The price of transfers

Maggie Williams considers the impact of DB-DC transfers on schemes’ funding valuations

Summary

- The impact of transfer values depends on the funding level of a scheme and strength of the covenant.
- Trustees have a number of options to mitigate the effect of transfer activity, including recalculating transfer values.
- Poorly funded schemes with a weak covenant could be forced into unscheduled valuations.
- Good quality management information is essential to help predict activity.

Few pensions topics have attracted as much attention over the last year as defined benefit (DB) transfer values and guidance practices. Amid much debate around whether transfer values are in members’ best interests, there is also the question of how they affect DB schemes themselves.

According to the Financial Conduct Authority, the total value of DB to defined contribution (DC) transfers grew from £7.9 billion in 2016 to £20.8 billion in 2017. Barclays Bank alone paid out £4.2 billion in pension transfers in that time, quadrupling the previous year’s activity, according to its annual report.

The trend shows no immediate signs of abating. The Pensions Regulator estimates that around 100,000 transfers took place in the 2017/18 financial year. A recent survey of 300 UK defined benefit (DB) pension schemes by Aon showed that 90 per cent have experienced an increase in transfer value requests over the past 18 months, and 40 per cent said that they have seen a significant rise. Figures from Hymans Robertson, released in February 2018, speculate that around a million members in total will transfer out of DB schemes over the next 25 years.

Do well-advised and carefully executed transfers represent a win-win opportunity for trustees and members, or is there a tipping point where they start to become detrimental to the scheme? Could the cumulative effect be sufficient that trustees need to call an unscheduled scheme valuation?

“It’s not unheard of for schemes to make allowances for transfer activity in triennial valuations,” says Willis Towers Watson retirement policy lead, David Robbins. “However, the norm at the moment is that it might be discussed but it’s not a big issue.” Robbins adds that, in many cases, transfers would make little difference to the scheme’s overall position. “If members are transferring close to retirement, the transfer value might not be much less than the technical provisions in respect of that member.”

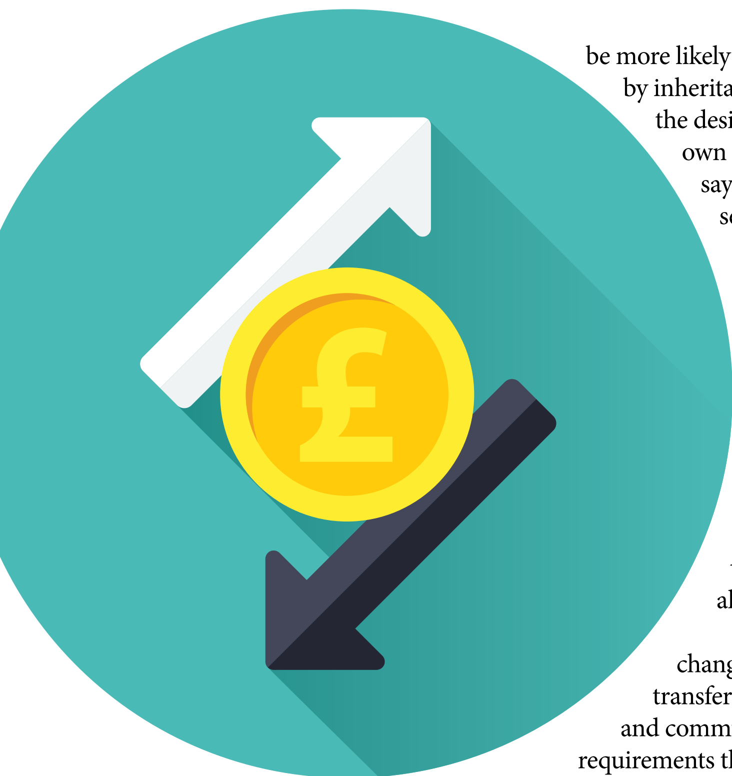
Impact on a scheme

A scheme’s funding level, the strength of the employer covenant and the way in which transfer values are calculated all determine the effect of transfer value activity. “If a scheme is well funded and the employer covenant is strong, paying out transfer values isn’t a problem,” says Hymans Robertson head of corporate DB Alistair Russell-Smith. In schemes where there are concerns about the employer covenant or where funding levels are poor, Russell-Smith says that reducing transfer values is a more likely first course of action. “If you are paying out 100p in the pound in transfer values, but the assets you’ve got are 80p in the pound, then every transfer makes matters worse,” he adds. “Trustees can unilaterally call an early valuation if there has been a material change in the demographics of the scheme or in the employer covenant, but I haven’t seen it happen yet.”

Even if it isn’t hurting the scheme, a flurry of transfers will affect a scheme’s cashflow profile and ultimately its investment strategy. Replacing a series of payments over time with a one-off cash payment requires more liquidity, changes the liability profile, and affects interest rate and inflation hedging. “If you have significant transfer value activity, you need to update your management information to better understand the impact on risk management and investment liquidity,” says Russell-Smith. “We haven’t yet seen many schemes building an allowance into the liabilities for people taking transfers in the future, but we are seeing a move away from growth asset classes such as equities and towards those that generate income, such as investment-grade credit.”

The effect of transfer value payments on investment strategy requires careful and timely management by trustees, to avoid forced sales and an unplanned loss of returns from growth assets. “Your ability to get investment outperformance could disappear,” says JLT Benefit Solutions director Charles Cowling. “In the most extreme situations, if a scheme expects a deficit to be made good by, say, 50 per cent contributions from the sponsor and 50 per cent investment outperformance, they then risk only being left with the contributions element. In that circumstance, you might want to accelerate the timescale of a valuation to find a way to make good the contribution to the deficit that you would have got from your investment outperformance.”

Transfer activity can also put the employer covenant under close scrutiny. A weak covenant combined with a poor



funding level could mean reducing the value of the assumptions used for calculating transfer values – as well as the scheme's appetite for alerting members to the existence of transfer options. "If funding reduces from 80-75 per cent because of a rush of transfer values, it could look as if you are prejudicing the rights of members," says Cowling. "But if there is no risk to the scheme's viability, then shrinking the scheme makes sense in the longer term."

A more settled pattern

Trustees undertaking a triennial valuation in 2018 will be the first to see the effect of a full three years of freedom and choice. Is it still too soon to understand the longer-term impact of transfer values?

Cowling believes that, to an extent, trustees can start to make assumptions about future patterns of transfer activity. However, a number of factors still make predictions challenging. One of those is the scheme's membership profile. "Higher value pension members tend to be more likely to transfer, incentivised by inheritance tax planning and the desire to manage their own investments," Cowling says. "A scheme might see an average take up of transfer values of around 5 per cent for three to four years, for example. That could then drop off as the number of higher value pensions left in the scheme starts to dwindle. At that point, most of those who want to take a transfer may already have done so."

The second factor is changes to the way in which transfer values are calculated and communicated. New FCA requirements that come into force from 1 October will see transfer value analysis reports replaced with a mandatory transfer value comparator (TVC) and an appropriate pensions transfer analysis (APTA). A TVC compares the transfer value on offer with the estimated annuity value required to replace DB income, and an APTA provides context for the TVC based on an individual's personal circumstances such as marital status and health. Further changes to transfer advice, including revaluation and indexation assumptions, will take effect from April 2019.

It's anticipated that in many cases, the replacement value shown on the TVC may be greater than the transfer value on offer, which could make them start to look less attractive. "We don't yet know how the FCA's new regime will affect behaviour," says Robbins. "But it might put more focus on individuals' motives for transferring."

One further consideration is the effect of member behaviour. "We have definitely seen word of mouth affecting transfer activity," says Cowling. "One of the most powerful factors in decision-making is what your friends and colleagues are doing. That is potentially more influential than anything trustees or advisers might say." But he adds, "trustees should be monitoring transfer activity. If the level of activity is causing alarm bells to ring, they can react and protect the fund by asking their actuary to change how transfer values are being calculated and produce an insufficiency report".

Balancing the long and short term

In addition to known quantities such as membership profiles and FCA rule changes, there are also more unpredictable factors, such as an increase in interest rates or changes to inheritance tax rules, that could see transfer value activity plummet as quickly as it has risen.

Given the difficulties involved in predicting future activity, trustees must take careful account of the effect that transfer values are having on their scheme. "Employers are entering a tougher environment for funding and there's more pressure to plug deficits more quickly. There could be a hidden prudence margin if you think people are likely to transfer out of the scheme, so you might need to allow for that," says Robbins.

Ultimately, Russell-Smith concludes that the effect of transfer values comes down to each scheme's own circumstances. "If a scheme is well funded, irrespective of its covenant, paying out transfer values is helpful for everyone. If the scheme is poorly funded, but has a strong covenant, trustees might conclude that they will pull the deficit back over time. However, in the very small minority of schemes where there is a poor funding level, a weak covenant and a lot of transfer activity, trustees might conclude that they need to call a valuation."

Written by Maggie Williams, a freelance journalist