

Cash Equivalent Transfer Values

Introduction

The framework for calculating Cash Equivalent Transfer Values (CETVs) changed from 1 October 2008, following the publication of new regulations by the Department for Work and Pensions. The responsibility for setting the assumptions used in the CETV calculation passes from the Scheme Actuary to the trustees of pension schemes. On the 29 September 2008, the Pensions Regulator published guidance for trustees on their new requirements.

Key Principles of Regulations

- The trustees are to set the assumptions that will apply to the CETV calculation, having first obtained advice from the Scheme Actuary.
- The trustees will be responsible for calculating an initial cash equivalent (ICE) on a best estimate basis. The ICE is the amount that is needed 'to make provision within the scheme for a member's accrued benefits, options and discretionary benefits'.
- The trustees are able to pay higher transfer values than the ICE (subject to receiving employer consent if this is required under scheme rules).
- The trustees can reduce transfer values if the scheme is underfunded, as with current practice.
- Provision is to be made for member options that increase the value of benefits and consideration is to be given to the inclusion of discretionary benefits in the calculation.
- There are additional requirements for the disclosure of information to members on the Statement on Entitlement (SoE).

Calculation Assumptions

The demographic, economic and financial assumptions that the trustees use should, as a whole, lead to the best estimate of the ICE. This means that each and every assumption need not be set as best estimate.

Demographic assumptions must take into account the main characteristics of the scheme's membership, or if a small scheme, the wider population sharing similar characteristics. The Regulator's guidance suggests considering pension size, the industry employing the members and their geographical location when deriving a mortality assumption.

The trustees are to have regard to the expected return on scheme investments and the investment strategy when setting discount rates. Any future changes to the investment strategy, such as choosing to purchase annuities on retirement of a member, should be allowed for. The transfer value basis should allow for changing market conditions. This may prompt trustees to set discount rate assumptions that are linked to market yields.

Trustees are encouraged to make evidence based objective decisions when choosing assumptions and should monitor and review their ongoing appropriateness. It is likely that a more full review of the CETV calculation would take place at the same time as the scheme funding valuation.

The requirement for best estimate can be contrasted with the prudent assumptions that are used to calculate the technical provisions under the statutory funding objective. It follows that the CETV assumptions are likely to be less conservative than those used for scheme funding purposes, with lower values placed on a member's benefits under a CETV basis than under a scheme funding basis. However, the scheme funding basis can allow for options that reduce the value of members' benefits, e.g. cash commutation on retirement, whereas the CETV regulations do not allow the inclusion of such options.

Reducing Transfer Values

Trustees can offer CETVs that are lower than the ICE if the scheme is underfunded on the transfer value basis. However, the Scheme Actuary has to provide an Insufficiency Report to the trustees before any reduction can be applied. An Insufficiency Report can be requested at any time, not just when the scheme funding valuation is in progress.

Even if there is an Insufficiency Report, the trustees can decide not to apply a reduction. The Regulator's guidance sets out the matters the trustees should consider before reducing CETVs and suggests that transfer values would not normally be reduced when the sponsoring employer has a strong covenant, where a contingent asset arrangement is in place or where any scheme funding recovery period is short.

When a scheme is underfunded, it is often appropriate to consider the 'priority order' of the different elements of members' benefits when sharing out the scheme assets. The transfer value legislation implies that the trustees can apply a more straightforward level rate reduction to all members rather than use a priority order approach, although the Regulator's guidance states that 'it should be assumed that the more equitable treatment is to take account of the (wind up) priority order'.

Statements of Entitlement

A new set of required disclosures on the Statement of Entitlement (SoE) will apply from 1 October 2008. As well as informing the member about the Financial Services Authority, the Pensions Regulator, the Pensions Advisory Service and the Pensions Protection Fund, there should be a recommendation that the member seeks financial advice before deciding on transferring benefits from the scheme. The Regulator's guidance recommends the good practice of disclosing the transfer value calculation basis and assumptions on request.

Timescales

The new regulations must be applied for all transfer values calculated from 1 October 2008. The current practice of providing the SoE within three months of receiving the member's request remains in place. This means that trustees must issue a new style SoE within three months for transfer value requests received from 1 October 2008.

For transfer value requests received before 1 October 2008, the new regulations will apply unless the SoE was issued by 30 September 2008.

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