

Enhanced Transfer Value Exercises

Background

All non-pensioner members of defined benefit pension schemes are entitled to ask to transfer the value of their benefits out of the scheme. The transfer value paid is usually the best estimate of the cost of providing the benefits from the scheme, so that the affect of a member taking a transfer can be cost neutral to the scheme. However, in recent months, many employers have been considering, and carrying out, enhanced transfer value exercises whereby pension scheme members are offered a financial incentive in return for transferring their benefits away from the pension scheme.

Enhancement offer to members

With this type of exercise, members are offered a cash equivalent transfer value (CETV) in excess of the standard CETV that they would normally be entitled to from the scheme. A 'transfer value analysis' carried out by an independent financial adviser will indicate the critical yield, or investment return, which would be sufficient to provide broadly the same benefits from investment in a defined contribution arrangement, than the retirement benefits available from the final salary scheme. The level of enhancement to the standard CETV is often set so that the transfer value analysis will produce a sufficiently low critical yield, e.g. 6% or 7% pa, for an independent financial adviser to be able to advise the member to transfer their benefits.

These exercises do involve some risks for members and it is therefore important that they are provided with the appropriate information in order to make an informed judgement on the offer being made to them. In order to enable the members to fully understand the offer, it is appropriate for the employer to pay for the cost of independent financial advice to be provided to each member.

Benefits for the sponsoring employer

An enhanced transfer value exercise is often designed to improve a scheme's funding position and also to reduce the scheme's exposure to volatility in the funding position. The rationale is that so long as the total payments made are less than the 'funding cost' of providing these benefits, the funding level will improve. The measure of funding level used is likely to be the buy out or solvency funding level which values the cost of securing the benefits with an insurance company or similar organisation, and will be much higher than the CETV cost. These exercises are therefore often referred to as 'liability reduction exercises'.

Example of enhanced transfer value offer

A member aged 45 has a pension entitlement of £7,500 pa as at the date of leaving service and has a normal retirement age of 65.

The standard CETV offered by the scheme is £75,000. An independent financial adviser is unlikely to recommend transfer as the critical yield, or investment return required, on this standard transfer value over the next 20 years to provide benefits of similar value to those from the scheme could be as high as 10% pa.

However, offering an enhanced CETV of £110,000 brings the required yield down to 7% pa and, along with consideration of other factors relevant to the individual member's financial and personal circumstances, can result in the financial adviser recommending that the member accept this offer.

The employer does have to fund the £35,000 increase in the CETV (47% enhancement) and the approximate £1,000 - £1,500 cost of financial advice, but these amounts are much less than the £80,000 say of additional costs required to buy out the liabilities with an insurance company.

Management of Enhanced Transfer Value Exercises

Some of the steps required to progress an enhanced transfer value exercise and the issues to be considered by the various parties involved are listed below.

- Discussion between all parties, including the Independent Financial Adviser (IFA), and the employer to understand rationale for carrying out the exercise
- Provision of a set of sample calculations indicating typical levels of enhancement required to reach acceptable critical yield
- Analysis of non-pensioner members of the scheme to determine which categories of members are to receive the offer. It is likely that the actively employed deferred members are considered separately from the ex-employee deferred members.
- The employer receives advice on the form of enhancement to be offered
- Clarification of all costs of the exercise is sought by the employer
- The employer decides to offer enhanced CETV to chosen groups of members
- Communication material for members is drafted
- The trustees of the scheme are informed of the exercise, with copies of communication material passed to the trustees for comment
- Compliance with the Pensions Regulator's guidance is confirmed
- Initial letter to members is drafted, agreed and issued
- On site presentation(s) to actively employed deferred members is planned and delivered
- IFA has (an initial) 'one to one' meeting with interested members, at which a Confidential Fact Find is completed
- IFA produces a Transfer Value Analysis Report recommending transfer (if requirements are satisfied), either sent to member or presented at second 'one to one' meeting
- If the member accepts the offer, IFA provides advice on the investment of the enhanced CETV
- The employer pays enhancement to the scheme as special contribution
- The administrator of the scheme pays enhanced CETV direct to the insurance employer provider of policy being used to receive the CETV.

The Pension Regulator has produced its own guidance on this issue and this Technical Note should therefore be read in conjunction with the guidance document.

The design, communication and implementation of an enhanced transfer value exercise can be complex and will depend on the specific requirements of the employer and the scheme. Thomson Dickson Consulting has extensive experience of advising clients on the use of liability reduction exercises.

The information in this note should not be relied upon or taken as an authoritative statement of the law.