ASSOCIATION OF
CONSULTING ACTUARIES

Warnford Court, 29 Throgmorton Street, London EC2N 2AT
Tel: +44 (0)20 7382 4594 Fax: +44 (0)20 7374 6220 EMail: acahelp@aca.org.uk
Web: www.aca.org.uk

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Mike Rochford
Department for Work and Pensions
3rd Floor
Adelphi
1-11 John Adam Street
London WC2N 6HT

Dear Mr Rochford

Consultation on Approaches to the Calculation of Pensions Transfer Values

I am writing on behalf of the Association of Consulting Actuaries in response to the consultation document issued by the Department for Work and Pensions dated July 2007 containing draft regulations.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

Despite being generally supportive of the underlying proposals contained within your consultation document and draft regulations, we have three key concerns which we highlight below. None of these should be insurmountable, but unless they are addressed we fear that the implementation will be far more difficult than it should be with much larger costs imposed on the pensions industry than is necessary.

We also have a number of other detailed observations which we cover in the Appendix.

Concern 1 – Too tight an implementation timetable

The first is that the timetable for implementation is now very tight as there would appear to have been a three month slippage from the timetable announced in January this year. We note that there is no indication in the latest document as to the time when the regulations will be laid before Parliament although the 6th April 2008 commencement is still intended.

Although we continue to support a 6th April 2008 commencement, there are a number of reasons why we ask you to consider a transition period, which we believe should be twelve months. These include the likelihood that the regulations will not be laid before Parliament until the late autumn and the need to settle other material which we believe is necessary to make the new regime work (see Concern 3 below). Once this has been done every trustee body will need to review their arrangements to make sure they are fully aligned with the new regulations and document that they have done so. Even modest changes need discussion, agreement and implementation – quite often involving IT changes, which cannot be rushed. However, we have reasons for expecting many reviews to be comprehensive. This is because over the last couple of years many trustees have delayed carrying out a thorough review of their transfer bases whilst waiting for the regulatory position to settle down. So whilst the Government's policy intention is that little should change, the reality in many cases is that significant amounts of work will need to be carried out.

Our proposal is that trustees should be required to have moved to the new regime by 5th April 2009. Some may be able to get there shortly after the commencement date, but for many, the transition period will be a necessity. We would stress that this proposal is not for a delay in the coming into force of the regulations, but only for the introduction of a transitional period for compliance. Indeed, we see no reason (provided there is such a transitional period available and subject to Concern 3 – see below) why the new regulations should not come into force earlier than April 2008 so that any trustees who wish to can move to the new regime immediately.

Concern 2 – Regulatory requirements too prescriptive

Our second key concern is that you have tried to reflect much more of the current GN11 in the legislation itself than is appropriate. This is reflected in various comments in the Appendix.

The deregulatory review recently recommended a move to a principles-based legislative framework. In the light of this, we would question whether some of the material previously in GN11 would be better in guidance rather than in regulations.

Two particular areas where we feel that the attempt to hard-code in the regulations what has previously been in GN11 is likely to create significant practical issues are investment strategy and insufficiency reports. We expand upon these in sections 1.1. and 1.2. of the Appendix respectively.

Concern 3 – An incomplete package

Our third key concern is that there appear to be a number of significant items missing from the package.

- The regulations make reference to guidance from the Pensions Regulator and the Financial Services Authority which members may wish to access when weighing up whether or not to take a transfer value.

    - We are not aware of the existence of the Regulator's document nor do we know what consultation process it will go through before being available by presumably 6th April 2008.

- So far as the FSA document is concerned, would we be right in assuming that you are referring to *"No selling. No jargon. Just the facts about pension transfers. The risks of salary-related occupational pension transfers"* issued by the FSA in June 2007?

- Because you have quite rightly not taken all of existing GN11 into the regulations it does leave certain gaps which beg the following questions:

  - Whether the Pensions Regulator should produce some guidance for trustees so that trustees are clear as to how they should approach what is to be a new responsibility and what paper trail is needed. We provide more detail on this in section 2.1. of the Appendix.

  - Whether, with regard to transfer values, the actuarial profession should be reviewing the need to reinstate certain ethical aspects of the actuary's relationship with the trustees. We expand on this in section 2.2. of the Appendix.

  - Whether the Board for Actuarial Standards should produce a standard to support the new regulations.

    You do not state why there are no such plans. We had envisaged that technical guidance would build on the principles set out in the regulations. There would appear to be scope for the Board to give guidance on best estimate actuarial assumptions. If they do not, might there be a risk that too wide a range of actuarial assumptions will be adopted by trustees as "best estimates"?

Finally we ask why a very long standing public policy requirement that the basis for determining transfer values in should be consistent with that for transfer values out is being dropped.

We hope that you find our comments of assistance and look forward to working with you as you finalise the requirements of the new regime.

Yours sincerely

David Everett

David Everett
Deputy Chairman
Pension Scheme Committee of the Association of Consulting Actuaries

Appendix

This Appendix lists a number of detailed comments on the policy underlying the regulations and the wording of the regulations themselves.

1. Matters included in the regulations

We have a number of comments on the material covered in the regulations. We have not carried out a detailed reading of the draft regulations against the current regulations, so there may be typographical and referencing amendments which we hope that others will spot.

1.1. Investment strategy

We have a number of comments regarding the references within regulation 7B(3) to investment strategy. It is possible that some of the detail included in these regulations might be better deferred to guidance:

- We think that you need to refine the terminology since it is most unlikely that schemes will have an explicit investment strategy for a particular class of members. Rather they are more likely to have an investment strategy for the scheme as a whole that has regard to the nature of the membership. Our concern is that as the Regulation is currently expressed, it may prove to be unworkable. It also seems to be in potential conflict with the policy intention as set out in paragraph 15 on page 20 of the consultation document (*"The overarching policy is that the discount rates used should reflect the scheme's investment policy and any relationship between that policy and different classes of members, where such a relationship has been articulated."*).

- As the Regulation is currently drafted, schemes that are closed and are pursuing an investment strategy that might culminate in buyout at some future point would appear to be at risk of having to determine their cash equivalent basis now on something close to buyout. Is this the policy intention?

- We have concerns about the use of the word "current" in the phrase "current investment strategy". A scheme may be following a defensive bonds-based strategy on what is intended to be a temporary basis. Is it the policy intention that in such situations cash equivalents should be significantly higher than when the scheme had a more balanced strategy? If it is not the intention, to what extent do the regulations permit judgment in their interpretation, given the potential for misuse once one moves away from an objective measure?

- There is not an explicit requirement to take account of market rates of return. It would appear possible to read the Regulation in such a way that the actuarial basis selected by the trustees is long-term – ie with no adjustment for changing market conditions. Is this intentional – eg so as to give trustees additional flexibility?

It is not clear to us whether changes to the drafting will address these concerns. This may demonstrate the need for guidance to be produced that offers the prospect of trustees seeking to observe the spirit of the principles, instead of attempting to cover everything in the regulations themselves.

1.2. Insufficiency reports

We have a number of comments regarding insufficiency reports. In many schemes there will be a need to reduce transfer values for under funding currently (although this would be expected to diminish over time as schemes' funding improves). The application of reductions needs to be flexible, as is available under GN11. Our concern is that the way the regulations are drafted, there could be significant additional and unnecessary work:

- The explicit ability for the actuary to aggregate some or all of the priority liability classes (see paragraph 4.2.5 of GN11) does not appear to be carried into paragraph 7 of Schedule 1B. It is not clear whether this is the policy intention. If it is, the result could be to make insufficiency reports untenable as; for example, valuation of Pension Protection Fund benefits would be required in order to complete the report and Pension Protection Fund benefits would have to be separately identified within each transfer quote.

- It is not made clear why the ability to use higher values than the market value of assets (see paragraph 4.2.2 of GN11) is no longer permitted. This ability is particularly useful in relation to insurance policies where the surrender value is not a realistic measure for the purpose of the insufficiency report.

- It should be made clear within the regulations as to the principles on which the insufficiency report is based.

  It appears that a share of fund approach is being adopted on the assumption that where the scheme is not in wind up it continues in existence (hence no allowance for wind up expenses) and everyone requests to transfer (including those who cannot – ie pensioners) or take refunds. This appears to be an odd principle, although we can see the attraction from a simplicity point of view. This approach does not protect some of those who stay should the scheme actually wind up – in particular younger members could be disadvantaged compared to the asset shares if the scheme were to wind up outside the Pension Protection Fund.

  An alternative principle would be for the trustees to deliver a share of fund to the departing member commensurate to that available were the scheme to wind up outside the Pension Protection Fund. This would introduce some complexity (as the valuation would switch to a buyout basis) and some leavers could get more than the expected cost to the scheme.

Our view is that in recognition of there not being a simple answer to this issue, the regulations should make provision for an ability to reduce subject to receiving an insufficiency report, but leave the method up to the trustees subject to taking actuarial advice. On this basis, we would remove all of paragraphs 6 and 7 of Schedule 1B.

1.3. Other comments

We have a number of other comments on the draft regulations as follows:

- We support the logic for the terminology "initial cash equivalent" but wonder whether the term cash equivalent, which will now mean an amount after any reduction (whether for under funding or other reasons), could be misused.

- We ask whether the new Regulation 7(2) that allows trustees to increase a cash equivalent, will enable those who choose to do so, to obtain a statutory discharge. You say (see paragraph 6 on page 10) that *"the policy is that the regulations should set a minimum level for cash equivalent transfer values and that trustees should be able to pay higher amounts where appropriate"*. But it is not obvious to us that Regulation 7(2) to which you refer, will enable a statutory discharge to be obtained. Many trustees may well wish to set higher than best estimate transfer values, and for practical reasons would never wish to calculate directly the best estimate figures. The draft legislation as it stands is unclear on this.

- Regarding transitional issues we ask that you give consideration to allowing a twelve month implementation period from the regulations coming into force on 6th April 2008 which, as we have noted above (see Concern 1), we feel is likely to be too tight if immediate implementation is mandatory.

- We do not understand the logic in Regulation 7A(2) that where a scheme has begun to wind up, that fact is ignored in the cash equivalent calculation. Does this mean that any change in investment policy (such as moving away from risk-seeking assets) is ignored?

- Regulation 7A(4)(b) refers to the situation where different normal pension ages apply to different tranches of benefit. This concept seems to be counter to the definition of normal pension age in the Pension Schemes Act 1993 that makes no provision for different tranches and may open up an inconsistency between the treatment of deferred pensions and cash equivalents.

- We support the requirement to take account of the options available to the members that increase the value of the cash equivalent.

  We note the implication that trustees will not be allowed to take account of options that would decrease the value, such as poor commutation terms. This appears to be contrary to paragraph 3.3 of GN11 and so we ask whether this is intended since you have not highlighted it in your analysis and it would appear to be contrary to an expected cost to the scheme principle.

  We also have some concerns over the way in which the regulation is drafted. It would appear possible to read it so that account has to be taken of these options assuming a 100% probability of their being exercised (unlike paragraph 3.3 of GN11). We presume that this is not intended, and appropriate decrements based on scheme experience can be used for options such as unreduced pensions on early retirement as currently.

- We note that comparable changes are being made to the cash equivalent calculations made in connection with pension sharing on divorce. We ask that you do not lose sight of the need to reconsider whether the current policy approach is appropriate – especially the ability of trustees to remove ex-spouses compulsorily from the scheme at a price likely to fall significantly below the buyout cost of the pension credit.

Finally, under this section, we set out two areas where we are supportive of your proposals:

- The amendment to the cash transfer sum provisions enabling a cash transfer sum from a defined contribution scheme to be increased or decreased to reflect any changes in the value of the underlying investments between the date of leaving service and the date of surrender or dis-investment.

- The new framework in relation to discretionary benefits – in particular the ending of the need for a formal actuarial report before the trustees can direct that discretionary benefits should not be taken into account. The regulations also appear to be clearer in that the extent to which discretionary benefits are taken into account is left with the trustees. Under the current regulations there is an argument that there is an “all or nothing” situation.

2. Matters within GN11 that are excluded from the regulations

There are a number of matters which are currently within GN11 but which have been excluded from the regulations. Whilst we support their exclusion from the legislation itself we are concerned that they should not all disappear completely in the new regime.

2.1. Matters which may benefit from trustee guidance

Some of these matters may benefit from finding their way into some guidance by the Pensions Regulator which is aimed at trustees. This guidance could also address the concerns we have set out under 1.1. and 1.2. above.

- We agree that it would be good practice for schemes to disclose the assumptions they have used to calculate a transfer value when this is requested by the member. But more importantly, we suggest that, just as the statement of funding principles is disclosable to members on request, a similar statement of transfer value principles, which may or may not extend to giving detailed assumptions, should be disclosable. Under the new regime it is clearly inappropriate for the actuary to certify the calculation of cash equivalent transfer values, but we wonder whether there is sufficient member protection with the trustees not being required to certify or formally document (via a disclosure document) how they have arrived at their decision.

- We agree that the employer should not have a formal role in setting the minimum cash equivalent transfer value basis (unlike that for scheme funding). The employer has never had a formal role under the cash equivalent legislation and we see no reason to introduce it now (unless perhaps, the trustees intend to adopt a basis greater than expected cost to the scheme). You mention that the trustees ought to balance the interests of the various groups in the scheme when setting the transfer basis. It is not clear to us whether you are referring to the employer here or the interests of transferring members against that of non-transferring members. This is one of a number of matters that could usefully be flagged within Regulator guidance.

- We support the ability of the initial cash equivalent to be reduced to reflect any reasonable administration costs incurred by the scheme. However, the drafting of paragraph 18 of Schedule 1A could be interpreted as enabling trustees to reduce for expenses but not take account of any long-term savings such as the cost of paying pensions. It could be that rather than attempt to aim for precision in the drafting, this essentially ethical matter could be a topic suitable for Regulator guidance.

- You mentioned that where there are differences between incoming and outgoing transfers you would expect that these should be brought to the attention of any person wanting to transfer into the scheme. It is not clear how this policy intention is to find expression. This would appear to be a matter that could be dealt with by Regulator guidance.

- We have some concerns that the paragraph 3.8 requirement of GN11 for a separate value of an element of the cash equivalent to be quoted is not to be carried into the new regime. The rationale for paragraph 3.8 is long-standing and relates to concerns expressed many years ago that without a separate calculation, all of the cash equivalent might have to be regarded as contracted-out in the receiving scheme with subsequent restrictions on the nature of payment of benefits. Again this could be a guidance point.

- Paragraphs 4.4 to 4.6 of GN11 were inserted to ensure that consideration was given to protecting the position of those who had made a transfer into a scheme and now wished to transfer-out. Although we agree that the regulations should make no equivalent provision we ask whether this is a point that should be considered through some form of guidance aimed at the trustees. Without such guidance there may be a danger that inequitable results will occur.

2.2. Matters which may benefit from actuarial guidance

Other matters, which are to do with the way in which the actuary interacts with his or her trustee client, may benefit from being contained in some new guidance provided by the actuarial profession. Whilst clearly, these are matters for the actuarial profession to decide, we ask whether they have been considered in your thinking.

- With respect to the insufficiency report, the current requirement for the actuary to report to the trustees where the immediate payment of either a full or reduced cash equivalent would reduce the security for the remaining members seems to be an important protection (although we think that it should be expressed as a warning that can be delivered without the need to undertake detailed calculations). This could be re-expressed within new actuarial guidance or made more explicit within GN29.

- Regarding paragraph 4.7 of GN11 you state that the actuary ought to bring the matter to the attention of the trustees where an incoming transfer is insufficient to provide statutory benefits. We agree and this may be a subject that could be contained within an actuarial guidance note.

- We are content that paragraph 7.1 of GN11 should not re-appear in the regulations but there is an argument that some of the material within it, particularly the circumstances in which adjustment should be made to cash equivalents for changing market conditions, should appear in actuarial guidance.

3. Other matters

There are a number of other matters relating to transfer values which it would be useful to take the opportunity to address. These include the following:

- Since 6th April 2006 (A-day) HM Revenue and Customs has been content for partial transfers to be made. However the DWP legislation has not been amended to reflect this. So it currently does not appear possible for the trustees to obtain a statutory discharge should an individual with a defined benefit deferred pension and defined contribution AVCs wish to transfer his or her AVCs to what may be a better performing vehicle or one that more closely reflects his or her needs, unless at the same time the individual almost certainly exchanges the defined benefit deferred pension for an uncertain defined contribution vehicle.

- The draft regulations do not appear to make amendments to the Proceeds of Crime Act (Recovery from Pension Schemes) Regulations 2003 (SI 2003/291).