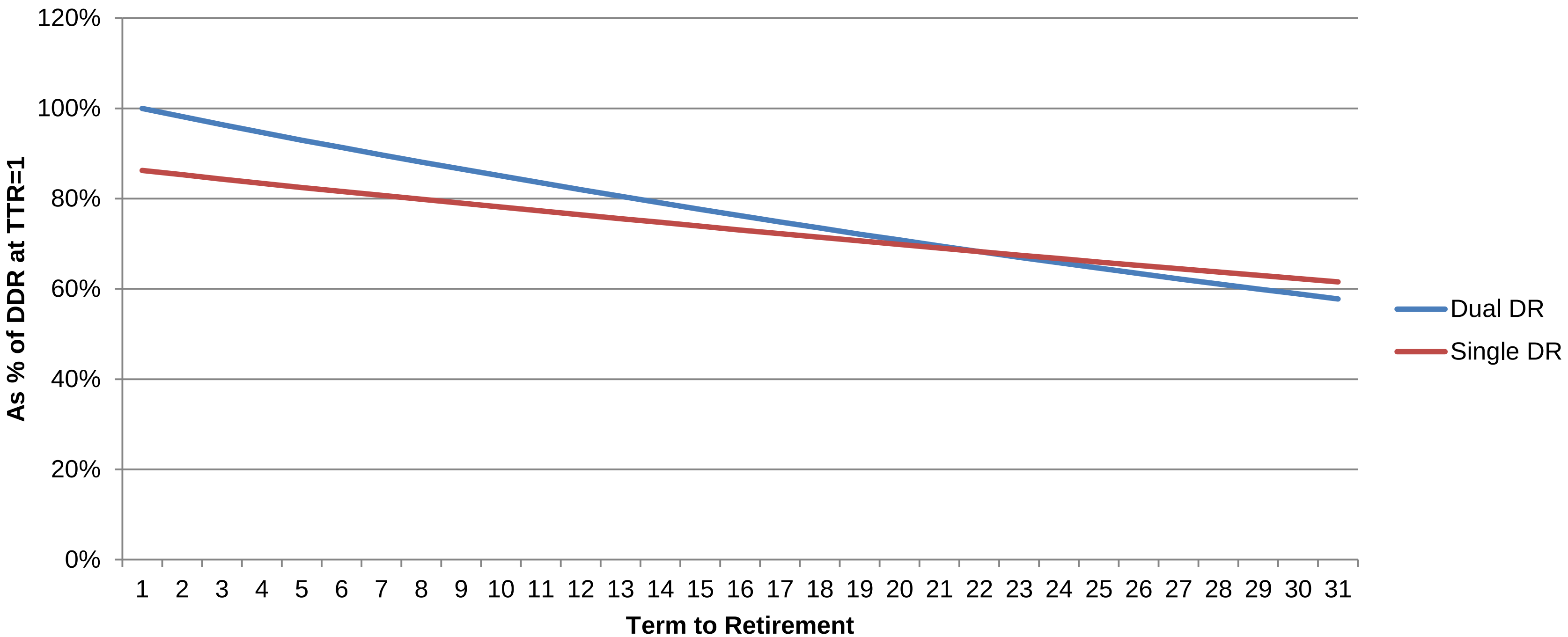
Approach to investment

- Neutral Basis is often used as a starting point
- Need to understand trustees investment strategy in giving advice
  - Consider SIP – but often this only describes the current investment profile not defining a long-term strategy
  - Discuss with trustees
  - Discuss with investment consultant
- “Old” approach to investment
  - Pensioners matched by bonds
  - Non-pensioners matched by growth assets
  - Lends itself to dual discount rate
- More modern approach
  - Bonds / LDI to reduce risk
  - Growth assets to produce returns
  - Single discount rate approach?
    - But investment strategy may suggest the profile will de-risk as the scheme matures. Single discount rate approach typically only looks at this moment in time.
- What is happening in practice?

Approach to investment



Dual DR assumes a DR of G+3% pre and G+1% post and that the investment policy is currently 60% growth and 40% matching. The single discount rate is derived using a return of G+2.2% (0.6 * 3 + 0.4 * 1)

Use of a single discount rate reduces transfer values for people closer to retirement.

Younger members may benefit (marginally)

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Approach to investment

- Single discount rate typically only considers today's investment strategy
- How will the strategy develop? And how will this be allowed for?
- Flight plan
  - Reduction in growth assets as funding level improves
  - How to allow for this?
  - Assume steady improvement in funding
    - Move to a curve approach to setting discount rates?
    - Move back to a dual discount rate as a proxy for an increasing proportion of LDI as a scheme matures? – only appropriate if length of flight plan is broadly consistent with maturity profile of the membership.
    - IT constraints? Additional costs?
    - Pragmatism?

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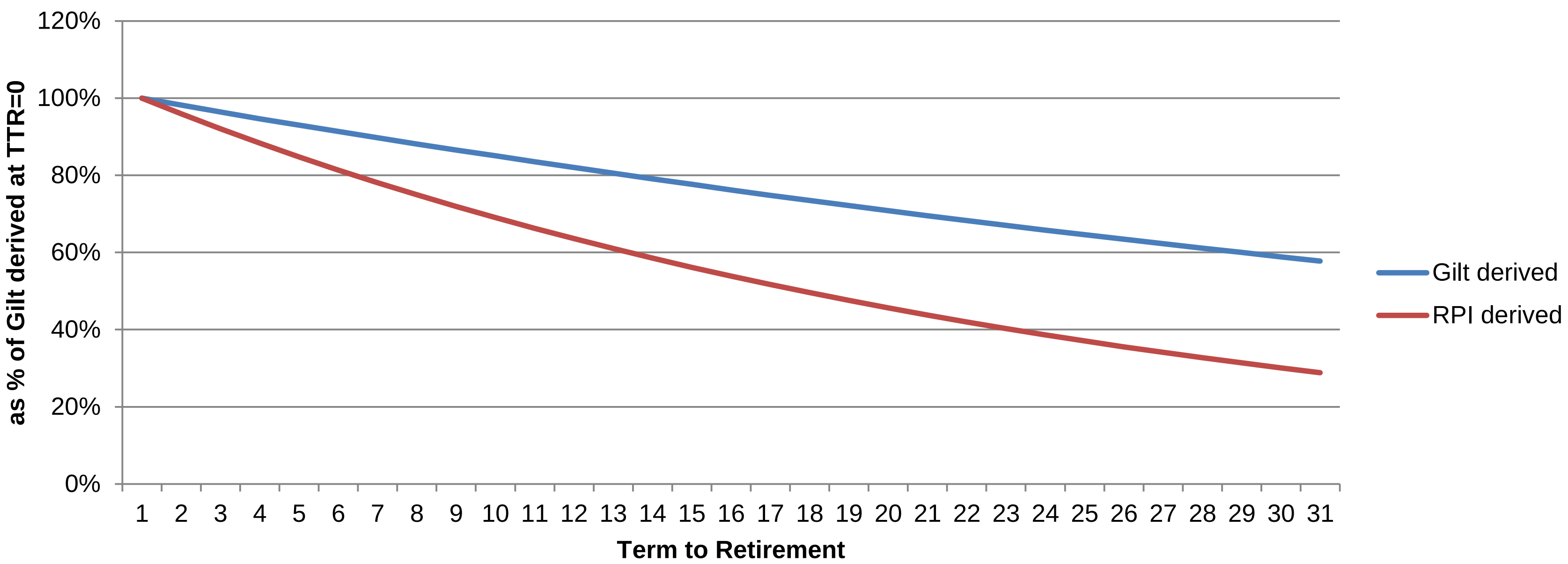
Investment returns

- How should investment returns be set?
  - Gilts
    - Index, reference point on a yield curve (actual assets or liability duration)
  - Corporate Bonds
    - AA rate? but what about wide range of corporate bonds (AAA, AA, AAA-AA-A, all stocks, high yield and "broad bonds" to name a few)
    - default risk adjustment
  - Equities
    - Fixed return? - with periodic review
    - Scheme specific modelling?

      or more commonly:
    - Gilts+? but plus what? +2.5% to +5%? (At 30/11/2015 g+3% = 5.63%)
    - RPI+ but plus what? (NDY + Div. growth - at 30/11/2015 = 3.28% x 3.63% x 1% = 8.1%)
      - Potential inconsistency between TP (gilts+) and CETV basis (RPI+)?
      - Need to monitor differential?
  - DGF / Property / Overseas equity / EM / EMMA / LDI / ELBF

RPI derived discount rates – pre-retirement - impact



- Post retirement assumed to be unchanged
- Gilt derived: Equity returns pre retirement derived using G+3% = 5.6% pa
- RPI derived: Equity returns are 8.1% pa
- Significant reduction in CETVs for younger members

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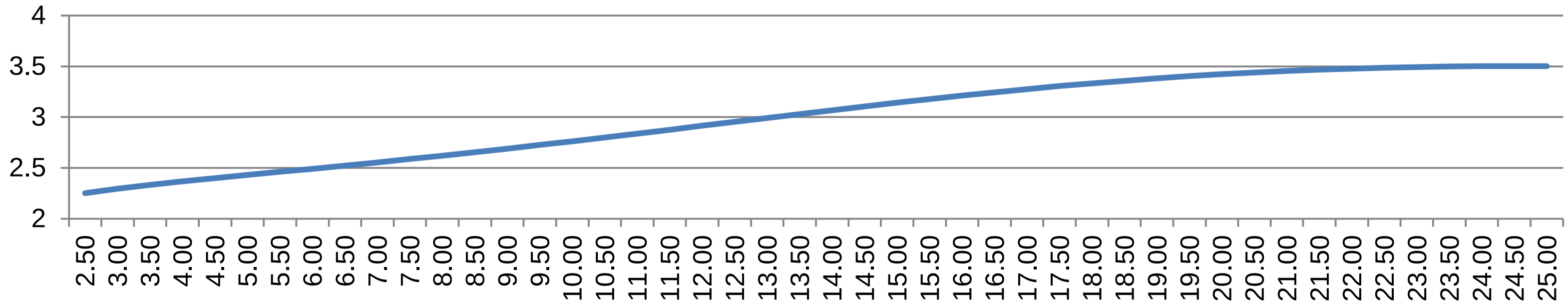
Other assumptions

- RPI – typically set by reference to a single point. (e.g. Bank of England inflation spot rates)



- Should we be allowing for different pre and post retirement RPI assumption?
  - Consistent with discount rates?
  - Especially if a high proportion of non-increasing benefit
- What curve should we be using: B of E? or some sort of RPI swap curve?
  - RPI Swap curve - less subject to supply & demand premium due to size of market. May still be some degree of inflation risk premium?
    - Consider extent of any inflation hedging
  - RPI Swap Curve was 0.07% lower than annualised Bank of England rates at 20 year duration as at 30 November 2015 – but differential can vary

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Other assumptions

- CPI differential
  - OBR paper – “The long-run difference between RPI and CPI inflation” - difference of between 1.3% pa and 1.5% pa (Nov 2011)
  - Bank of England – difference of 1.3% (February 2014)
  - What are people doing in practice? – suggest “norm” of 1.0% pa
- Pension increases in payment
  - Straight from RPI / CPI assumption – referenced against cap or collar
  - Black or Black-Scholes
    - But what volatility? Somewhere between 1% - 2%? What are people doing in practice?
    - Different volatilities for CPI and RPI
      - A suggestion is that CPI is more directly controlled by UK Government but the UK Government controls RPI through the ILG market
      - Are there statistics to support this?
  - If using a curve then consider against Caps and Collars

Other assumptions

- Mortality
  - Reference Neutral Basis
    - or Reference Technical Provisions?
  - Post code mortality analysis
  - Latest tables (S2 and 2015) – with reducing life expectancy
    - Given current size of CETVs against long term averages this may be less of an issue for CETVs
    - These tables may be a greater issue for TPs where prudence is required.
    - What are people doing in practice? CETVS? TPs?
  - Long term rates 1.0% to 1.5% perhaps
    - Is there a trend?
      - 1.0%?, 1.25%?, 1.5%?
    - Do latest 2015 tables suggest these should be starting to reduce?
      - What is happening in practice?
        - » Reductions? or just halt on increasing LTR?

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Other assumptions

- Retirement – generally quite easy as defined by scheme NRAs
  - but see comments later on equalisation
- Proportion married
  - latest population statistics suggest 76% married (male) and 68% (female) at 65. (ONS Nov 2011)
  - Consider definition and discuss discretionary practice for dependants
  - Use of post-codes to derive these assumptions?
- Age difference – 3 year gap is universal?
  - Supported by latest statistics (ONS February 2012)
  - Scheme Specific differences?
  - Individual assumptions?
  - Is anybody doing anything other than 3 years?

Consistency with other factors

- Concern re cash commutation and CETV
  - With April 2014 changes and the additional flexibilities that were introduced, transfer values now requested more frequently at NRA
  - Potentially highlights inconsistency with cash commutation factors e.g. CETV uses an annuity of 21 and members might be offered cash using a factor of between 9:1 and 15:1
    - Differences may be justifiable
    - Member plus spouse (CETV) v Single Life (cash commutation)
    - Cash commutation factors may be set within the rules and the employer is unwilling to change them given the deficits that exist in the scheme
  - Harder to justify differences where best estimate approach is required for cash commutation factors (especially where these are set by the actuary)
    - Justify e.g.
      - retirement is a typically a one-off decision (at NRA) rather than an option which members may look into on numerous occasions to maximise their benefit (CETV) so some smoothing justified,
      - health status of people retiring – but may be difficult to justify too great a difference
    - consider updating cash commutation factors (or adopting weaker end CETV basis)
- Trivial Commutation
  - As liquidating a liability in full, consistency with CETV? Perceived unfairness with standard cash factor.

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Non-statutory transfers

- Much bigger issue post 2014 flexible retirement options
- What constitutes a Non-statutory transfer value?
  - Within 1 year of NRA
    - But equalisation: does this mean 64 or 59. Legal advice? We have seen legal advice going both ways on this.
  - 2+ quotes in a year?
- What do the rules say about non-statutory transfers?
- Same basis as statutory transfers?
  - Regulator: “As a consequence of the legislation, the same basis should normally be adopted for the calculation of CTSs as for statutory cash equivalents. Normally, we would also expect the same approach for non-statutory transfer values. This is pragmatic and fair and also avoids any discontinuities in the amount of a transfer across an age or other threshold.”
- Can non-statutory transfer values be reduced?
- Guaranteed 3 months?
- Stronger discharge required? Legal input?

Equalisation

- How to value the Barber tranche?
  - Benefits split into separate NRAs and valued at different ages, or
  - Benefits valued at single NRA and ERF / LRF applied to Barber benefits
    - Consider preservation, ensure LRF represents fair value for benefits being transferred – should be ok but how long since LRFs have been reviewed
  - Significant complexity when valuing benefits where GMPs exist – to what extent are simplifications acceptable?
  - GMP Equalisation?

Insufficiency reports

- Low gilt yields produce lower funding levels – when should transfer values be reduced?
  - Regulatory guidance
  - Imminent insolvency? (suggest: yes – where possible)
  - Weak covenant? (suggest: yes – where possible)
  - Strong covenant poorly funded? Much harder – depends upon degree of underfunding – seek additional one-off funding
- Where a reduction is decided upon by the Trustees - what reduction?
  - Actuary decides? – should discuss with Trustees
  - PPF priority or Flat rate – probably depends upon likelihood of insolvency and mix of membership
    - Pragmatism, fairness, perceived fairness
- Reductions will probably kill off all transfer values – unless insolvency is understood by members to be very close

Corporate perspective?

- Transfer Values need to be set at the right level
  - Too Low
    - Members do not transfer and they retain the liability
  - Too High
    - Transfers more likely to be taken
    - Transfers accepted may be greater than the Technical Provision liability – weakens TP funding – but probably still cheaper than a buy out
  - Just right?
    - Transfers taken and funding improves!
    - But if yields rise, will hindsight suggest the CETVs were at the right level

AOB / questions

- Concern that members / IFAs may choose to challenge transfer values etc. more in the future.
  - Any evidence of this?
- Schemes targeting buy-out – to what extent should this be allowed for in the CETV basis?
- Daily / Monthly / quarterly yield updates?

Regulatory Statement

The information contained within this presentation does not constitute financial advice.

The information provided is based on our understanding of current law and taxation as at 5 February 2016.

HMRC policy, practice, and legislation may change in the future.

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