

Guidance on calculation of cash equivalent transfer values

A consultation document

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Introduction

This is a consultation document on guidance to trustees in relation to their new responsibilities around the calculation of transfer values which come into effect from 1 October 2008. This consultation is issued by the Pensions Regulator (“the regulator”), the body which regulates work-based pension arrangements.

Background

As from 1 October 2008, trustees will become solely responsible for the calculation of defined benefit transfer values (called cash equivalents in the legislation). Up to then, that responsibility has largely rested with the scheme’s actuary who has to follow a technical standard designated GN11 which, since April 2006, has been the responsibility of the Board for Actuarial Standards. GN11 is due to be withdrawn from 1 October when the revised legislation comes into force.

A transfer value in respect of defined benefits is calculated on actuarial principles as the capital sum which, if invested appropriately, is expected to provide the relevant member’s benefits as they fall due. The calculation requires assumptions to be made about many factors, including investment returns, mortality rates, inflation rates and the relative age of any dependant(s).

The broad thrust of the new legislative requirements is that the basic cash equivalent should be at least the best estimate of the cash required to be invested in the scheme to reproduce the relevant member’s benefits. There is provision to allow this basic amount to be reduced in certain circumstances, including where the scheme is poorly funded.

Many aspects of the current transfer regime are not affected by the legislative changes. For example, where a member is within one year of normal pension age, the cash equivalent legislation remains inapplicable, though scheme rules may allow such transfers to take place. And the general procedural aspects of transfers remain as they are.

In fact, transfers of defined benefits are relatively uncommon in practice. There are several reasons for this, though principal amongst them is the fact that the risk-reward profile of the transfer value in a money purchase arrangement is not usually attractive to most defined benefit members.

Nevertheless, there can be reasons why it is imperative for a member to take a transfer, for example, to take benefits early where the scheme does not permit it. And the transfer value calculation forms the basis of pension sharing on divorce settlements.

One circumstance where transfers are commonly being completed is where a scheme’s sponsor is looking to manage its defined benefit risks by offering to provide extra cash if deferred members take transfers, usually referred to as an inducement offer. In contrast to the situation where it is the member who must initiate the transfer process by asking for a quotation, in an inducement offer, the employer, via the

trustees, makes the first move and approaches the member with a pre-calculated transfer value together with the offer of extra cash either in the form of an enhanced transfer or cash in hand.

Although in most cases transfer values need member consent and can't proceed without it, the regulator believes it is important that transfer values are calculated in accordance with the requirements of the legislation. Consequently, we intend to issue guidance to trustees on these new responsibilities, particularly in respect of aspects of the legislation which leave some scope for trustee judgement.

There are also some aspects of transfers which don't fall within the ambit of the revised legislation but which were the subject of GN11, such as the calculation of transfer values which aren't classed as cash equivalents, benefits granted in exchange for a transfer in, and transfers out following a previous transfer in. These are all matters for the trustees and we have provided some guidance on them.

The proposed guidance

The full text of the proposed guidance follows in the next section.

We welcome views on all the guidance but particularly on the following matters:

Options

The legislative intention is that only benefit options which increase the CETV may be included. Some argue that the legislation does not achieve this (it requires added value options but is silent on reduced value options). In paragraph 13 we make a clear interpretive statement supporting the legislative intention.

And in paragraph 14, we add to this by clarifying that reduced value options should not be used to offset added value options.

Discretionary benefits

Although the legislation is silent on this, we suggest that trustees should consult the employer where the employer has the discretion to award a benefit before deciding on the extent to which that discretionary benefit is included for CETV purposes. See paragraph 18.

Investment strategy

We suggest that a scheme's funding strategy should be discussed with the actuary as being potentially relevant to the investment assumptions underlying CETV, particularly the dual interest rate approach to funding (implicitly assuming different investment strategies before and after retirement). Our concerns are that without such considerations, trustees may assume an investment policy which does not appropriately reflect how they in fact intend to invest over the term of a deferred

member's lifetime. For example, in an immature scheme, the expected returns from the current asset allocation of the scheme as a whole might not reflect those expected for a particular member close to retirement. See paragraph 21.

Reductions for underfunding

Reductions to full cash equivalents where a scheme is underfunded on the TV basis are permissive only. We emphasise that trustees should not automatically reduce just because the law permits it. In particular, we suggest that where an employer's covenant is judged to be good and any recovery plan is not too long, trustees should generally not reduce. See paragraphs 35 and 46.

In relation to reductions in the case of underfunding, the actuary is permitted to allow for the wind-up priority order when preparing an insufficiency report. We are giving guidance suggesting that this approach is usually the fair one. See paragraphs 44 to 46.

Quotations in a PPF assessment period

Although transfer values may not be paid during an assessment period, there is no corresponding embargo on issuing statements of entitlement (SoE). In cases which have come to our attention, we have taken the pragmatic stance of telling trustees that we will not take action if they decline to issue SoE (other than where required in connection with pension sharing on divorce) as long as they tell members why. We are now suggesting that this should be usual practice. See paragraph 50.

Disclosure

Although not mandated under the legislation (except in relation to discretions when providing an estimate), we are telling trustees it would be good practice to disclose the transfer basis on request and to tell members what options and discretionary benefits are included in the CETV. See paragraph 69.

Consultation draft

Transfer Values—Guidance to the trustees of private sector occupational pension schemes providing defined benefits

Introduction

Purpose

1. The guidance has been written to help trustees understand and fulfil their new statutory¹ and scheme rule² responsibilities in relation to transfer value matters.
2. As from 1 October 2008, it is the responsibility of the trustees to take the decisions on which the calculation of cash equivalent transfer values (CETV) is based. Previously, the calculation had to be certified by the scheme's actuary as consistent with a professional technical standard. The Board for Actuarial Standards, which has responsibility for technical actuarial standards, has withdrawn [is due to withdraw] the standard relevant to transfer values, designated GN11, as from 1 October 2008. Trustees may make decisions before 1 October 2008 which will affect transfer values calculated after then.
3. Whilst the guidance is primarily aimed at trustees, it will also be relevant to actuaries and others involved with transfer values, such as scheme administrators. It is also likely to be of interest to employers.
4. Trustees may find it helpful to discuss the more technical aspects of this guidance with their actuary as part of their overall discussions on the assumptions to be adopted for calculating CETV.
5. The guidance covers:
 - The calculation of CETV in respect of defined benefits;
 - The calculation of other transfer values in respect of defined benefits which are not CETV as defined in legislation (including cash transfer sums);
 - The calculation of defined benefits granted in exchange for a transfer-in.
6. The guidance does not cover money purchase CETV.
7. This guidance must be read in conjunction with the legislation itself. It does not override the legislation. It is divided into the following eight parts:
 - Part 1: The calculation of CETV
 - Part 2: The best estimate method for calculating CETV
 - Part 3: The alternative method for calculating CETV
 - Part 4: Reducing cash equivalents to allow for underfunding

¹ See The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 (SI 2008/1050).

² A scheme's governing documents (the trust deed and rules) may have provisions permitting or requiring trustees to offer transfers in circumstances not covered by the overriding statutory provisions of the Pension Schemes Act 1993. In addition, scheme rules will address transferring in to the scheme.

- Part 5: CETV for schemes in wind up and in a PPF assessment period
- Part 6: Non-statutory transfers out and Cash Transfer Sums
- Part 7: Transfers into schemes
- Part 8: Practicalities, administrative expenses, presentation and pensions to former spouses or civil partners

Part 1: The calculation of CETV

Background

8. A CETV represents the expected cost of providing the member's benefits within the scheme. In the case of money purchase benefits, this is generally straightforward – it is the accumulated contributions made by and on behalf of the member together with investment returns. In the case of defined benefits, the CETV is a value determined on actuarial principles, which requires assumptions to be made about the future course of events affecting the scheme and the member's benefits.
9. In either case, but more often in relation to defined benefits, in certain circumstances the CETV as described in paragraph 8 may be reduced.

The cash equivalent (defined benefits)

10. The legislation provides for two methods for calculating CETV:
 - A method based on a best estimate of the expected cost of providing the member's benefits in the scheme; and
 - An alternative method where trustees want to pay CETV which are above the minimum amount.

Part 2: The best estimate method for calculating CETV

11. The legislation establishes a framework which provides for the calculation of an "initial cash equivalent" (ICE) which is then adjusted if necessary to arrive at the final CETV available to the member to transfer. The ICE must place a value on the member's accrued benefits together with any options and discretionary benefits that the trustees decide should be included.

Options

12. Most defined benefit schemes give members some benefit options, usually at retirement, other than the 'standard' benefits. For the purpose of calculating CETV, an option is something which can be exercised by the member without needing anyone else's consent (trustees or employer). Common options are:
 - To exchange some pension for a lump sum at retirement;
 - To begin taking pension earlier or later than normal pension age (which might be subject to a reduction or an increase respectively in the amount of pension);
 - To give up some pension in exchange for a higher dependant's pension on death.

13. Only those options which would increase the value of benefits may be included within the benefit for cash equivalent purposes under the best estimate method. The trustees will need to take advice from the actuary over which options would increase the ICE. Two such options are considered further below.
 - The option to exchange (commute) some pension for a cash lump sum at retirement is very commonly taken up by members. However, unless the commutation terms are such as to increase the expected value of a member's benefits, commutation may not be included as an option within the ICE;
 - There may be the option to retire before normal pension age without the need for consent. If so, and the early retirement factors increase the value of the benefit, the legislation requires the trustees to include an allowance for early retirement within the benefits to be valued for ICE purposes. However, in doing so, they are not obliged to assume that the member will definitely select the option. They may allow for the chance that the member will not take up the option, which could be based on their views of the scheme's likely future experience informed by past experience of the proportion of members taking it up.
14. Where an option (which would increase the value of the ICE) is included, trustees should not offset that by another option which on its own would reduce that ICE. For example, where an early retirement option is incorporated, trustees should not reduce the effect of that by assuming that early retiring members will commute pension unless the commutation terms would increase the ICE.
15. Options which require consent should be treated as discretions and dealt with as described below.

Discretionary benefits

16. Many schemes also have some benefits which are not automatic, but which can be awarded at the trustees' and/or the employer's discretion. Trustees must decide on whether, and if so to what extent discretionary benefits are to be included within the benefits to be valued. In doing so, they must have regard to:
 - any established custom for awarding them; and
 - any consent requirements needed (which will usually involve the employer).
17. A typical discretionary benefit is the award of pension increases over and above what the rules of the scheme automatically provide, another is early retirement on favourable terms with consent. Once a discretionary benefit is awarded, it becomes part of a member's accrued benefit. Awarding discretionary benefits sometimes requires the consent of the sponsoring employer.
18. When considering the extent to which discretionary benefits are to be included, trustees:

- should make a decision in relation to each discretionary benefit the trustees can provide under the scheme's rules;
- should understand the relevant scheme rule which provides for the award of the discretionary benefit in question, bearing in mind that they may need to take legal advice;
- may wish to consult any person (usually the employer) whose consent is needed;
- should consider the past history and future intentions with regard to the award of the benefit, taking into account the relevant circumstances (for example, the scheme's funding) which influenced or could influence the award;
- should take into account any agreed policy relating to the award of the benefit; and
- should consider whether allowance is made in the scheme's funding plan (explicitly, or implicitly through the degree of prudence in the funding assumptions) for discretionary benefits, bearing in mind that they may need to take actuarial advice.

Best estimate

19. 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.
20. When deciding on the assumptions for this best estimate, and to put them in a position to make informed decisions, trustees must seek advice from their actuary. They should discuss with their actuary:
 - Whether a particular assumption is likely to be influenced by scheme specific, industry specific, and/or member specific factors. For example, assumptions about the likelihood of a member having a dependant will be influenced by the scheme rule on eligibility for dependants' pensions. And mortality assumptions may be influenced by, for example, the industry in which the employer operates and/or by geographical location (often used as a proxy for affluence);
 - When deciding on demographic assumptions (mortality rates, proportions with dependants, relative ages of dependants), the main characteristics of the scheme's membership which will inform the choice of assumptions;
 - Whether it would be appropriate to subdivide the scheme membership into groups with shared characteristics, such as those adopted for funding purposes, using objective criteria for the purpose of making certain assumptions. For example, it may be appropriate to set mortality assumptions using pension size or location criteria;
 - Relevant scheme, or external data from which average values can be deduced and trends observed. For example, when making an assumption about future improvements in longevity, trustees should discuss emerging

trends from national population data published by the ONS and similar data published by the CMI; and

- Expert opinions on the likelihood of past data remaining valid for the future. For example, economists' opinions on the likely future relationship between bond and equity returns could modify trustees' views based on an analysis of the historic record alone. Trustees may wish to consult their investment adviser on such issues.

Investment strategy

21. 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 (or any similar document where their scheme has not completed its first valuation under the funding regime of the Pensions Act 2004). 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.
22. Assumptions as to investment returns which are used to derive the appropriate discount rates should be net of investment management fees and expenses.

Evidence base

23. Trustees should make evidence-based objective decisions. Of course, evidence in the conventional sense is not available on the future. In this context what we mean by evidence is facts about the past, and opinions about the future based on those facts, which can be objectively used by the trustees to make judgements about the likely course of future events. This evidence can take a variety of forms, including:
 - Past history of investment returns from various asset classes and the relationships between them;
 - Published mortality tables;
 - A scheme's own experience to the extent it is statistically reliable;
 - Published statistics on such matters as the prevalence of marriage and civil partnership, the relative ages of partners, the numbers and ages of dependent children, etc;
 - The opinions of recognised experts; and
 - The output of suitable stochastic models as advised by the scheme actuary.

Consistency with technical provisions

24. Assumptions for the calculation of technical provisions under the scheme funding regime of Part 3 of the Pensions Act 2004 must be chosen prudently. This often means taking a margin on the cautious side of best estimate.

Consequently, it will often be efficient for trustees to consider their CETV assumptions around the same time as their technical provisions assumptions. The two sets of assumptions should be capable of rational reconciliation. That is, it should be possible, starting with the best estimate assumptions behind the ICE, to demonstrate that the funding assumptions are prudent.

Special cases

25. When deciding on the allowances to be made for options and discretionary benefits and in choosing assumptions, trustees should ensure that they consider not only all the standard benefit structures within the scheme but usually also any non-standard benefits which might require separate consideration. This will avoid the need to revisit decisions should such a case become the subject of a transfer request. For example, a member may have a non-standard pension age or pension increases which might require different treatment of early retirement options and an additional assumption respectively.

Reviewing assumptions

26. Trustees should monitor and review the appropriateness of the assumptions underlying the calculation of the ICE.
27. The frequency of monitoring and review should be influenced by considerations of practicality and cost. It would be reasonable for trustees always to review assumptions at the same time as a scheme funding valuation. On the other hand, reviews between valuations should be considered where the ICE is no longer within a reasonable margin of materiality of a best estimate. Trustees should instruct their actuary to alert them when this appears likely to be the case.
28. Circumstances justifying an inter-valuation review include:
 - A significant change in investment policy;
 - A change in policy regarding the exercise of discretions;
 - Becoming aware of significant experience differences in respect of demographic assumptions; and
 - When new standard mortality tables are published or other mortality information released.
29. Trustees may decide to incorporate some form of market yield based adjustment into the calculation of the ICE with the aim of maintaining the best estimate level in the face of normal market movements. Nevertheless, trustees should continue to monitor whether the assumptions remain appropriate in changing market conditions.

Part 3: The alternative method for calculating CETV

30. Although the legislation sets a floor on transfer values; it also provides a basis for paying higher amounts. Trustees might set CETV at a higher level than under the “best estimate” basis where, for example:
 - The scheme’s rules require it;

- A shared cost scheme³ is in surplus on its funding basis;
 - The employer asks the trustees to do so; or
 - The trustees and the employer agree that it would be cost effective to adopt assumptions which are overall likely to produce higher CETV than under best estimate, rather than to go into the level of detail necessary to ensure best estimate; or
 - The trustees consider it is reasonable to do so after consulting with the employer.
31. If the employer has asked the trustees to calculate CETV at higher than “best estimate” values, the trustees must still consider whether it is proper to do so. They may need to take legal and actuarial advice before deciding. One consideration for the trustees should be whether the scheme is fully funded in relation to the statutory funding objective⁴ and if not, the pace at which any under-funding is due to be made good.
32. The precise way of determining alternative, higher, CETV is a matter for the trustees. They will need to discuss it with their actuary. One possible method is to use one or more assumptions on the prudent side of best estimate but otherwise adopting the same approach to options and discretions as under the best estimate method. If this approach is adopted, the trustees will need to have gone through the process of deciding what options to allow for and discretionary benefits to take into account as for the best estimate method. Whatever approach is adopted, the trustees must be able to check that the resulting CETV is higher than it would be under the best estimate method.
33. Where the trustees decide to use an alternative method for calculating CETV they may take the view that paying them at full value would prejudice the security or remaining members because of the current state of funding of the scheme. In these circumstances, the trustees may commission an insufficiency report analogous to that under the best estimate method but with liabilities calculated on the chosen assumptions. Where this is the case, particular care must be taken to ensure that any reduced CETV on the alternative method are higher than CETV on the best estimate method, though the latter might also be reduced if the trustees decide and if that is justified by an insufficiency report on the best estimate basis.

Part 4: Reducing cash equivalents to allow for underfunding

Insufficiency reports

34. In certain circumstances, trustees are permitted to offer transfer values which are less than the ICE under the best estimate method. One of the permitted reductions is to allow for the funding situation of the scheme. However,

³ A shared cost scheme is one where the members share the cost with the employer rather than the more usual type of scheme under which the members pay a fixed contribution with the employer paying the balance of the cost.

⁴ See section 222 of the Pensions Act 2004 and paragraph 26 of the Regulator’s code of practice number 3: Funding defined benefits.

trustees may only reduce cash equivalents for this reason after obtaining an assessment by the actuary of the funding of the scheme using the transfer value assumptions and known as an “insufficiency report”⁵. Reductions to cash equivalents to take into account scheme funding must not exceed the maximum reduction identified in the insufficiency report.

35. However, although trustees may reduce cash equivalents to allow for low funding levels, they are not obliged to do so. The fact that the actuary has prepared an insufficiency report on the instruction of the trustees should not in itself be taken to be a recommendation that cash equivalents should be reduced. Matters trustees should take into account when deciding to reduce cash equivalents include:
- The degree of under-funding. The worse the funding position, the more necessary it may be to reduce cash equivalents to protect remaining members;
 - Their assessment of the strength of the employer’s covenant. The stronger the covenant, the less the trustees may feel it necessary to reduce transfers;
 - The structure of any recovery plan in place. The sooner a funding deficiency is being addressed, the less necessary reductions may be;
 - Whether there are any contingent assets in place and if there are, their form⁶. If contingent security is available to plug a funding gap if the employer were to become insolvent, reductions in transfer values may be unnecessary; and
 - Whether the employer has undertaken to make a compensatory payment to the scheme each time a transfer is paid at an unreduced level.
36. Trustees should ask the actuary to advise on one or both of the following as appropriate:
- The implications of not applying a reduction where one would be permitted;
 - The implications of applying a lesser reduction than would be permitted.
37. An insufficiency report (or a replacement insufficiency report following a scheme funding valuation) is not required unless the trustees wish to consider applying reductions to cash equivalents.

When to commission an insufficiency report

38. It will usually be convenient to commission an insufficiency report at the same time as, and with the same effective date as, a scheme funding valuation. Indeed, any reductions to initial cash equivalents being applied by virtue of an insufficiency report must cease as soon as a fresh funding valuation is received. If the trustees wish to continue reducing initial cash equivalents they may only do so after receiving a replacement insufficiency report with effective date no earlier than that of the new valuation (and the reductions must be based on that new insufficiently report).

⁵ See regulations 7D(2) and 7E(4) and Schedule 1B of the Occupational Pension Schemes (Transfer Values) Regulations 1996 as amended with effect from 1 October 2008.

⁶ See the Regulator’s ‘Guidance on the role of contingent assets in scheme funding’, available from our website.

39. If trustees wish to consider reducing cash equivalents because of under-funding before they have received their first scheme funding valuation⁷, they must either commission an insufficiency report or, where appropriate, base reduction on a GN11 report (see next paragraph).
40. A so-called *GN11 report*⁸ which was prepared prior to 1 October 2008 under the legislation current at the time may be treated as an insufficiency report at the discretion of the trustees. This is likely to be appropriate where:
- The effective date of the report is recent enough that the funding position can be expected not to have materially changed since then;
 - The assumptions adopted for that report are sufficiently close to assumptions adopted by the trustees for the calculation of transfer values on or after 1 October 2008; and either:
 - the actuary advises that in his or her opinion any resulting maximum reductions to initial cash equivalents would not be materially different to those which would result from an insufficiency report, or
 - the trustees wish to apply a lesser reduction than the maximum permissible and still need to be comfortable that it is appropriate and the actuary advises that the GN11 report provides that comfort.
41. An insufficiency report may be commissioned by the trustees at any other time. Since funding deficiencies revealed at valuations must be addressed by recovery plans, the need for reductions in transfers because of poor funding should generally diminish with time. However, in some circumstances a new insufficiency report may be needed. These circumstances include:
- When the employer's covenant appears to have weakened such that trustees wish to revisit a previous decision not to reduce transfers;
 - When economic conditions suggest that a deficiency may have arisen or worsened since the last valuation;
 - When for any other reason it appears that a deficiency may have arisen or worsened since the last valuation;
 - Following a change of assumptions consequent upon a review (see paragraph 30 above).
42. Since funding is normally expected to improve between valuations – at least in respect of under-funded schemes where recovery plans are in place – a reduction to a cash equivalent which is appropriate just after the last valuation, may no longer be appropriate as time passes. This situation could be addressed by trustees in different ways, for example:
- By commissioning further insufficiency reports as and when the actuary suggests that the funding position (in relation to transfer values) has improved by an agreed margin;

⁷ Under section 224 of the Pensions Act 2004.

⁸ A GN11 report is a report by the actuary in accordance with section 4 of actuarial guidance note GN11 (adopted by the Board for Actuarial Standards on 6 April 2007 and withdrawn with effect from 30 September 2008).

- By setting reductions expected to be appropriate on average between valuations (since reductions do not have to be set at the full amount permitted by an insufficiency report); or
- By setting reductions at the full amount permitted by the insufficiency report but reducing the level of these at intervals based on approximate calculations by the actuary.

Wind-up expenses

43. When comparing assets with liabilities for the purpose of an insufficiency report, the actuary may make reasonable allowance for the estimated cost of winding up the scheme (and deducting this from the assets). Although this decision is one for the actuary, the trustees should expect the actuary to consult them. Circumstances where it is likely to be appropriate to make an allowance for the expected cost of winding up the scheme include:
- Where the scheme is expected to enter wind up shortly; or
 - Where the employer's covenant is acknowledged to be very weak so that a wind-up is a significant possibility over the near term.

Priority order allowance

44. Reductions to ICE are permitted with the aim of retaining parity in benefit security between those transferring and those remaining in the scheme. Benefit security for remaining members is assessed by comparing the value placed on liabilities (using the assumptions chosen for calculating initial cash equivalents) with the value of scheme assets on the assumption that no further money would be available to the scheme. When a scheme winds up, assets are used to secure benefits in a certain order (the priority order). Broadly, the position since 6 April 2005 is that assets must first be used to secure benefits up to the level of PPF compensation. If there are any assets left, they are used to secure any remaining scheme benefits.
45. When preparing an insufficiency report, the actuary may allow for the different categories of benefit under the priority order. Whilst this is a decision for the actuary, trustees should expect the actuary to discuss the matter with them.
46. Trustees need to bear in mind that the objective of reductions in full cash equivalents is to protect the security of remaining members over the short term. Where an employer's covenant is judged to be strong, and any funding shortfall is being remedied over a reasonably short period, trustees should not normally reduce CETV. On the other hand, where there are concerns about the employer's covenant over the term of an agreed recovery plan⁹, trustees should consider reductions in order to provide similar security to transferring as to remaining members. If the scheme were to have to wind up without sufficient assets, members' benefits are protected in a certain priority order. Consequently, it should usually be assumed that the more equitable treatment is to take account of the priority order when preparing an insufficiency report

⁹ A recovery plan must be put in place whenever a funding valuation reveals a shortfall. See the Regulator's code of practice number 3: Funding defined benefits, paragraphs 99 to 108.

unless combining categories would not give rise to significantly different degrees of reduction in the initial cash equivalent for any member.

47. The actuary may make reasonable approximations when preparing an insufficiency report. This is particularly relevant when estimating the PPF compensation level, where absolute precision could involve considerable expense and complexity. The trustees should discuss with their actuary the nature of the approximations made.

Part 5: CETV for schemes in wind up and in a PPF assessment period

Schemes in wind-up

48. The new legislation applies where the scheme is in wind-up, though a scheme's investment strategy is likely to differ markedly from what it would otherwise be and this will be reflected in the best estimate investment assumptions.
49. Where the scheme is being wound up, cash equivalents cannot be reduced in accordance with an insufficiency report. Rather, they may be reduced to the extent necessary to comply with the legislative requirements for the allocation of assets on a wind-up. Many schemes in wind-up will not have sufficient assets to secure all benefits in full and in these circumstances the CETV will, in effect, represent the members' shares of the assets of the scheme taking into account:
 - The estimated future costs of completing the wind-up;
 - The cost of securing benefits with insurance companies;
 - The applicable priority order (which will depend on the date wind-up formally commenced);
 - The likely proceeds from the sale of scheme assets;
 - Any likely payments from the employer; and
 - Any contingency margin the trustees consider reasonable.

Schemes in a PPF assessment period

50. Schemes in a PPF assessment period are not normally permitted to pay transfer values, though there is no explicit exemption from the requirement to provide a CETV quotation (known as a Statement of Entitlement). However, unless the quotation is needed to comply with pension sharing legislation, it will usually be appropriate to inform inquiring members that as transfers are not permitted, the scheme will not be providing these quotations. The Regulator will not seek to take action where members have been kept informed.

Part 6: Non-statutory transfers out and Cash Transfer Sums

51. Some schemes permit transfers which are not covered by the cash equivalent legislation; for example, a transfer in respect of a member who is within one year of normal pension age. Unless scheme rules specify how such transfer values must be calculated, the trustees must decide on their approach.

52. Since 6 April 2006, early leavers with between 3 months and 2 years of pension scheme service but who do not qualify for a preserved benefit must be provided with the option of a cash equivalent called a Cash Transfer Sum (CTS). The legislation covering the calculation of CTS broadly parallels that covering CETV¹⁰.
53. As a consequence of the legislation, the same basis should normally be adopted for the calculation of CTS 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.

Part 7: Transfers into schemes

54. There is no statutory obligation for a trust based scheme to accept transfers-in and provide benefits in exchange. Some schemes do offer defined benefit transfer credits, typically in the form of 'added years' counting for benefits on the scheme's normal formula. Other schemes offer money purchase benefits in exchange for transfers, in which case no issues arise as to assumptions for determining benefits.
55. The calculation of a transfer credit will usually be addressed by the scheme's rules. These may give the trustees a decision making role. In exercising this role the trustees should take into account the following principles:
- From a transferring member's perspective, the transfer credit should be fair value for any transfer received;
 - A transfer credit should not be expected to prejudice the security of existing members' benefits; and
 - A transfer credit should not be expected to require additional funding from the employer in the long term.
56. Within these principles, the trustees will need to establish assumptions so that the transfer credit can be actuarially determined from the transfer value received. Choosing best estimate assumptions for the cost of providing the benefits within the scheme will usually be appropriate. However, there is potential for a 'selection' effect in these cases in that it is likely that the option will be particularly attractive to those members who expect their pay to increase at higher than average rates. It would be appropriate for trustees to take this into account.
57. Although in general, assumptions should not vary between individual members, account may be taken of identifiable characteristics expected to have a bearing on the eventual cost of benefits. These should be based on evidence and could include:
- The known marital (or civil partnership) status of the member and the age (and sex) of the spouse/partner; and

¹⁰ See sections 101AA to 101AI of the Pensions Schemes Act 1993 and the Occupational Pension Schemes (Early Leavers: Cash Transfer Sums and Contribution Refunds) Regulations 2006 (SI 2006/33) as amended.

- The employment category of the member.
58. Trustees should make it clear to potential transferring members what assumptions are being made in the calculation of the transfer credit offered. Individuals considering transferring into the scheme should also be advised to take their own financial advice.
59. Where a member's pension is shared on divorce and the former spouse is to remain in the scheme, the award of benefits to her (or him) must be consistent with the benefits which are awarded where a person transfers into the scheme. Where a scheme does not accept transfers in, the award of benefits to the former spouse should nonetheless reflect the principles in paragraph 55.

Transfer out following a previous transfer-in

60. If a member who has been granted a defined benefit transfer credit leaves the receiving scheme shortly afterwards and wishes to transfer out, the calculation of an appropriate CETV can be problematic. In these circumstances, the transfer value offered in respect of the previously transferred-in service can be lower, sometimes significantly so, than the original transfer-in received or than the value of the transferred-in service, particularly when the transfer credit was in the form of added years.
61. Trustees of schemes offering 'added years' should discuss this issue with their actuary and decide how to deal with these members. A common approach is to provide some form of underpin based on the original transfer adjusted for investment returns.

Part 8: Practicalities, administrative expenses, presentation and pensions to former spouses or civil partners

Practicalities

62. In all but the smallest schemes, trustees are likely to find it convenient and cost effective for the scheme's administrator to calculate transfer values using instructions provided by the actuary. Trustees should discuss with the actuary and the administrator how best to ensure that calculations are carried out correctly. This might be achieved by the actuary undertaking sample checks on a range of cases. In addition, it would be good practice for trustees to have transfer values over a certain amount routinely checked.
63. Even where the scheme's administrator normally calculates transfer values, it may be more cost effective for the actuary to undertake the calculations for cases involving non-standard benefits, or for sections of a scheme not expected to generate many transfer quotations.

Allowance for administrative expenses

64. Trustees are permitted to reduce an ICE under the best estimate method to reflect reasonable administrative costs associated with the transfer process. However, if they decide to do so they must offset against those costs any

reasonable administrative savings for the scheme. The trustees must disclose any such reductions made when providing the statement of entitlement¹¹.

65. Administrative costs are limited to dealing with a typical transfer on the assumption it will go ahead. These costs can usually be estimated based on past experience of dealing with members transferring to a range of receiving schemes.
66. The administrative savings which must offset any costs will be the capitalised value of the expected cost of:
 - administering the deferred pension up to retirement;
 - dealing with a deferred member at retirement; and
 - administering the resulting pension and dependant's pension after retirement.

Presentation

67. When a cash equivalent quotation is issued to a deferred member of a defined benefit scheme by way of a Statement of Entitlement, trustees must alert the member to the fact that information about transfers that may assist the member in making a decision is available from:
 - The Financial Services Authority (see in particular http://www.moneymadeclear.fsa.gov.uk/pdfs/risk_transfers.pdf)
 - The Pensions Regulator (see <http://www.thepensionsregulator.gov.uk/pdf/inducements.pdf>); and
 - The Pensions Advisory Service (see in particular http://www.pensionsadvisoryservice.org.uk/occupational_pensions/transfer_s/) and http://www.pensionsadvisoryservice.org.uk/pension_rights/transfer_incentives/).
68. The regulator's guidance on inducement exercises¹² is primarily intended for trustees, employers, and advisers but scheme members may also find it helpful.
69. It would be good practice for trustees to:
 - make available reasonable details of the scheme's relevant transfer value basis (including the underlying assumptions) on request from a member or a member's financial adviser; and
 - provide with statements of entitlement (and any transfer value estimates to active members¹³) a note of which options and discretionary benefits have been included within the ICE where the best estimate method is adopted.

¹¹ A statement of entitlement is the formal quotation of the available transfer value provided to a defined benefit member on request. See section 93A of the Pension Schemes Act 1993.

¹² An inducement exercise in this context refers to an exercise initiated by a scheme's sponsoring employer with the aim of encouraging eligible members to take a transfer out of the scheme by offering a cash payment or an enhancement to the normal transfer value.

70. Because benefits deriving from contracting out of the State second tier pension (GMP and post 6 April 1997 service) when transferred to a money purchase scheme are still subject to certain restrictions, trustees should ensure that the amount of the transfer relating to these benefits is identified.

Former spouses' or civil partners' pensions

71. The legislation governing pension sharing on divorce makes provision for benefits for a former spouse or civil partner to be either provided within the scheme concerned or by way of a transfer to another pension arrangement. However, if transfers are being reduced because of underfunding, the transfer option is only permitted if the former spouse or civil partner has refused an offer to provide an unreduced pension credit within the scheme.

¹³ See Regulation 11(1) and Schedule 1 of The Occupational Pensions Schemes (Transfer Values) Regulations 1996. It is a legislative requirement to provide information on discretionary benefits included in an estimate of a cash equivalent.

Responding to the consultation

Responses may be made in either of the following ways:

- By email to: transfervaluesguidance@thepensionsregulator.gov.uk (preferably attached documents should be in Word format)
- By post to: Erhan Kalyon, The Pensions Regulator, Napier House, Trafalgar Place, Brighton, BN1 4DW

We may need to share the feedback you send us within our own organisation or with other government bodies. We may also publish this feedback as part of our response to the consultation. If you wish your comments to remain anonymous, please state this explicitly in your response.

If you wish your response to be kept confidential, please make this known and we will take the necessary steps to meet your request. However, please be aware that, should we receive a formal request under Freedom of Information legislation, we may be required to make your response available.

When responding, please advise whether you are responding as an individual or on behalf of an organisation (and if the latter, which organisation).

The closing date for this consultation is 19 September 2008.

The consultation has been limited to a period of six weeks on the grounds that we have worked with some representative industry bodies in preparing this draft of the guidance for formal exposure.