

Guidance on calculation of  
cash equivalent transfer values  
Consultation report

November 2008

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# 1. Introduction

In April 2008 the Department for Work and Pensions (DWP) published new regulations relating to the calculation of transfer values from occupational defined benefit (DB) schemes. This followed a policy decision to transfer responsibility from scheme actuaries to trustees, and to mandate a 'best estimate' approach and an extended consultation process summarised in the DWP's final consultation response.

To help trustees to meet the requirements and to assist in the formation of good practice, the Pensions Regulator elected to publish guidance in this area. The regulator believes it is important that transfer values are calculated in accordance with the requirements of the legislation and wants to assist trustees in meeting those requirements.

The regulator also believes that, while a degree of discretion has been provided to trustees when formulating transfer values appropriate for their scheme circumstances, trustees will need to establish and develop good and fair practice in this area for the benefit of leaving and remaining members. Our guidance therefore includes areas of consideration beyond the minimum requirements, and our expectations in forming good practice.

The regulations, as drafted, form the basis of expectation upon trustees in this new regime. In producing guidance, the regulator has also considered the policy intention underpinning the regulations - to assist and enable practical application and provide a comprehensive starting point for trustees developing new procedures in this area.

Due to overwhelming requests from our stakeholders to have final guidance available before the effective date of the regulations, we decided to make the release of the final guidance itself our priority, publishing it on 29 September 2008. As a result, this consultation response document was published after the release of the final guidance.

We noted the requests by some respondents not to make major changes to the final guidance, as decisions had been made and/or procedures set up by trustees based on either the underlying regulations or the draft guidance in the run up to the effective date of the regulation.

However, we had to balance this with the need to create a durable document based on wide feedback. We have, therefore, fully considered all comments and their implications in determining our view. While the wording has been refined in a number of areas, in response to many helpful comments, we do not believe that there have been major changes of message from the original draft.

In creating the draft we undertook a pre-consultation exercise with some key stakeholders, with the aim of providing a more developed and comprehensive draft for consideration by all interested parties.

This document outlines the full consultation process, key consolidated comments, our views on these comments and how we have dealt with them.

We would like to thank all those who have taken the time to consider the draft guidance and give us the benefit of their views.

## **2. The draft guidance**

The draft guidance was focused on providing guidance to trustees calculating transfer values for DB schemes under the new requirements. This included considerations of some scheme specific circumstances, such as winding up, but we did not extend the scope to cover all implications.

In the draft, we explored the two statutory bases for calculating CETVs (Best Estimate and Alternative). As we did so, we listed the key considerations we believed trustees should address in reaching the appropriate decisions for their scheme circumstances.

There are also some aspects of transfers which do not fall within the ambit of the new regulations but which were the subject of GN11<sup>1</sup>, such as the calculation of transfer values which are not 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 trustees, which we included in the draft.

## **3. The consultation**

We issued the draft guidance for public consultation on 8 August 2008. The consultation period lasted for six weeks, ending on 19 September 2008. Pre-consultation, to assist drafting, took place in the months of May and June 2008.

### **3.1 Pre-consultation**

We undertook a pre-consultation exercise ahead of publishing the consultation document, to test regulatory thinking with some of our key stakeholders from different segments of the industry concerned with this area. This was to enable us to provide a more developed and comprehensive draft for public consultation.

### **3.2 Public consultation**

The public consultation was intended to refine the insights gained from pre-consultation and give trustees a foundation to start developing processes and procedures ahead of the effective date of the new requirements, based on some insight into regulatory thinking.

The consultation welcomed comments from all interested parties, both individuals and representative bodies, for consideration when we were producing the final

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<sup>1</sup> GN11 was a guidance note issued by the actuarial profession which governed transfer value calculations up to 30 September 2008

guidance. While we welcomed comments on all areas on the guidance, we specifically invited comments on six focus areas – key areas of practice where trustees' discretion could be applied. These areas were:

- options
- discretionary benefits
- investment strategy
- reductions for under-funding
- quotations in a PPF assessment period
- disclosure.

Appendix A contains detailed outlines of the consultation questions. Key and consolidated responses and our approach to them are outlined below.

## **4. The outcome of the consultation**

### **4.1 Focused consultation responses**

Within the focus areas, the most substantial responses were addressed to the issues of reductions to under-funding and options. These areas generated a healthy debate with many strong views submitted. While many of these views were aligned, in each case there were equally strong contrary opinions which we needed to balance.

#### **4.1.1 Options**

Some respondents were concerned at our approach of only including options that increase the value of the quotation. While we acknowledge the argument that our approach of not allowing for options that reduce an initial cash equivalent may be considered illogical in a 'best estimate' method, this argument was continually raised and debated in formation of the regulations and we consider it to be settled. Our guidance reflects the final form of the regulations.

The approach outlined in the guidance is also consistent with the practice outlined as standard actuarial practice in GN11, and therefore does not represent a deviation from existing practice.

##### **4.1.1.1 Options treated as discretions**

Some respondents noted that where commutations require trustee consent under the scheme rules, these could be treated as discretionary, allowing transfer values to be reduced to the extent that the ultimate cost to the scheme of providing the benefits would be reduced by commutation. We would contend that if a decision is made as a matter of course, there could be an argument about whether the provision is truly discretionary or not. In the cases where this decision is a matter for trustees, they should consider their fiduciary duty to their members.

##### **4.1.2 Discretionary benefits**

The regulations were silent on this matter but we have suggested that trustees consult with the employer on their inclusion or exclusion in setting transfer values.

We included an outline of the considerations trustees should make when determining the extent to which discretionary benefits are included. This approach has attracted broad support from respondents.

### **4.1.3 Investment Strategy**

We have reinforced the principle of setting assumptions that reflect the investment strategy of the scheme. We have struck a balance between asserting this principle and avoiding excessive prescription. Trustees will need to make reasonable assumptions that best reflect the cash required to make provision for their member's benefits. This may include, as in our example, use of dual discount rates where members are approaching retirement, as may be reflected in the scheme's Statement of Investment Principles.

Most respondents agreed with having broad principles that trustees can apply to the specific circumstances of their scheme when determining the appropriate assumptions for their membership. We believe that adding a further level of detail to this area of this guidance would be overly prescriptive and may constrain trustees from making reasonable judgements applicable for their circumstances and adapting these to the changing circumstances of their scheme.

### **4.1.4 Reductions for under-funding**

There was a range of divergent views on our policy decision to suggest that trustees should not normally consider reductions on transfer values except for those schemes in adverse funding circumstances.

We maintain our view that, where a scheme is under-funded but is supported by a strong employer who will be addressing that deficit over a short period of time, reducing a member's transfer value on account of short term circumstances is inappropriate.

However, we recognise that considering whether to reduce transfer values at specific times for under-funding is a delicate matter of judgement. There are no absolutes in determining whether reductions are appropriate or not. The regulator would expect trustees to consider fully the circumstances and implications and be able to rely on solid justification for any reductions made.

Some respondents have expressed concerns that the views expressed by the regulator are an extension to the requirements, could be seen as 'gold-plating', and are a new direction for the regulator when providing guidance. We maintain that our guidance is just that, guidance, and is there to assist trustees in making the right decisions for their scheme's circumstances. We would expect trustees in any area of governance and administration to formulate practice that not only is in keeping with the minimum requirements but also acknowledges their fiduciary duties to act in the interest of all their beneficiaries, including those who wish to exercise a right to transfer.

Concerns were also expressed that we gave undue attention to the issue of the priority order. However, we think this is consistent with our overall position – if there is enough genuine concern to warrant a reduction in the first place then the

implication is that wind-up in insolvent circumstances is a real possibility. In that situation, the priority order is clearly relevant. We do expect schemes to be pragmatic in the level of detail applied to priority order adjustments, but simply ignoring them appears inconsistent with the motivation for reduction of initial cash equivalents in the first place.

#### **4.1.5 Quotations in a PPF period**

Our statement on this issue is an example of where the regulator will take a pragmatic approach to enforcement of the requirements, owing to the specific circumstances of the scheme. We maintain that if members are informed of the circumstances and reasons for not processing their request, outside of pension sharing on divorce cases there should not be any objections. We have had support for our approach from respondents.

#### **4.1.6 Disclosure**

Mostly, respondents supported our stance on disclosure. Some respondents stated that the guidance went further than what had been required by the regulations, and was at odds with DWP deregulation in this area. While it is not a requirement to inform members of the basis of their transfer value calculation, we believe this transparency can assist members in understanding how the transfer value relates to their entitlement and helps them decide how to exercise their options.

Some respondents suggested that the provision of these details could confuse or burden members with information they may find difficult to understand, or make the provision more onerous for the scheme. We accept that this is a sensible concern and have responded by suggesting that trustees may want to make this information available only on request. However trustees may opt to provide the information as a matter of course. It may be that over time financial advisers will routinely ask for this information.

### **4.2 Other comments**

#### **4.2.1 Transitional issues and timing**

Concern was raised by a number of respondents about the timing of the release of this consultation and its impact on trustees preparing for the effective date of 1 October 2008.

There is no requirement for the regulator to publish guidance in this area. We have done so to assist trustees in understanding and building good practice in the production of transfer values. We recognise that, by doing so, our guidance may diverge from decisions already taken by trustees implementing procedures ahead of the effective date for these requirements. We would expect good practice to evolve over time as trustees develop their processes in line with new regime. As a minimum we would expect the legislative requirements to be met. Where issues are raised with us around transitional difficulties, we will take due consideration of the merits of each case when we decide our response.

We published the guidance in draft form approximately two months before the regulations were due to commence, to outline our position on this matter. We had held a pre-consultation exercise with the industry to shape this draft guidance and to produce a position with a firm basis.

Readers of the draft guidance at that time would have been aware that it amplified the legislation published earlier in the year and provided enough indications to start forming practice in preparation for the new requirements. While we accept that it would have been helpful to have the final guidance further in advance of the effective date of the legislation, we do not believe the actual timing to be detrimental to long term compliance with the regulations or guidance.

#### **4.2.2 Pension Sharing on Divorce**

There were a number of responses on pension sharing on divorce. While we have considered these responses in the context of this guidance, the focus of this guidance is not to explore fully the difficulties around this specific area. Although the guidance is relevant to those involved with pension sharing, it is not intended as a guide on this aspect of regulation and the issues surrounding it.

We did respond to comments that we had focused narrowly on some particular divorce matters without adequately addressing the full range of issues. We have therefore removed any detailed comments on divorce issues, which we believe are properly the responsibility of other authorities.

#### **4.2.3 Status of the guidance**

This guidance does not have the same legal status as a statutory code of practice issued by the Pensions Regulator. It does, however, give our regulatory view on how we expect trustees to approach certain aspects of the new transfer framework.

Where we have used language advising trustees what *should* be done in addition to the legislative requirements, we consider this good practice and consistent with the expectations of the regulator.

#### **4.2.4 Transitional issues around insufficiency reports**

It is recognised that in some cases a particular difficulty arises for schemes which are poorly funded but have not yet completed a Part 3 funding valuation. Paragraph 39 of our guidance seeks to clarify that the regulator considers both old and new style reports, for the purposes of reducing transfer values, to be an acceptable approach where relevant, even if this is not strictly in compliance with the current regulations. While the regulator can not sanction a breach of the regulations, we will take a pragmatic approach to the merits of a case and circumstances that give rise to it.

#### **4.2.5 Reconciliation with scheme funding**

Concerns were raised regarding the link we established with 'best estimate' and 'prudent' assumptions. Our intention here was to help trustees come to reasoned assumptions that could be seen as justifiable in the context of assumptions used for other scheme purposes. We did not intend to prescribe a formal reconciliation, which we recognise can raise practical difficulties. While we still maintain that the

consideration of rational reconciliation is a helpful tool for making decisions in this area, we have removed direct references to this principle, to avoid implying that extra requirements are being placed on trustees.

#### **4.2.6 Transfers in / out**

In response to comments made, we have changed the wording in this area to ensure clarity that the preference is for consistency between these.

#### **4.2.7 Existing quotes**

The legislation is silent on quotations provided before 1 October 2008 and their validity after this date. The regulator has decided not to cover transitional issues in its guidance and on this issue does not have a view either way. Trustees who have provided quotations before this date may wish to seek legal advice, and will need to take a view on whether they will honour those quotations or have grounds, and consider it in the interests of the membership, to re-issue them under the new basis.

## **Appendix A – Consultation questions**

We asked for 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.

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 CETVs, 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 under-funding**

Reductions to full cash equivalents where a scheme is under-funded 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 under-funding, 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)

## **Appendix B: List of respondents to the public consultation**

**ACA** – Charles Young  
**Actuarial Profession** – Robert Hails  
**Aegon** - Kate Smith  
**Albert Goodman Pension Consultants** - Clive Weir  
**Aon** - Jillian Pegrum  
**Aries Training & Information Systems Ltd** - Ian Neale  
**Bridges UK** - Stephen Bridges  
**Buck Consultants** - Martin Rawe  
**Capita Hartshead** - Andrew Short  
**Church's Financial Planning** - Paul Cobley  
**Deloitte** – Orlando Harvey Wood  
**Eversheds** - Tim Smith  
**Hamish Wilson & Co LLP** - Gary Tansley  
**Hewitt** - Peter Williams  
**HSBC** - Stewart Lee  
**Hymans Robertson LLP** - Brian Nimmo  
**JLT Benefit Solutions** - Phil Wadsworth  
**John Boocock FCA**  
**KPMG** - Roger Higgins  
**Legal & General** - Bill Lumb  
**Mercer** - Jane Biggerstaff  
**Mercury Financial** - Phil Gammond  
**Mills & Reeve** - Philip Way  
**Norwich Union** - Emma Ward  
**PMI** - Vince Linnane  
**Punter Southall** - Jane Beverley  
**PWC** – Peter Tompkins  
**Sacker & Partners**  
**SAIC** - Suli Yacoob  
**SAUL** - Catherine Quinn  
**Scottish Life** - David Dickson  
**SPC** - John Mortimer  
**Towers Perrin** - Micheal Parker  
**Watson Wyatt** - Graham McLean  
**Xafinity Consulting** – Peter Sayers