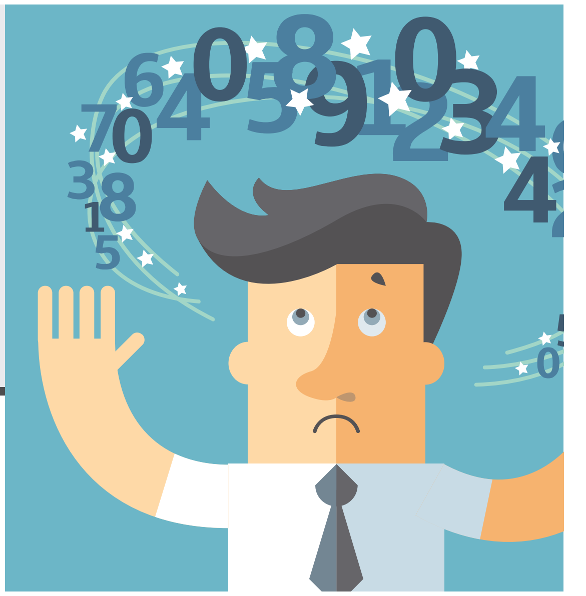
Summary
- A recent IFoA report has found a wide gap between transfer values and commutation rates given to members.
- The gap occurs for a number of reasons, including different rules for setting the amounts and varying valuations by actuaries.
- The factors for determining the transfer values and commutation rates should be reviewed regularly.
- Industry-wide benchmarking of transfer values and commutation rates may help reduce the differences in amounts.
- Trustees play a vital role in setting the amounts, so greater engagement with the process is encouraged.



Making sense of the numbers

Actuarial valuations of transfer values and commutation rates for members can differ widely, which the IFoA has recently highlighted as a cause of concern. Laura Blows explores why this difference occurs and the level of trustee engagement in setting the amounts

Actuaries play a vital role in the effective running of a DB scheme; however, the work they do is usually hidden behind the scenes, calculating overall scheme funding. Yet there are two areas where an actuary can have an upfront and immediate impact to an individual member – with calculating cash-equivalent transfer values (CETVs), and with commutation rates for the up to 25 per cent tax-free lump sum that can be taken at retirement.

It is because of this public interest, the Institute and Faculty of Actuaries (IFoA) senior review actuary, David Gordon, says, that the IFoA carried out its first thematic review into the actuarial factors used to calculate benefits in UK pension schemes in December 2020.

The *Thematic Review Report* looks at the work of 63 individual scheme actuaries from 19 organisations of all sizes, and "we found that the advice was generally at a very high standard", Gordon says.

However, the report discovers a wide gap between transfer values and commutation rates. It finds that the median transfer value at age 65 for £1 per annum pension is £29; the equivalent median commutation rate at the same age is £18.

"We are concerned that the quality of actuarial advice in some instances may be contributing to commutation rates being well below transfer values, which may lead to poor value to members," IFoA Regulation Board lay chair, Neil Buckley, says in the report.

"The difference between transfer values and commutation rates is not new," Gordon adds, "but this review shines a spotlight on how wide the gap can be. Setting these factors is an area where actuaries directly influence member benefits. Although the ultimate decision often rests with the trustees, the advice provided by the actuary is critical."

Setting amounts

A key reason for the difference is that setting transfer values and commutation rates are subject to different requirements.

A transfer value must be at least a 'best estimate' according to regulations, which can only be deviated from if the scheme has a significant deficit. Determining the 'best estimate' is subject to a variety of factors, such as trustee expectations of future investment returns and predicted longevity of members.

"Transfer values are meant to represent the best estimate of what the value of the benefits are if the member stayed in the scheme. These two numbers are meant to be the same; we are not looking to make a profit or loss," Dalriada Trustees director, Vassos Vassou, says.

In contrast, commutation rates have no 'official' rules other than what is said in scheme documents, usually that the rate is 'reasonable' and set by the trustees based upon advice.

Therefore, considerations taken by trustees when determining commutation rates, such as selection risk and market volatility, should be subject to further research, the IFoA advises.

"This is particularly important where commutation rates are materially below an equivalent best estimate transfer value *[IFoA research finds that in most cases actuaries advised trustees to set commutation rates below best estimate]*, which may result in poor value to the scheme member taking the commutation option. There are reasons why these factors may differ at an individual scheme level: "Actuaries need to explain the rationale for this, in line with technical actuarial standards," the report states.

One such reason for these below best estimate recommendations, the report finds, is to reflect recent lower yields, "as it might be difficult to reduce *[commutation rates]* again in future should yields rise".

PwC global head of retirement and pensions consulting, Raj Mody, states that he is fine with the difference between transfer values and commutation rates as, unlike transfer values, the majority of members take the tax-free lump sum, so keeping rates steady provides them with certainty in the run up to retirement.

However, he is more concerned that if the commutation rate is set too low or too high, trustees will be "benefitting one set of members over another".

Reviews

Commutation rates are usually reviewed every three years, at the same time as the scheme's triennial valuation, which the IFoA suggests should be the maximum time between reviews.

"This is crucial to ensure that the basis underlying the latest advice does not become out of date and lead to poor outcomes for members," it states.

Ross Trustees trustee director, Richard Cousins, suggests that larger schemes should review the factors for determining transfer values and commutation rates annually.

In contrast, Vassou states that he has come across a scheme that did not review the determining factors for commutation rates for a couple of valuation cycles, resulting in the amounts offered being "too low by quite a margin". This created the conundrum of "whether to increase the rate, by quite a high jump, leading to the issue of fairness for members who had retired with the old rate recently" or to gradually increase the amount.

Trustee engagement

Mody states that transfer values and commutation rates should be "a live trustee agenda item in their own right, not just a bolt-on to the triennial valuation".

There is too much focus on the calculations and not enough on the governance of the factors determining transfer values and commutation rates, he adds.

Therefore, when determining transfer rates and valuations, Mody recommends that trustees understand the different possible ways any legal requirements that setting the rates could be interpreted. He also suggests that trustees understand the limitations of advice given.

As Cousins says, trustees regularly review all their advisers, including actuaries, on the basis of cost-effectiveness and timeliness, "but whether they review and challenge the advice actually being given is a different question".

The IFoA finds that actuaries tend to use their own company's benchmarking, meaning that there can be quite a "marked difference" with benchmarks between different actuarial firms.

"If you are a client of one of these consultancies you probably do not get the full picture of what is being done across the industry, even though actuaries often explain the limitations of their benchmarking," Gordon says. "The IFoA is calling for industry-wide benchmarking to be compiled, as then there is a chance that trustees can make improved decisions through being able to see what everyone else is doing."

The IFoA is also calling for improved actuary communication generally. "Actuaries tend to write lengthy, detailed reports," Gordon says, "but they are not so good at just answering simple questions of what changes to suggest and why, and how that will affect members and funding."

Vassou agrees that an actuary with both good technical and communication skills is rare. "Actuaries need to talk the trustees' language more," he adds.

However, he notes that there has been more engagement from trustees with actuaries in recent years.

"Seven to eight years ago, actuaries would just print a report and the trustee would just say fine. Nowadays trustees are more likely to be asking questions about the impact of the report's findings," he explains.

The possibility for member complaints of unsuitable transfer values or commutation rates are unlikely to succeed, DLA Piper pensions partner, Matthew Swynnerton, says.

"Whilst there is always a possibility of complaints being raised, provided trustees have correctly followed the procedure under their rules, including taking appropriate advice where required, agreed a calculation basis that is not perverse and then correctly applied it, such complaints are unlikely to succeed. It was largely for these reasons that The Pensions Ombudsman rejected the class action steelworker complaints against the British Steel Pension Scheme in relation to CETVs and early retirement factors," he explains.

However, it is not for fears of a legal fallout that trustees should be engaged in setting in transfer values and commutation rates, Mody advises, "but because it affects the member forever".

"The actuary has a calculator role," he adds, "but trustees look at the context of what transfer values and commutation rates are designed to do. The member is giving up some or all of their DB pension security for one lump-sum amount.

"That is why it is important to ensure that this is not just an actuarial, purely prudent, process."

Written by Laura Blows