

**APPROACHES TO  
THE CALCULATION OF PENSIONS TRANSFER  
VALUES**

**CONSULTATION DOCUMENT**

**JUNE 2006**

**DWP** Department for  
Work and Pensions

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## **Preface**

This consultation document seeks views on approaches to the calculation of pensions transfer values.

## **Consultation arrangements**

**Website** This document is on the Department's website at:

<http://www.dwp.gov.uk/consultations/2006/>

**Responses** Please ensure your response reaches us by:

**Friday 11 August 2006.**

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## 1. INTRODUCTION

1. Legislative provision for calculating individual transfer values between pension arrangements have, broadly, been in place since the mid-1980's. This consists of Department for Work and Pensions (DWP) regulations enabling transfers to be made that, other than for certain money purchase benefits, delegate responsibility for determining the calculation framework to the Actuarial Profession, who fulfil their obligations by issuing a mandatory Guidance Note, GN11, dealing with this issue. Since this Guidance Note was first issued in December 1985 it has been revised on a number of occasions to reflect, for example, legislative change.

2. In May 2005, the Actuarial Profession issued a draft revised version of GN11, known as Exposure Draft 54 ("EXD54")<sup>1</sup>, asking for comments on their proposals to alter substantially the framework for the calculation of transfer values. EXD54 created a great deal of comment both within the actuarial profession and the wider pensions community.

3. Following a due process of evaluation of the comments made on EXD54, the Actuarial Profession approached the Government and asked it to reconsider the legislative basis for the calculation of transfer values.

4. The Profession's formal submission to the Government<sup>2</sup> outlines the issues they regard as relevant. Following further consultation with the Profession, the Government has decided to review the legislation with a view to setting out in regulations the principles underpinning the framework for calculating transfer values, supported by an actuarial standard issued by the independent Board for Actuarial Standards which took over responsibility for setting technical actuarial

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<sup>1</sup> Weblink: <http://www.actuaries.org.uk/files/pdf/pensions/exd54.pdf>

<sup>2</sup> Weblink: [http://www.actuaries.org.uk/files/pdf/pensions/briefingnote\\_transfervalues200510.pdf](http://www.actuaries.org.uk/files/pdf/pensions/briefingnote_transfervalues200510.pdf)

standards from the Actuarial Profession from 19 May 2006.

5. In the meantime the existing DWP regulations remain in force as does version 9.2 of GN11 issued 30 December 2005.

**6. This consultation document is intended to prompt consideration and discussion. The Government has not formed any firm views about the way that transfer values should be calculated and at this stage wants to gather together opinions and views from all sections of the pensions community. In particular, please do not restrict comments to the approaches outlined in the document; information on any other possible approaches would be very useful.**

7. **Timetable** This element of the consultation has been restricted to six weeks. There will be a separate consultation period covering the response to this document and the draft regulations that result.

8. The Government's aspiration is to have regulations in place in time to come into force in April 2007.

## 2. BACKGROUND TO CURRENT ARRANGEMENTS

### Legislation

1. Before the Social Security Act 1973, individuals who left an occupational pension scheme before normal pension age (“early leavers”) generally received a refund of their own pension contributions (if any) and no deferred pension from that employment. The 1973 Act introduced the requirement that all occupational pension schemes had to offer early leavers the right, subject to certain qualifying conditions, to a ‘deferred’ or ‘preserved’ pension through entitlement to a ‘short service benefit’. Instead of providing short service benefit a scheme could, with the member’s consent, provide for the member’s accrued rights to be transferred to another scheme with a view to the acquisition for that member of transfer credits under the other scheme.

2. The Social Security Act 1985 introduced legislation giving early leavers, whose pensionable service ended on or after 1 January 1986 and at least one year before normal pension age, a statutory right to have the ‘cash equivalent’ of their benefits transferred to another pension arrangement, with associated regulations the Occupational Pension Schemes (Transfer Values) Regulations 1985. The legislation is now consolidated in sections 93 to 101 of the Pension Schemes Act 1993, with associated regulations the Occupational Pension Schemes (Transfer Values) Regulations 1996.

3. One of the conditions in the earlier Regulations was that cash equivalents<sup>3</sup> have to be calculated and verified by adopting methods and making assumptions that were certified by an actuary to the trustees of the scheme as being consistent with “Retirement Benefit Schemes – Transfer Values (GN11)” issued by the Faculty and Institute of Actuaries, and current at the date of calculation. The 1996 regulations (which came into force on 6 April 1997) require that the

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<sup>3</sup> Except a cash equivalent (or any portion of one) which relates to money purchase benefits which do not fall to be valued in a manner which involves making estimates of the value of benefits.

version of GN11 to be used is the one current at the guarantee date<sup>4</sup> or, if the cash equivalent is of money purchase benefits, at the relevant date<sup>5</sup>. This changed wording reflected the introduction of statements of entitlement and guaranteed cash equivalents for early leavers from salary-related pension schemes.<sup>6</sup>

## **GN11**

4. GN11 applies to all occupational pension schemes, whether in the private or public sector.

5. While the main focus of GN11 is on transfer values, it is also used for:

- (i) valuing and sharing pension rights when a marriage ends on divorce (or a civil partnership is annulled);
- (ii) the valuation of directors' pension benefits in company annual reports.

6. The term 'cash equivalent' is not defined in the legislation. In GN11 to date it has generally been interpreted to mean that the transfer value calculated under GN11 is a cash value that must fairly reflect the deferred benefits of members which they are entitled to under the transferring scheme and which would be given up on transfer<sup>7</sup>. This permits transfer values to be assessed having regard to the market rates of return on equities, gilts or other assets as appropriate. This can result in a wide variation in transfer values depending on the chosen

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<sup>4</sup> The date by reference to which the value of the cash equivalent is calculated, which must be within the period starting with the date of the member's transfer application and ending with the date on which the statement of entitlement is provided to the member.

<sup>5</sup> The date of the member's transfer application or, if later, the date that pensionable service terminated.

<sup>6</sup> Statements of entitlement and guaranteed cash equivalents were introduced to provide more certainty for transfers from defined benefit schemes. The statement of entitlement provides a written statement of the amount of the cash equivalent on the guarantee date. That amount is then guaranteed for 3 months following the guarantee date (but with exceptions).

<sup>7</sup> The current version says "It is a fundamental requirement, stemming from the legislation, that a cash equivalent should represent the actuarial value of the corresponding accrued benefits. Such actuarial value should represent the expected cost within the scheme of providing such benefits and should be assessed having regard to market rates of return on equities, gilts or other assets as appropriate."

asset class and assumed rate of return used to discount future pension payments<sup>8</sup>.

7. The trustees (or, for public sector schemes, the managers) determine the approach to be used on the basis of actuarial advice. The framework of legislation and professional guidance sets out a minimum approach to the calculation, but leaves trustees free to pay out higher amounts, if they choose.

8. Legislation also allows the actual transfer value paid from private sector schemes to be lower than the GN11 amount, where the scheme is underfunded. In these circumstances, payment of the full GN11 amount could otherwise unfairly reduce the remaining scheme assets which back the benefits of the other members and pensioners. Scheme members who request a transfer value quotation must be told whether the transfer value on offer has been reduced and, if so, must be told what the unreduced amount would be.

### **The Goode Report**

9. Transfer values were looked at by the Goode Report 1993<sup>9</sup>, which said:

“The cash equivalent of the preserved benefit must be calculated allowing for current market conditions. Of the various elements used as a basis for calculating the amount of the transfer value, the rate of interest chosen has the most influence.

Different schemes have different experiences, different membership profiles and different investment strategies. It would therefore be quite wrong to impose standardised bases for the calculation of the transfer values for all schemes. Nevertheless, we believe that the bases under GN11 are too wide and recommend that the actuarial profession be

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<sup>8</sup> The effect on transfer values of changing discount rates is illustrated in Annex A.

<sup>9</sup> Pension Law Reform: The Report of the Pension Law Review Committee.

charged with responsibility for tightening them so that the possible range of transfer values becomes much narrower than at present. This will not lead to exact transfers in the sense of ten years' service in one scheme buying ten years' rights in the new scheme.”

10. One aspect of the introduction of the Minimum Funding Requirement dealt with this particular recommendation. The Minimum Funding Requirement generally required private sector defined benefit schemes to fund to a minimum prescribed level for the first time and it also provided an underpin to the amount of the cash equivalent.

### **Changes to GN11**

11. The current version of GN11 (version 9.2) came into effect on 30 December 2005. Many of the changes that have been made since GN11 was first put in place are as a result of legislative change – for example, version 9.2 was needed to take account of the removal of the Minimum Funding Requirement underpin from the calculation of cash equivalents.

12. GN11 has said consistently that a transfer value should represent the actuarial value of the corresponding accrued benefits and the expected cost within the scheme of providing such benefits. However, guidance has changed over the years about what discount rate should be assumed in the calculation. Initially this tended more to gilts, but this was changed in 1997 to make it clearer that actuaries could assume equity returns as well as gilt returns when setting discount rates and this approach has remained unchanged since then.

### **EXD54**

13. There has been debate within the actuarial profession for many years about the appropriate basis for calculating cash equivalents. The Pensions Board of the UK Actuarial Profession decided to review GN11 in 2003. A policy setting

consultation was held in early 2004, both within the profession and with outside bodies (including DWP).

14. As a result of this earlier consultation, in May 2005 a proposed revised GN11 - Exposure Draft 54 (EXD54) – was issued for consultation, the main points of which were:

- it set out a more prescriptive method using discount rates derived from investment in bonds;
- it required an assessment to be made of the default risk – that is, the likelihood of the full value of the benefits being paid in full from the scheme. Where the benefits are considered to be secure, the discount rate would be lower (giving a higher transfer value). Where there is considered to be a large degree of risk that the benefits will not be met in full the discount rate would be higher (giving a lower transfer value);
- when assessing risk, the actuary should take account of a number of factors, including taking instructions from the trustees on the default risk associated with the employer. Different factors could apply to different tranches of benefit. In particular the tranche of benefits that would be eligible for compensation if the scheme were to be transferred to the Pension Protection Fund (PPF) might be calculated using a lower discount rate than benefits considered to be less secure;
- if the trustees do not want the actuary to take account of default risk associated with the employer, the actuary must use a discount rate equal to yields on Government bonds, but subject to an upper limit

determined by the yield on any bonds issued by the employer company.

15. It is understood that the theoretical background to the proposed change of approach is that changes made by the Government (basing the employer debt calculation for solvent employers who decide to wind a scheme up on the cost of buying out benefits with insurance annuities, and calculating PPF-level benefits by reference to buy-out terms on wind-up) signal greater security for members and greater certainty that the pension promise will be delivered. Reflecting that approach in cash equivalent transfer value calculations points towards a method based on bond yields.

16. There were over 100 responses to the consultation, about one third from actuarial firms or individuals, one third from trustees and one third from companies and representative organisations. Amongst the two latter groups, there was widespread concern about the move to bond-based discount rates. Those respondents considered that the new transfer values would be too high: funded schemes could scale back transfer values if the scheme was underfunded, but doing this would run the risk of a further weakening of confidence in defined benefit schemes.

17. Although the consultation showed that there was no agreement on what a transfer value should represent, a significant number of respondents (both from within and outside the actuarial profession) said that determining a fair cash equivalent should take account of wider social policy issues and hence was an appropriate matter for Government to determine.

### **Future guidance**

18. Following the recent “Morris Review” of the role of the Actuarial Profession, the responsibility for GN11 is shortly to transfer to the independent Board for Actuarial Standards.

### 3. PUBLIC POLICY

1. The provision of occupational pensions remains a voluntary act freely entered into by employers, with the aim of recruiting and retaining employees. Government policy is to encourage employers to provide access to pension schemes and to encourage contributions to pension schemes by employers and employees.
2. It is public policy to ensure schemes are funded at an appropriate level to meet the pensions promise, and the introduction of the Pension Protection Fund (PPF) is intended to provide a greater degree of assurance that these pensions promises will be kept.
3. The issues of transfers, and portability in general, are important both to individuals and in terms of labour market flexibility. However the key issue, in pensions policy terms, is that the provision of pensions should be supported and encouraged.
4. The compact between employer and employee in a defined benefit (DB) scheme is to provide benefits at a known level, to which the employer must, and employee may, contribute. The approach to transfers from a DB scheme has in the past been based on the “cost to the scheme” basis.<sup>10</sup> This is underpinned by an approach whereby over relatively long periods of time pension schemes can choose to take greater risks in investment terms, usually by greater exposure to equities, because in the event of a shortfall the employer promises to make up any deficit.
5. The current situation in the DB world demonstrates how that arrangement works in practice. Substantial efforts are being made to fill deficits over

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<sup>10</sup> That is, the cost to the scheme had the early leaver remained in, and got a pension from, the scheme.

reasonable periods of time thus providing more assurance that the benefits promised will be paid.

6. The key public policy question is how changing the discount rate to deliver a “value to the member”<sup>11</sup> outcome would affect all those with an interest in pension schemes.

7. Currently the decision to be made concerns the balance between the options. Transferring from DB to DB is less common and as exporting and importing schemes use broadly the same calculation, this provides a relatively level playing field.

8. The main issue concerns transfers from DB to defined contribution (DC) schemes. Here the argument is that in order to secure the same benefits in the new arrangement that the DB scheme offers, underpinned by the PPF, the value of assets transferred should increase. The Actuarial Profession suggested that this could be achieved by changing the discount rate to a bonds basis rather than equities.

9. This could result in a number of outcomes. The person taking the transfer takes the cash equivalent transfer value and invests in a DC option such as bonds with the aim of providing a level of return congruent with the valuation. Another outcome could be that the person taking the transfer takes a DC option that has greater risk than the bond option and, if successful, secures a higher level of benefit, or, if unsuccessful, suffers a loss which means that the original DB benefit will not be forthcoming.

10. A common feature of both these examples is the requirement to purchase an annuity under the DC arrangements. Annuity rates have fallen substantially

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<sup>11</sup> That is, which looks at the implicit value of the member's benefits, taking account of the likelihood of payment.

over the last five years and increasing longevity indicates that the value offered will continue on that path. This has to be compared with the known benefit and PPF protection in the exporting scheme.

11. Another important aspect of this debate is the effect altering the discount rate would have on schemes and the members remaining in them. Great care is needed to ensure that a positive incentive to transfer is not created at the expense of remaining scheme members and/or scheme sponsors as this could seriously undermine the viability of schemes.

### **EU Portability Directive**

12. The final form of the Portability Directive remains the subject of considerable discussion between Member States. The general emphasis of the Directive is on achieving a fair outcome for all involved.

13. Portability is likely to be defined in general terms and unlikely to set out a formula for dealing with issues such as transfers values. In general terms it is probable that it will lay equal emphasis on the entitlements of the individual, as it does on ensuring that the framework established does nothing to affect the viability of pension schemes. Member States will have to strike a balance between the entitlements of those seeking a transfer and the viability and security of those who remain in the scheme.

### **PPF compensation**

14. In examining the balance of interest between the individual and the scheme the creation of the Pension Protection Fund (PPF) has substantially altered the pensions landscape.

15. As it stands, eligible DB schemes are required to pay a levy to the PPF. The PPF pays compensation to scheme members should the sponsoring employer become insolvent (and other qualifying conditions are met). The PPF

pays two levels of compensation. The compensation paid under these levels will vary according to the particular circumstances of members and schemes, but in very general terms:

- those over the scheme's normal pension age (at the start of the PPF's involvement with a scheme) will receive the 100% level of compensation. Crudely, this means that initial compensation payments will be at the same level as the pension that would be payable by the scheme but future increases will be subject to PPF rules on indexation (for example, no indexation will be paid by the PPF on benefits accrued before 1997);
- those under the scheme's normal pension age will receive the 90% level of compensation. Under this level of compensation (again this is a crude summary) a member's accrued rights in the scheme are revalued according to PPF rules until payments begin. The revalued rights are subject to an overall cap (currently set at £28,994 at age 65 but actuarially reduced for those below this age) and then a 10% reduction is made. Increases to the amount of compensation, once it is in payment, will be subject to PPF rules on indexation.

The PPF Board and the Secretary of State have reserve powers to reduce the level of compensation payable (although it is envisaged that these powers will only be called upon as a measure of last resort).

16. Thus for the first time, a body exists that protects, to a limited degree, the pensions paid by eligible DB schemes. In the existing transfers regime, no account is taken of this underpin and there is no requirement for those considering transferring from a DB scheme to be made aware of the significant value of this protection.

17. So the creation of the PPF is a significant factor which will substantially influence the consideration of any request for a transfer.

## **Full buy-out**

18. The Government introduced in 2004 (but with effect from June 2003) a requirement for solvent employers to fund their pension scheme to a level sufficient to buy out in full the entitlements of scheme members if they wished to wind up a DB scheme<sup>12</sup>.

19. This was to close a loophole that allowed solvent employers to close DB schemes that had a funding deficit, leaving employees who had contributed to schemes for the whole of their working lives – in some cases 30 years or more – with as little as 10% to 15% of their pension entitlement. The Government took the view that that was unreasonable, and brought in legislation to prevent viable companies renegeing on their pension promises.

20. The full buy-out measure has been deployed as a reason for changing the method of the calculation of transfer values to match in some way the requirement on employers to fund to the “full buy-out” level if they wish to wind up an existing DB scheme.

21. It has been argued that a ‘full buy-out’ standard should now be applied to the calculation of individual transfer values, as well as in cases of scheme wind up. But the two sets of circumstances are different and, in the Government’s view, the fact that full buy-out is applicable in the latter case does not necessarily mean that it should apply in the former.

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<sup>12</sup> The Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc) (Amendment) Regulations 2004 (SI 2004/ 403).

## 4. APPROACHES TO THE CALCULATION OF TRANSFER VALUES

1. This section of the consultation document is divided into three sections:
  - issues to be considered in the development of policy
  - possible objectives of the policy on transfers
  - possible approaches to the calculation of transfer values.

### I. ISSUES TO BE CONSIDERED IN THE DEVELOPMENT OF POLICY

#### **Stakeholders**

2. In the calculation of transfer values, the key stakeholders are:
  - the member wanting to transfer out; members remaining in the scheme; the scheme trustees; the sponsoring employer, including the Government as an employer in respect of pension schemes in the public sector; the Pensions Regulator; and the Pension Protection Fund.

***Question 1.*** *Are there any other key stakeholders whose interests need to be addressed?*

#### **“Striking a balance”**

3. Any proposals for change will have to strike a balance between the different interests of the stakeholders, in particular the member considering transferring out, the members remaining in the scheme and the sponsoring employer.

**(i) Members considering transferring out**

4. There are a number of legal matters which will need to be taken into consideration in relation to transfer values, which include the following.

4.1. *Article 141 EC Treaty* The calculation of transfer values falls within the scope of this Article which concerns the principle of equal pay for men and women for equal work.

4.2. *Human Rights Act 1998* Article 1 of the First Protocol of the European Convention on Human Rights provides that:

“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.”

4.3. Any proposals on the way transfer values are to be calculated will need to be considered against this requirement and against Article 14 of the European Convention on Human Rights (freedom from discrimination in the exercise of convention rights).

4.4. Taken together there would appear to be grounds to argue that members wanting to transfer out of a scheme do have rights in law. The possibility of legal challenge cannot be eliminated but it can be reduced by making sure that there is a strong justification for policy.

4.5. *Draft Portability Directive* The draft Directive is currently being considered by an EU Working Group. It is not clear when the Directive will gain final approval, nor what the final form of the wording will say. But currently Article 6.2 of the draft Directive provides that:

“Member States, in accordance with their national practice, shall ensure that, where actuarial estimates and those relating to the interest rate determine the value of vested pension rights to be transferred, these shall be fair to the outgoing worker.”

4.6. It is hoped that the final wording of Article 6.2 will reflect domestic policy and the UK Government is working towards this.

**Question 2** *What is your view about the legal rights of a member wanting to transfer out of a pension scheme?*

**(ii) Members remaining in the scheme / the sponsoring employer**

5. Because of their overlap of interests in relation to transfers, members remaining in the scheme and the sponsoring employer are here considered together. The purpose of the pension scheme is to provide pensions for members. Whilst it is appropriate that members should be able to transfer out to other schemes, it is imperative that transfers should not jeopardise the position of members remaining in the scheme, or that they should lead to the employer having to make extra contributions to the scheme, purely as a consequence of having paid a transfer.

6. Under the new scheme funding requirements (which replaced the Minimum Funding Requirement from 30 December 2005) trustees are required to exercise prudence when choosing the actuarial assumptions to be used in the calculation of a scheme’s technical provisions<sup>13</sup> at an actuarial valuation. In doing so they are advised (by the Pensions Regulator’s code of practice) to consider whether, and if so to what extent, account should be taken of a margin for adverse deviation. A prudent approach might involve the use of cautious assumptions on, for example, mortality, inflation and yield on assets. A particular issue is whether

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<sup>13</sup> Broadly, the value placed on the scheme’s accrued benefits.

these same assumptions should be used when calculating a transfer value or whether it is appropriate to use other assumptions. Or, to put it another way, the issue is whether, and if so to what extent, the degree of prudence built in to the calculation of the technical provisions should also be taken into account in the calculation of transfer values.

**Question 3** *Your views are sought on whether it would be reasonable to have a separate set of assumptions for the calculation of transfer values, and if so, the principles underpinning the choice of those assumptions.*

7. The current rules on the calculation of transfer values for private sector schemes provide that where the scheme is underfunded (ie the assets are insufficient to pay the full amount of cash equivalent transfer values in respect of all of the members) the transfer value may be reduced to the extent that there is a shortfall. Because of underfunding transferring members will not therefore get the full value of their pension rights. The current rules provide that where a transfer value is paid, even where that value is reduced because of underfunding, the trustees or managers are discharged of their liabilities in respect of that person.

8. An argument in support of this position is that the transfer is an option that members are exercising and it is a matter for them to decide whether to proceed with the transfer in these circumstances. On the other hand it could be argued that the funding deficit is the responsibility of the sponsoring employer and that it is unfair that members should lose all future rights to the employer underwriting the scheme when they take their transfer value.

**Question 4** *Do you consider it right that private sector schemes should continue to be able to reduce transfer values because of underfunding and that the payment of a transfer value should discharge the scheme of all further liabilities for the transferring member?*

9. Transferring to another scheme is an option which members may exercise. But their right to a transfer needs to be set against any consequences for the sponsoring employer.

**Question 5** *To what extent do you think that any new rules should define the rights of all those involved in the scheme?*

### **Pension schemes in the public sector**

10. Any new arrangements for the calculation of pension transfer values will have to apply to pension schemes in the public sector, most of which are unfunded. The Government's aim is for arrangements which can be applied equally to private and public sector, funded and unfunded schemes.

### **Pension Protection Fund**

11. Where a pension scheme's employer becomes insolvent, the Pension Protection Fund (PPF) now offers a means of compensating members. There are however limits on the amounts of compensation. An argument has been put forward that pension rights which, in the event of the scheme failing, would be met by compensation payments from the PPF, should be treated in a particular and separate way in the calculation of transfer values. For example if the scheme's normal method of calculating transfer values is to use a discount rate based on an equity premium ("higher risk"), the argument would be that benefits which would be met by PPF compensation benefits in the event of insolvency, should be discounted using a "lower risk" index, perhaps a bond-based return. A counter argument is that, unless a scheme's employer becomes insolvent (and even then entry to the PPF cannot be guaranteed), the existence of the PPF is an extraneous factor and ought not to be considered in the calculation of transfer values.

**Question 6** *Do you consider that the existence of the PPF should be factored into the calculation of transfer values and, if so, in what circumstances?*

### **Information for members**

12. Members considering whether to transfer to another scheme need information about their choices. In particular they need information about:

- the benefits and risks of remaining in their “home” scheme;
- the existence of PPF compensation payments;
- the benefits their transfer payment would buy in the “new” scheme, particularly where that scheme is a money purchase scheme and any associated risks.

13. The Government could regulate to require schemes to provide this information. But the Government’s wider agenda is to cut down on regulation and to reduce the burdens on schemes. And in fact, recent representations have been made that the current rules on allowing scheme members to obtain annual transfer valuations are administratively onerous and expensive. As an example, one scheme has said that out of the 1,000 valuations a year that they provide only 80 (or 8%) result in a transfer.

14. If changes to the disclosure regime in respect of more information about cash equivalent transfer values involve greater administrative costs, this could be offset by restricting members’ requests for valuations to one every three years. The intention would be to provide a cost neutral solution.

15. Another option might be a requirement that a member must show he or she has obtained independent financial advice before the trustees or managers are

permitted to make a transfer payment. But that might be thought to be too heavy handed.

***Question 7** Views are sought on how best to provide information to individuals and on the possibility of restricting valuations to a three year cycle.*

## **II. POSSIBLE OBJECTIVES OF THE POLICY ON TRANSFERS**

16. This section sets out some possible objectives of the policy. This is an initial view about the objectives. It should be noted that however the objectives are eventually defined, it is unlikely that any one approach to the calculation of transfer values would meet all of them; inevitably therefore in considering the approaches there will need to be some trading off as between objectives.

17. Possible objectives include the following:

**(a) Broadly fair to transferring member** Any new arrangements for the calculation of transfer values should be broadly fair to the transferring member. In particular there should be no explicit discrimination against the transferring member.

**(b) Scheme funding requirements** Any new arrangements should not weaken the scheme's funding position or increase the likelihood that the employer will have to make extra contributions at some future date. In particular any new arrangements should be considered in the context of the scheme funding requirements contained in Part 3 of the Pensions Act 2004.

**(c) Broadly neutral** Any new arrangements should be broadly neutral in their impact on the level of unreduced (for underfunding) transfer values, compared to the current position.

### III. APPROACHES TO THE CALCULATION OF TRANSFER VALUES

18. This section sets out three different potential approaches to the calculation of pensions transfer values:

**A. PRESCRIBED ASSUMPTIONS**

**B. SCHEME SPECIFIC BASIS**

**C. “EXD54” BASIS**

Each of these approaches is discussed below. For each approach, there is firstly a **description** of its key points. The approach is then tested against the **possible objectives** identified in the previous section. Other “**pros and cons**” of each approach are considered. Finally there is a short summary **discussion** of each approach.

19. **These approaches have been set out because they represent different theoretical options, and illustrate many of the key issues involved, though they are not necessarily all equally feasible. Equally, if you consider that there are other approaches which deserve consideration, please include them in your comments.**

## A. PRESCRIBED ASSUMPTIONS

20. **Description** Regulations would set out in detail the assumptions to be used in the calculation of transfer values and would also describe in detail the extent of any actuarial discretion. For example the regulations could define the mortality tables to be used; the expected revaluation rates; and a discount rate, for example a rate linked to AA bonds or a rate reflecting a degree of equity outperformance. The rules would apply to all schemes, funded and unfunded, and in the public and private sectors. The transfer value could be cut back to reflect underfunding.

21. **Objectives** In relation to the objectives:

(i) **Broadly fair to transferring member** Schemes would have to use prescribed assumptions, which could be significantly different from the assumptions used in the scheme's technical provisions. The transferring member may feel badly treated if there is a significant mismatch between these assumptions.

(ii) **Scheme funding requirements** The new scheme funding arrangements are based on a scheme specific approach; having a set of prescribed assumptions for transfers which applied nationally would in principle be at odds with the scheme funding approach. In addition, in order not to weaken schemes' funding position, the prescribed assumptions would have to be set towards a lowest common denominator. Having two sets of divergent assumptions might give rise to questions about one or both.

(iii) **Broadly neutral** Amounts of transfer values could remain roughly the same – depending on where the assumptions were set.

## 22. Other Pros / Cons

**Pros** - This approach would be simple for schemes to operate. It would provide certainty for members in terms of transferring out of the scheme. It is equitable as between members of different schemes. It would be easy to communicate to members.

- The same calculation could be used for all kinds of schemes, including public service schemes.

**Cons** - The prescribed assumptions would have to be reviewed on a regular basis to make sure they were still appropriate. This would necessitate a regular process of review and regulation making. The experience of the Minimum Funding Requirement powerfully demonstrates the difficulty of this approach.

- If the Portability Directive is not substantially changed, there would be a chance that the regulations could be challenged on the grounds that they were ultra vires ie that they failed correctly to adopt the requirements of the Directive.

23. **Discussion** On the face of it, a “one size fits all” approach has attractions. Members could be readily told the value of their pension rights. But this approach could discriminate against transferring members. Potentially there would be difficulties with the Portability Directive. There could also be difficulties in relation to scheme funding arrangements. It would be difficult to argue the fairness of a system where one set of assumptions was used within the scheme funding arrangements to calculate liabilities for deferred members, but for transfers, prescribed national assumptions had to be applied.

## B. SCHEME SPECIFIC BASIS

24. **Description** Under this approach, schemes would be able to calculate transfer values by reference to assumptions and values that reflected the funding position of their scheme. One option would be to take the lead from the principles governing FRS 17 calculations, which require assumptions underlying a valuation to be “mutually compatible and lead to the best estimate of the future cash flows that will arise under the scheme liabilities”. This approach would result in transfer values based on the trustees’ **best estimate**, on actuarial advice, of the cost to the scheme of providing for an individual’s deferred benefits. The transfer value could then be cut back, if appropriate, to take account of any underfunding in the scheme.

25. It should be noted that under the new scheme funding arrangements, trustees are required to take a prudent approach in deciding on the assumptions to be included in the technical provisions. A prudent approach to scheme funding effectively provides for safety margin to be built in. Calculating transfer values on a **best estimate** basis would mean that the safety margin remained within the scheme and did not transfer with the outgoing member.

26. A variant on the ‘best estimate’ approach would be to base the calculation of transfer values on the calculation of the scheme’s technical provisions for scheme funding purposes. For the reasons outlined above however, this might be expected to lead to higher transfer values for many schemes.

27. **Objectives** In relation to the objectives:

- (i) **Broadly fair to transferring member** The approach would be fair as between deferred members remaining in the scheme and members taking a transfer, provided (if the FRS 17 type approach was adopted) that it

could be shown that it was reasonable for the safety margin to remain in the scheme.

(ii) **Scheme funding requirements** Arrangements would be consistent with, if not identical to, scheme funding.

(iii) **Broadly neutral** Transfer values could change, depending on the assumptions used by the scheme.

## 28. Other Pros / Cons

**Cons** - Separate arrangements would be needed for unfunded schemes.

29. **Discussion** This approach builds on the new scheme funding arrangements and means that members remaining in the scheme and members transferring out are treated broadly the same. The only difference is that (on the FRS 17 model) the safety margin in the scheme, reflecting the prudent assumptions used in the technical provisions, would remain in the scheme and not transfer with the member.

## C. “EXD54” BASIS

30. **Description** The other two approaches discussed in this consultation document consider the calculation of transfer values from the perspective of the “cost to the scheme”. This approach addresses the issue by reference to the “value to the member” of his or her pension rights.

31. “Exposure Draft 54” (EXD54) was an option put forward by the Actuarial Profession in a consultation on proposed major revisions to GN11. EXD54 was

issued in May 2005. (See also **Background to Current Arrangements.**)

32. EXD54 provided for the calculation of transfer values by reference to the implicit value to the member of his or her benefits. That value was to be based on the likelihood, or risk, of the benefits being paid. Benefits considered to be secure would have a high transfer value; conversely benefits considered to have a larger degree of risk would have a lower transfer value.

33. EXD54 proposed that differences in risk should be reflected by difference in the discount rate used in the calculation of transfer values. Factors which the actuary would need to consider included the strength of the employer covenant and the existence of PPF compensation. Different factors could be applied to different tranches of benefits; for example benefits which would fall into a category of PPF compensation would be treated as relatively secure and hence would have a lower discount rate.

34. If the trustees did not want the employer default risk to be included as a factor to be considered by the actuary, EXD54 required that conservative standard discount rates should be used, based on the rates of return on Government bonds.

35. The transfer value could also be cut back to reflect underfunding.

36. **Objectives** In relation to the objectives:

(i) **Broadly fair to the transferring member** This approach would favour the member wanting to transfer out of the scheme.

(ii) **Scheme funding requirement** In some cases the transfer value could exceed the provision made in scheme funding for that transferring individual. If enough people took transfers, the scheme's funding position

would be weakened. It would increase the likelihood that the employer would have to make additional contributions.

(iii) **Broadly neutral** Amounts of transfer values likely to rise.

### 37. Other Pros / Cons

**Pros** – Because of the default discount rate that this approach includes, it could be used in unfunded schemes.

**Cons** – Would encourage members to leave DB schemes to join DC arrangements, weakening the “home” scheme. But even with increased transfer values it would still be questionable whether they would end up “better off” in the DC arrangement.

- Trustees could find it very difficult to take an objective view about the strength of the employer’s covenant.

- If employers felt they would have to contribute more to their schemes that would encourage more to close or wind up their schemes.

- Higher transfer values would increase costs for Government in respect of transfers out of unfunded public service schemes.

38. **Discussion** This approach would result in higher transfer values for members. But it has been argued that it would be difficult for many trustees to take an objective view about the strength of their employer’s covenant each and every time a transfer value has to be calculated. The default option contained in this approach, of a discount rate based on Government bonds, would have an arbitrary relationship to the way that individual schemes’ funds are actually invested. By increasing the likelihood that employers would have to make

additional contributions at some point in the future, this approach would further weaken employers' support for their DB schemes.

## 5. CONSULTATION ARRANGEMENTS

1. Because of the highly specialised nature of this issue, Ministers have decided that it is not appropriate to publish it under the provisions of the Cabinet Office Code of Practice on consultation. It does, however, apply best practice from the Code.
2. This consultation, on approaches to the calculation of transfer values, will be followed later in the year by a consultation on draft regulations. The Government envisages this as being part of the same consultation process.

### **Freedom of Information**

3. According to the requirements of the Freedom of Information Act 2000, all information contained in the response, including personal information, may be subject to publication or disclosure. By providing personal information for the purposes of the public consultation exercise, it is understood that a Respondent consents to its disclosure and publication. If this is not the case, the Respondent should limit any personal information which is provided, or remove it completely. If a Respondent requests that the information given in response to the consultation be kept confidential, this will only be possible if it is consistent with Freedom of Information Act obligations and general law on this issue. The contact point to discuss is:

Charles Cushing  
Freedom of Information  
2nd Floor  
Adelphi  
1-11 John Adam Street  
London  
WC2N 6HT

4. More information about the Freedom of Information Act can be found on the website of the Department for Constitutional Affairs:

### **Consultation - general**

5. When responding please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of a larger organisation please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

6. A list of those consulted is attached at Annex B. If you have any suggestions of others who may wish to be involved in this process please contact us.

### **Summary of responses**

7. A summary of responses will be published following the consultation. The Government will aim to publish this summary around the time when the next phase of the consultation process on draft regulations starts. The summary of responses will be available on the Department's website at <http://www.dwp.gov.uk/consultations/2006/> and paper copies will be available on request.

8. DWP values feedback on how well it consults. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact the DWP Consultation co-ordinator or any suggestions as to how the process of consultation could be improved further. Please contact:

Geoff Ashton  
DWP Consultation Co-ordinator  
5th Floor East, 1 Trevelyan Square  
Leeds  
LS1 6EB

Tel: 0113 23 27 107

E-mail Geoff.Ashton@dwp.gsi.gov.uk

**Regulatory impact assessment**

9. A Regulatory Impact Assessment will be published to accompany the consultation on the draft regulations.

## Annex A

### EFFECT OF DIFFERENT APPROACHES ON THE AMOUNT OF TRANSFER VALUES

1. At this stage, the focus is on the principles that should underpin the calculation of transfer values rather than the details. As noted earlier, the amount of cash equivalents is very sensitive to the discount rate used in the calculation, as shown in the indicative table below, and this must inform discussion of the right approach to be taken.
2. The table shows, in very broad terms and all other things being equal, the effect of moving away, by +/- 1%, from a baseline of 100 that uses a 'central' discount rate (all other things being equal). It shows the effect for taking a transfer at different ages, assuming a normal pension age of 65.

<b>Age</b>	<b>Baseline</b>	<b>-1%</b>	<b>+1%</b>
20	100	155	65
30	100	140	70
40	100	125	80
50	100	115	85
60	100	105	95

## **Annex B**

### **List of those consulted**

ABI  
ACA  
APL  
AXA Sun Life  
BAS  
Ernst & Young  
F&loA  
Friends Provident  
FSA  
GAD  
HBOS  
HM Treasury  
Hewitt  
ICAEW  
JWG  
Law Debenture  
Legal and General  
Mercers  
NAPF  
Norwich Union  
PAS  
PMI  
Pensions Ombudsman  
Pension Protection Fund  
Pensions Regulator  
Pricewaterhousecoopers  
Prudential  
Scottish Equitable  
Scottish Life  
Scottish Widows  
SPC  
Standard Life  
Watson Wyatt  
TUC