
Commutation Factors

Background

The Actuarial Profession established a working party in early 2006 to review issues arising from actuarial advice in connection with setting terms for cash commutation and other member options. In February 2007, the working party wrote to actuaries setting out its recommendations. A key conclusion of the working party's report was as follows: "Where an actuary has an explicit or implicit obligation to advise trustees on the terms for member options, changes in market conditions may make it appropriate for the actuary to advise that the terms may be out of date and should be reviewed."

Commutation factors in use

Many schemes use a commutation factor of 9.0 for a male retiring at age 65. This rate will equate £1 of pension to £9 of cash benefit. A simple example is shown below.

Total pension entitlement at age 65 = £18,000 per annum

Member has the option to commute pension for a cash benefit of £45,000

If the cash option is chosen, the member gives up £5,000 of pension (= £45,000 divided by 9) to receive a residual pension of £13,000 per annum

Most schemes only allow the member's pension to be commuted therefore the taking of a cash benefit does not affect the spouse's pension. It follows that the commutation factors only need to take account of the value of the pension payable to the member.

Typical commutation factors of between 9.0 and 12.0 say have been in use for some time and are likely not to have been reviewed for many years. These rates are now considered to be out of date as they do not reflect the greater value currently placed on the payment of an annual pension due to lower interest rates and increasing longevity.

Commutation factors may be used for other purposes, including the conversion of an Additional Voluntary Contributions fund to a scheme pension or to commute trivial pension benefits for a lump sum payment.

Basis for calculation of commutation factors

Commutation factors could be set to be cost-neutral on a basis that is consistent with a scheme's Statement of Funding Principles, ie the scheme specific funding basis. This approach would result in there being no gain or loss to the funding level of the scheme when a member chooses to commute pension for cash.

Commutation factors which place a lower value on pension benefits than that obtained using a scheme's funding basis means that each member's commutation acts as a source of profit to the scheme on that funding basis.

An alternative approach for the calculation of commutation factors is to link with the calculation of Cash Equivalent Transfer Values (CETVs). Cash commutation is considered to be similar to taking a transfer value as both options involve giving up an entitlement to pension for a cash lump sum. As the calculation basis for CETVs is often similar to the scheme specific funding basis without the margins for prudence, it follows that commutation factors could be set on a basis less generous than the scheme specific funding basis.

Trustees may wish to introduce factors that are lower than cost-neutral on the scheme specific funding basis. Possible justifications for this approach may include the scheme being underfunded, the favourable tax treatment of the cash lump sum and the member preference for a cash benefit.

A full set of commutation factors could be used that allow for male and female members, varying by age (the usual approach) and allowing for elements of pension which increase at different rates. Many small and medium sized pension schemes tend to apply a more straightforward approach with a set of age dependent rates for both males and females.

Trustees also need to consider how often the commutation factors are reviewed. The rates could be linked to interest rates that require updating each month, reviewed after each triennial valuation or on a significant change in market conditions.

The impact of the Pension Protection Fund (PPF) should also be considered in respect of cash commutation. The PPF levy paid by a scheme is linked to the value of the liabilities measured on the PPF basis. The higher the PPF liability, the higher the levy. As pension benefits accrued after April 1997 have a higher value on the PPF basis, it would be sensible to require members to commute post '97 pension before pre '97 pension in order to reduce levy costs. However, if a scheme were to enter the PPF following a company's insolvency, members would prefer to have more post '97 pension benefits with attaching PPF increases rather than non-escalating pre '97 pension.

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