New rules for pension transfer advice - how generous are transfer values?

LCP survey of DB Transfer Value Comparators

October 2018

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Over £20bn was transferred out of DB pensions in 2017.

Background

DB transfer values are high on the agenda of many trustees and corporate sponsors of DB pension schemes. The introduction of pension flexibility and freedom, combined with favourable inheritance tax rules and record high transfer values, has led to a revolution in the pension transfer market. In 2017, the available statistics suggest that in excess of £20bn was transferred by individuals from DB schemes to DC schemes (more than the amount of bulk annuities purchased by all schemes over the same period). Concerns are being expressed by market commentators and the press that some of these transfers are inappropriate and will lead to pensioner-poverty, and some trustees and corporate sponsors of pension schemes have similar concerns.

In March 2018, the FCA announced changes to the rules that govern the way in which financial advisers provide advice on these DB to DC transfers. One key aspect of the new rules is the introduction of a "Transfer Value Comparator" ("TVC"). We have conducted research that investigates TVCs, how they may be interpreted by financial advisers and members, and how they may be viewed through the lens of trustees and corporate sponsors of DB pension schemes.

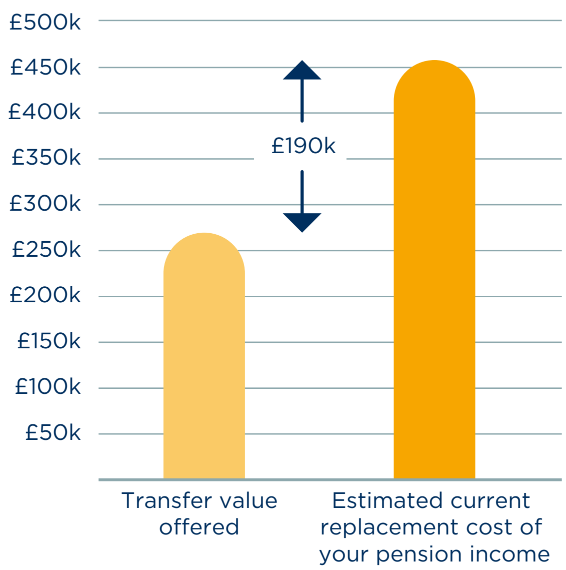
What is the Transfer Value Comparator (TVC)?

Any member of a DB pension scheme who wishes to transfer benefits worth more than £30,000 must first take appropriate independent financial advice. This advice is regulated by the FCA.

From 1 October 2018 the FCA will require all pension transfer advice to include a Transfer Value Comparator. The TVC will show, in graphical form (see example overleaf and Appendix 1 for more detail):

- The cash equivalent transfer value offered by the DB scheme
- The estimated cost of replacing the client's DB income in a DC environment, assuming so called "risk-free" investment returns prior to retirement and assuming that the client uses their entire fund at retirement to purchase an annuity with an insurer (the TVC replacement cost).

Illustrative TVC for a typical 55 year old currently 10 years away from retirement with a DB pension of £10,000 pa.



You have been offered a cash equivalent transfer value of **£260,000** in exchange for you giving up any future claims to a pension from the scheme.

It could cost you **£450,000** to obtain a comparable level of income from an insurer.

This means the same retirement income could cost you **£190,000** more by transferring.

The financial adviser must take reasonable steps to ensure their client (ie the member) understands how the outcomes from the TVC have contributed to the adviser's personal recommendation on whether or not to transfer.

The TVC will take no account of the client's personal circumstances (eg attitude to risk, amount of pension they wish to take as cash, whether they have a dependant etc).

However, the cost of replacing the client's DB income will be tailored to reflect the benefits provided by the DB scheme (eg the normal retirement age, level of pension increases etc). Therefore, two different pension schemes providing the same pension benefit to two different members will in theory have the same replacement cost reported on a TVC on any given day because the assumptions underlying the calculation are prescribed by the FCA.

The TVC will replace the current requirement of providing a "TVA" report, which concentrates on the investment return needed in order to replace a member's benefits.

One of the FCA's aims of introducing TVCs is to provide financial advisers and their clients with a measure of the cost of flexibility - that is, the financial cost (at least compared to the TVC "no-risk" basis) of giving up a promised pension income in order to achieve a member's objectives which may for example be a more flexible income, better provision for dependants, or the creation of a tax-efficient family asset.

A typical TVC assessment may show a transfer value to be only 50-60% of the TVC replacement cost.

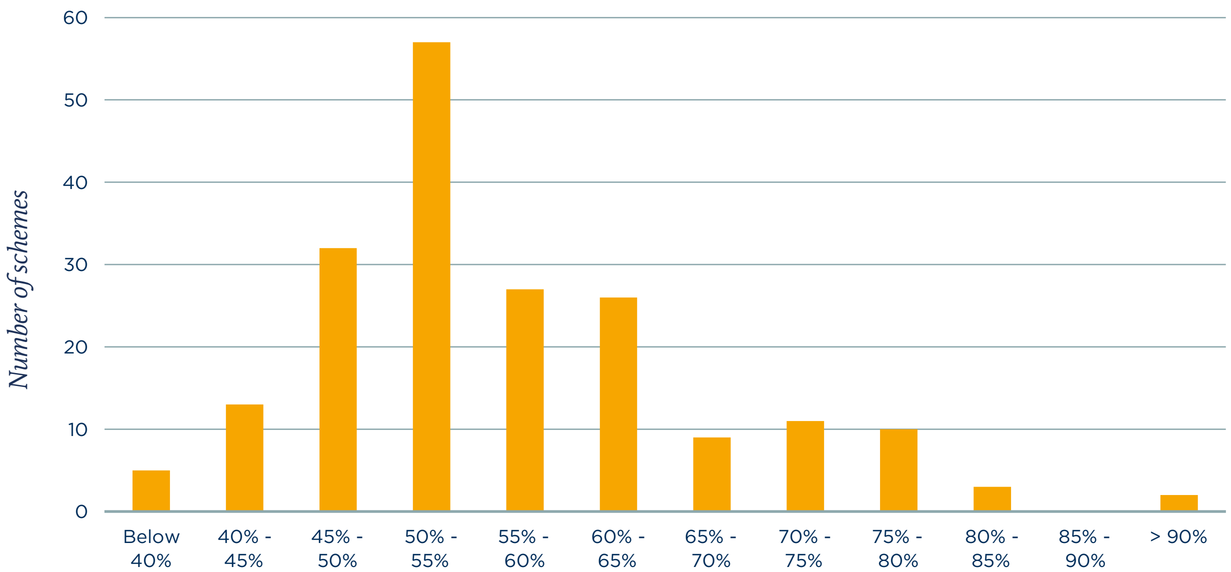
How do transfer values differ between schemes?

Transfer values offered by two different pension schemes are likely to differ. By law, the assumptions underlying transfer values are determined by each set of trustees, having taken advice from their own actuary and, critically, having regard to the expected best estimate returns on their scheme's investment strategy. Therefore, a scheme invested in more return-seeking (and hence more risky) assets, is likely to have lower transfer values (per £1 of benefit) than a scheme invested in lower-risk assets [1]. This is because a scheme invested in return-seeking assets hopes to make higher investment returns in the future, and therefore needs less money now, for each member. As a consequence some schemes' transfer values will appear to be considerably more "generous" to members than others and this will be illustrated by the new TVC requirements.

This survey looks at how transfer values differ across schemes, when looked at through the lens of the new TVC. Around 200 schemes were included within this survey and represent a wide cross-section of UK pension schemes, across all industries, with scheme sizes ranging from less than £100m to more than £10bn. The survey includes both schemes for which LCP is scheme actuary, and schemes that have scheme actuaries from other firms.

The following graphs shows the distribution of the transfer values expressed as a percentage of the TVC replacement cost for each of the 200 schemes in the survey. We first show the distribution for members 10 years from retirement and then another chart follows for members 1 year from retirement (see Appendix 2 for detailed assumptions). A few of the schemes in the survey reduce transfer values for underfunding but this reduction has been ignored for the purposes of this analysis.

Transfer value as a % of TVC replacement cost (10 years from retirement)



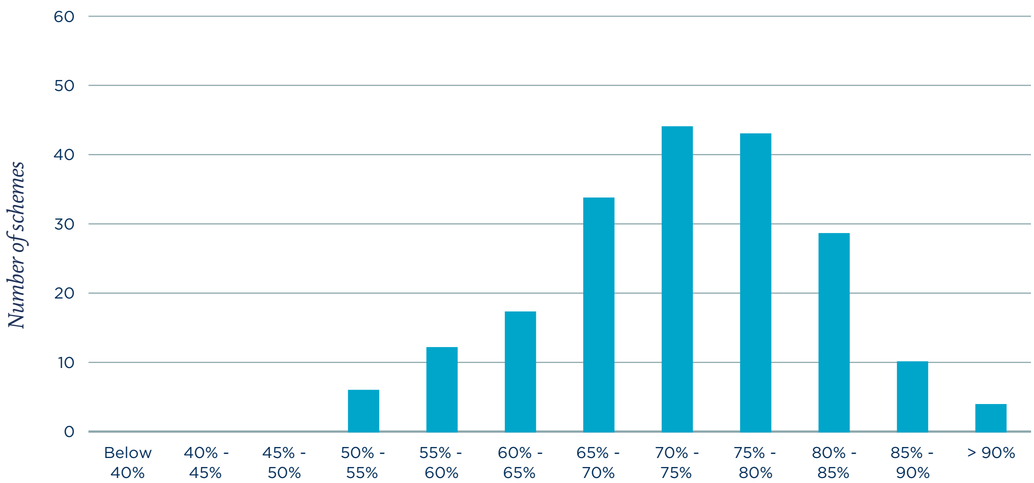
[1] In addition, if a scheme's assets are not sufficient to pay transfer values for all members, transfer values may be reduced for underfunding.

The mean ratio in our survey for members 10 years from retirement is 57%. In other words the average transfer value across all schemes surveyed provides such a member with 57% of the estimated cost of replacing their benefit by purchasing an annuity at retirement (using the prescribed FCA assumptions).

Whilst the significant gap between the transfer value and TVC replacement cost may come as a surprise to some members, this is due to the "risk-free" nature of the required FCA assumptions underlying the replacement cost, including the cost of an individual purchasing an annuity at retirement. In contrast, schemes typically invest in a mixture of assets including equities and bonds, and do not purchase individual annuities when members retire.

It is also interesting to note how large the range of transfer values is – there are a number of schemes that provide transfer values more than double other schemes. This reflects the wide range of investment strategies adopted by schemes, and the wide range of assumptions adopted by trustees for calculating transfer values. In turn this reflects differing views on key assumptions such as the likely future evolution of the scheme's investment strategy and longevity. This wide range is to be expected given the requirements and flexibility within the law governing the calculation of transfer values, but may come as a surprise to some members.

Transfer value as a % of TVC replacement cost (1 year from retirement)



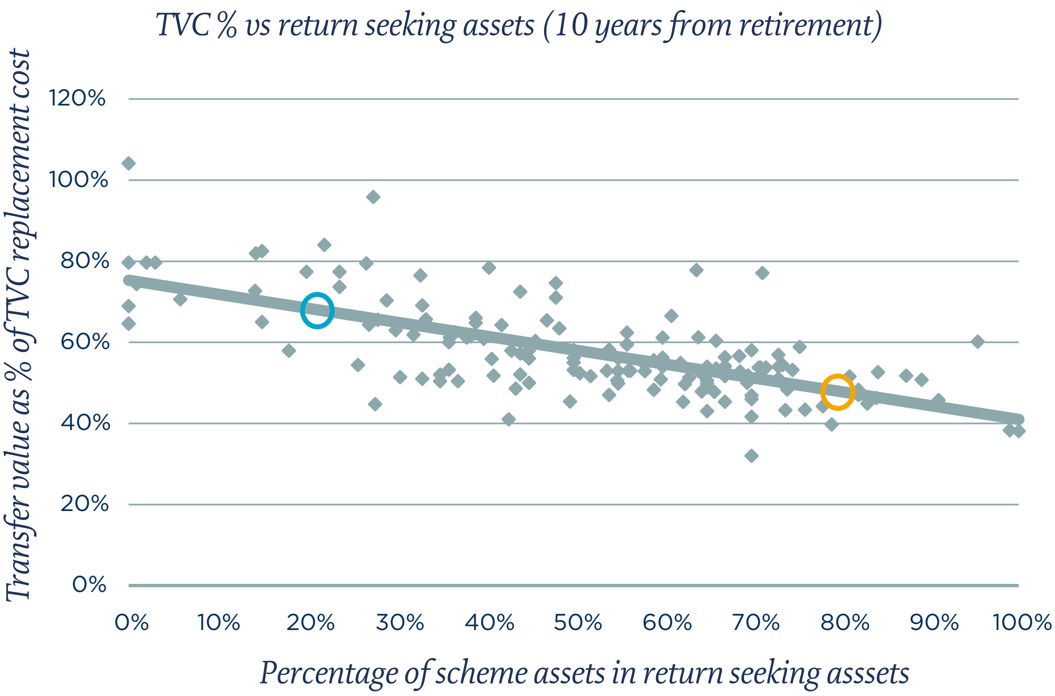
Transfer values appear more generous closer to retirement

For members who are closer to retirement, the gap between the transfer value and the TVC replacement cost reduces significantly. This is because many pension schemes are expecting to hold return-seeking assets for a shorter period of time in respect of older members. The range of transfer values is also lower for the same reason. The mean ratio in our survey for members just 1 year from retirement is 73%.

How does a scheme's investment strategy impact the TVC?

The graph below shows that pension schemes investing more in return-seeking assets, such as equities, typically provide lower transfer values when measured against the TVC replacement cost. This is to be expected given the legal requirements that govern the calculation of transfer values.

A scheme invested in more return-seeking assets is likely to have lower transfer values.



For example, for members who are 10 years from retirement, a scheme that is invested 80% in return-seeking assets (equities etc - the orange circle on the chart) will typically offer a transfer value that is only around 50% of a TVC replacement cost, whereas a scheme that is invested just 20% in return-seeking assets is more likely to offer a transfer value that is around 70% of the TVC replacement cost (the blue circle on the chart). The variation around this trend reflects different approaches taken by actuaries and trustees to many of the other assumptions underpinning transfer values, including the critical assumptions of the expected future evolution of the scheme's investment strategy and the longevity of the scheme's members.

As many DB pension schemes continue the journey of reducing risk by switching from return-seeking assets to lower risk assets such as government bonds, it might be expected that transfer values will increase (all other things equal, and assuming de-risking at a faster rate than that already assumed in the transfer value calculations). This effect is in addition to other key factors that can be expected to impact on transfer values, which include:

- A member's age (a transfer value is generally expected to increase as a member gets older);
- Expectations for future interest rates (it is long term expectations that matter, rather than any changes made to short term rates by the Bank of England – generally, interest rates staying lower for longer than expected are likely to increase transfer values); and
- Longevity expectations (generally, if expected improvements in life expectancy slow down, this can be expected to lead to lower transfer values).

Transfer values are likely to increase as pension schemes de-risk

How do transfer values and the TVC replacement cost vary across industry sector?

We also analysed the transfer values by industry sector and found that pension schemes that are sponsored by companies in the financial sector provide transfer values around 5% higher than average. Banks and insurers have additional reserving requirements that can result in them having a preference for their pension schemes to take less investment risk; this, in turn, appears to be leading to higher transfer values.

How might the TVC illustrations impact the number of members transferring?

Once the new TVC requirements are in force, members and their financial advisers will for the first time be able to benchmark clearly the apparent "generosity" of one scheme's transfer value against another scheme (albeit that from the perspective of the trustees of the schemes, the range of transfer values makes sense). We anticipate that financial advisers will develop rules of thumb to help them determine whether a particular scheme's transfer value option is relatively attractive compared to others, and hope that the analysis presented in this survey will assist in this. This may have the following impacts on transfer decisions:

- Some members and their advisers may decide that transfer values with lower TVC replacement percentages are not worth transferring;
- Some members and their advisers may decide to delay transfers until just before retirement, when the TVC replacement percentage is likely to be at its highest; and
- The TVC may provide a useful metric to enable members and their advisers to decide between two or more transfers – with schemes with the higher TVC replacement percentages being more likely to experience transfers-out.

We also anticipate that some trustees and sponsoring employers may benchmark their transfer values against other schemes using this analysis, and this may lead to a reconsideration of the assumptions adopted for transfer values being offered by some schemes (with potential adjustments upwards or downwards). However, given the legal constraints on trustees when calculating transfer values, we do not anticipate a wide-spread move towards median TVC replacement percentages – a wide range of transfer value TVC replacement percentages is likely to remain for some time.

A1 Prescribed form of the Transfer Value Comparator (TVC)[2]

This table belongs to *COBS* 19 Annex 5 1.1R.

You have been offered a cash equivalent transfer value of £120,000 in exchange for you giving up any future claims to a pension from the scheme.

Will I be better or worse off by transferring?

- We are required by the Financial Conduct Authority to provide an indication of what it might cost to replace your scheme benefits.
- We have done this by looking at the amount you might need to buy the same benefits from an insurer.

It could cost you £140,000 to obtain a comparable level of income from an insurer. This means the same retirement income could cost you £20,000 more by transferring.

Notes

1. The estimated replacement cost of your pension income is based on assumptions about the level of your scheme income at normal retirement age and the cost of replacing that income (including spouse's benefits) for an average healthy person using today's costs.
2. The estimated replacement value takes into account investment returns after any product charges that you might be expected to pay.
3. No allowance has been made for taxation or adviser charges prior to benefits commencing.

[2] https://www.handbook.fca.org.uk/instrument/2018/FCA_2018_15.pdf
This is the approach to be taken for clients with 12 months or more until their normal retirement age

A2 Notes to calculations

For comparison purposes we have modelled a simplified benefit structure rather than each scheme's actual benefit structure. In particular we have assumed:

- a pension payable for life from a normal retirement age of 65;
- a spouse's pension of 50% of the member's pension payable on death;
- pension increases up to retirement linked to Consumer Price Index (CPI) inflation, capped at 5% pa over the period; and
- pension increases in payment linked to Retail Price Index (RPI) inflation, capped at 5% pa each year.

More generous scheme benefits than this simplified structure would result in both a higher transfer value and higher TVC replacement cost. For most benefit structures we expect that the ratio between the two would be similar to those we have calculated and that the charts shown in our survey would therefore show a similar picture. The most significant impact on the ratios is the period of time between now (when a transfer is being considered) and when a member is due to reach their normal retirement age, and this difference is illustrated with the two charts shown in our survey (10 years and 1 year from retirement).

We have used market conditions as at 31 March 2018.

The TVC rules require a different approach to be taken for someone who is within 12 months of normal retirement age. In particular, the FCA's standard assumptions for illustrating the cost of an annuity are required to be replaced by an open market annuity quotation. This may lead to step changes in TVC calculations at this point in time, ie immediately after the "1 year from retirement" figures that we have analysed in this survey.

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