Institute and Faculty of Actuaries

Pensions Thematic Review
Key recommendations

IFoA Executive

12 January 2021

Executive summary

- The Actuarial Monitoring Scheme (AMS) Review Team has completed its initial Thematic Review on the actuarial factors used in UK pension schemes.
- Details of the Review Team's approach and their key recommendations are set out in the remaining slides. The draft report, which includes a comprehensive list of recommendations, is available on request.
- The Review Team is aiming to publish the Thematic Review Report in December.

Recommendations

- The Board is asked to:
  - endorse in principle the recommendations, and
  - ask the Executive to discuss the recommendations with FRC and TPR
- Next steps
  - Review Team to publish Thematic Review report in December in the form of non-mandatory guidance
  - Executive to provide updates to the Board on implementing recommendations

Today’s discussion

- Key recommendations and next steps
- Scope and approach
- Key recommendations in detail
- Supporting material
  - Background on actuarial factors
  - Notes on benchmarking charts
  - Useful links

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Key recommendations and next steps

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Key recommendations

- The standard of the examples we reviewed was generally very high.
  - Advice on transfer values appeared to follow closely the relevant regulations and regulatory guidance.
  - Advice on commutation factors, which is subject to less regulation but instead depends on each pension scheme's rules, is more variable, with more reliance on scheme actuary judgement.
- These are the headline recommendations which aim to improve further the quality of the advice given by actuaries:
  - Actuaries should explain why transfer values and commutation rates differ
  - Actuaries should regularly review commutation rates
  - Actuaries should certify commutation rates where required
  - Actuaries should improve how they communicate assumptions and results
  - Further research should be conducted on the way commutation rates are set
  - Industry-wide benchmarking should be compiled

Approval and next steps

- We have set out our key Thematic Review recommendations in this presentation. A full list of recommendations is included in the appendix. There are three types of recommendation:

	Type of action	Anticipated action
Member recommendations	• Highlighted area of existing regulations, legal requirements or standards which are not always being met.	• Scheme actuaries (and the organisations employing them) should reflect upon these recommendations and make appropriate adjustments to their future advice and advice templates in relation to actuarial factors.
Regulator recommendations	• Suggested adjustments to standards or regulations with the aim of improving the quality of future actuarial work in this area.	• Executive discussions with Financial Reporting Council (FRC) and the Pensions Regulator (TPR). • Members should also consider whether to comply with this type of recommendation now.
Research recommendations	• Suggested research areas, including collation of benchmarking information, aimed at assisting scheme actuaries with this type of advice.	• Executive discussions with FRC, TPR and potential research bodies.

- The Board is asked to endorse the recommendations in principle and to ask the Executive to discuss the recommendations with FRC and TPR.

Next steps

- Review Team to publish Thematic Review report in December in the form of non-mandatory guidance
- Executive to provide updates to the Board on implementing recommendations

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Scope and approach

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Review scope

- Transfer values
  - Is advice consistent with regulations, TPR guidance and scheme rules?
- Commutation factors
  - Is advice consistent with the actuary’s role under scheme rules?
- Is the frequency / timing of review appropriate?
- Are the criteria advised upon appropriate?
- TAS 100 / 300 and The Actuaries’ Code
- Benchmarking of actuarial factors

Submissions

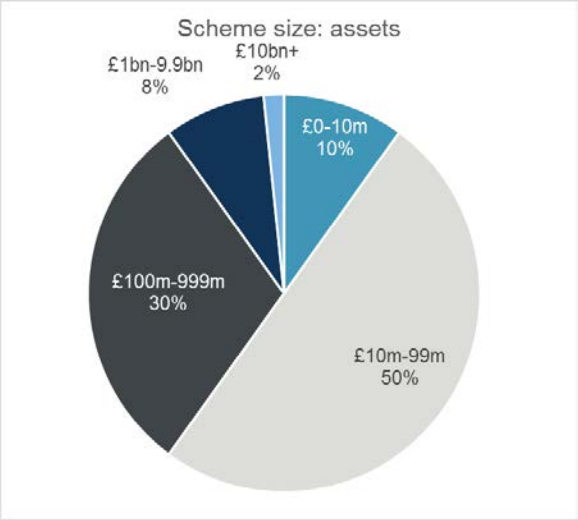
- We asked organisations employing scheme actuaries to submit to us examples of actuarial advice on **transfer values** and **commutation rates.**
- We asked for up to seven examples, based on the size of each organisation.
- We received a total 63 examples from 19 organisations:

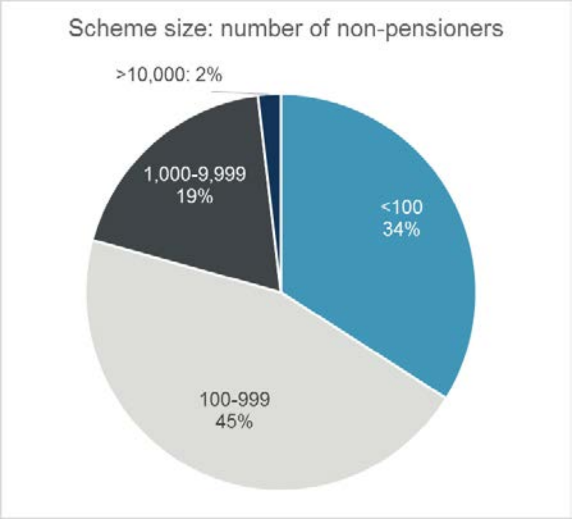
Aon ~ Atkin ~ Barnett Waddingham ~ Buck ~ Capita ~ Cartwright ~ Censeo ~ Deloitte ~ Exactval ~ First Actuarial ~ GAD ~ Hymans Robertson ~ LCP ~ Mercer ~ Quantum ~ Quattro ~ Spence ~ Willis Towers Watson ~ XPS

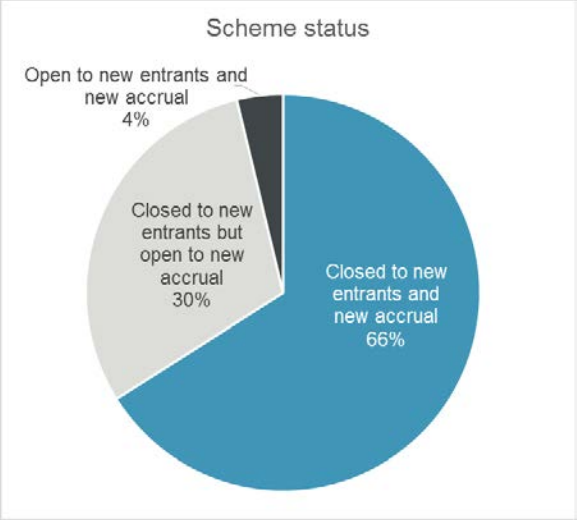
- We also held discussions with a subset of 15 scheme actuaries for further insight about their advice and the trustees' subsequent decisions.

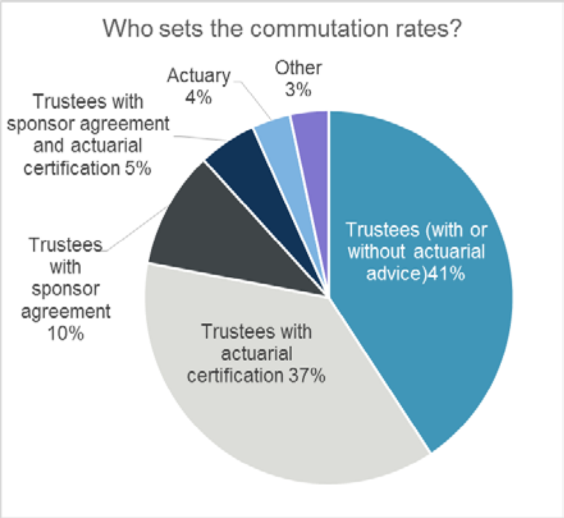
Types of schemes covered

- The pie charts illustrate the features of the schemes covered by the examples we received:









- Although our review was not designed to be statistically representative, it appears from these charts that we have obtained a reasonable range across a wide variety of scheme types.

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Key recommendations in detail

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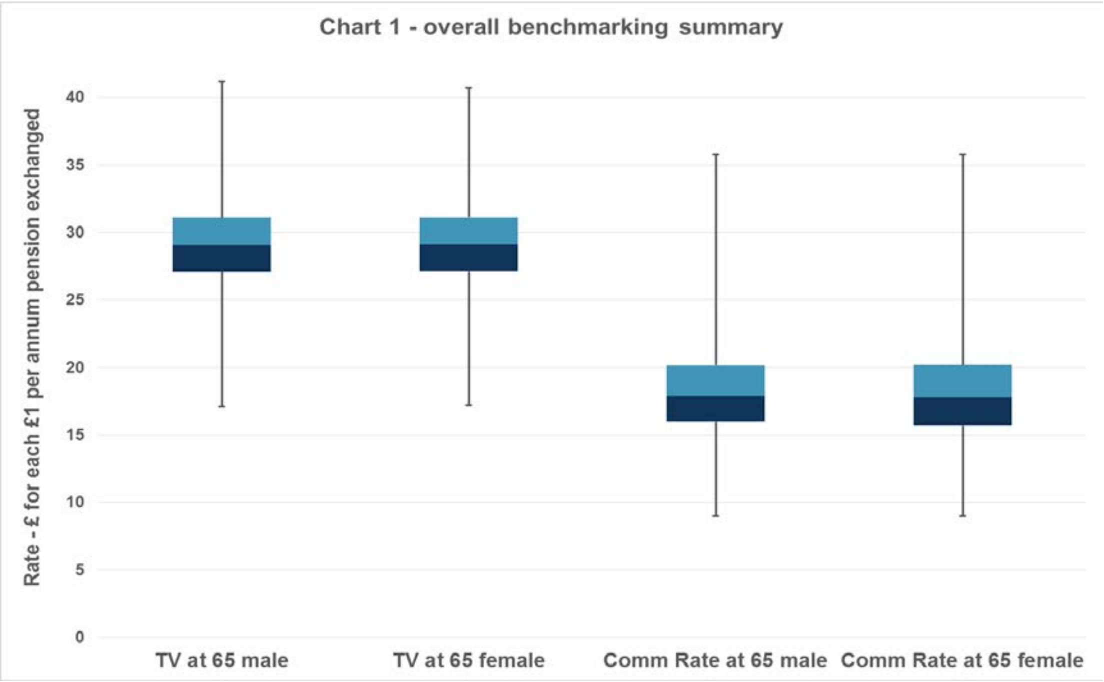
Actuaries should explain why transfer values and commutation rates differ

- We found that the median transfer value at age 65 for £1 per annum pension is £29. The equivalent commutation rate at the same age is £18.
- Although commutation rates do not typically allow for a spouse's pension, these rates are otherwise comparable in being a lump sum in exchange for a lifetime pension.
- The reasons why these factors differ stem from the way they need to be set:
  - Transfer values must be 'best estimate' according to regulations
  - Commutation rates are set in line with scheme's rules, and are often seen as part of the scheme design
- Trustees should understand the differences between the assumptions used for these factors.
- In line with TAS 300, actuaries should clearly explain to the trustees the rationale for these differences.



Actuaries should regularly review commutation rates

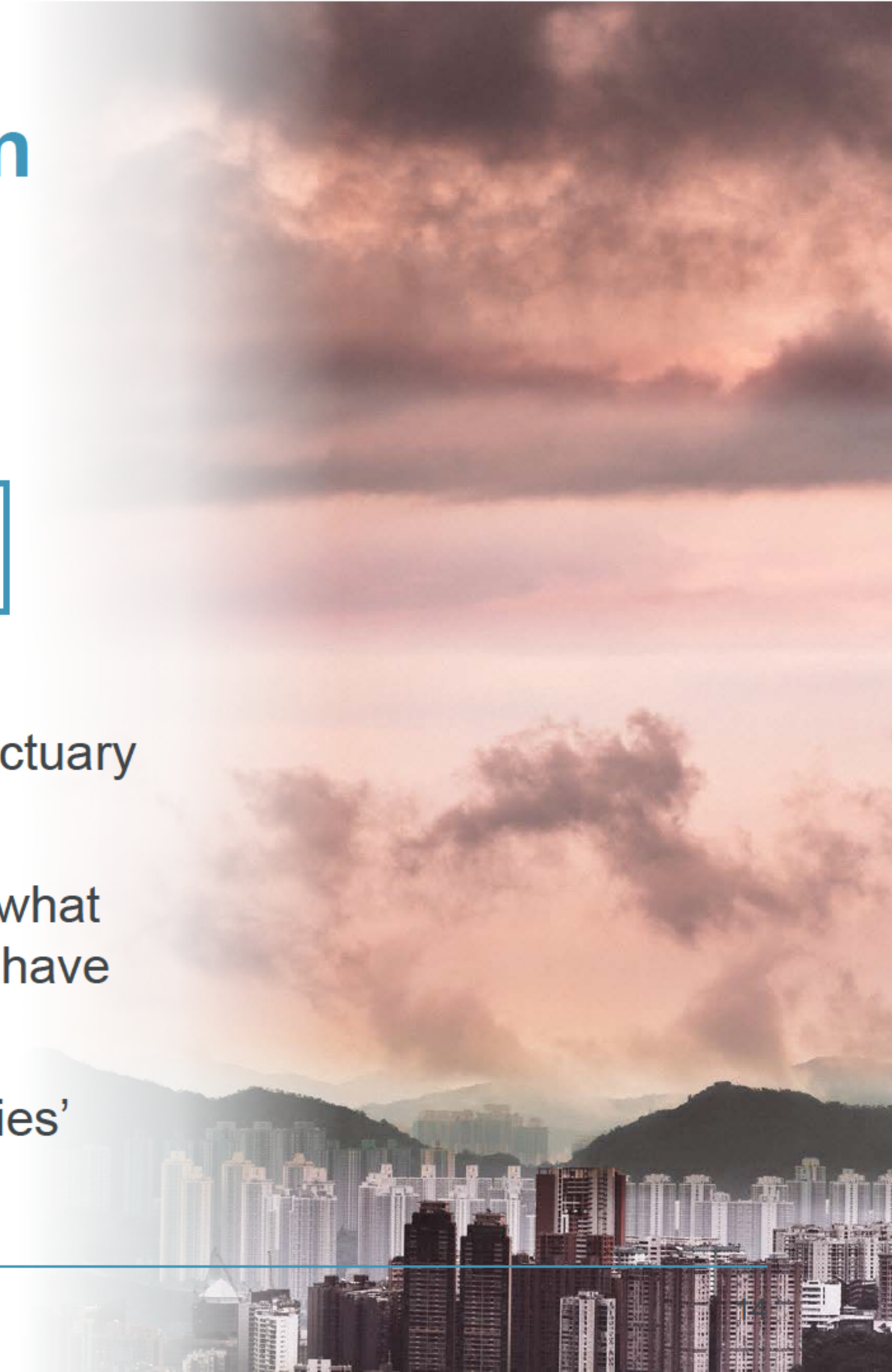
- The IFoA's 2016 Risk Alert called for actuaries to consider the frequency of providing advice about commutation rates and for actuaries to be aware of trends in market conditions.
- We found that most actuaries provided such advice on a three-year cycle aligned to triennial actuarial valuations, rather than in response to changes in market conditions.
- We recommend that three years should be seen as the *maximum* time between reviews, rather than the default, unless a scheme's commutation rates (like transfer values) vary with market conditions.
- This is important to ensure that the basis underlying the latest advice does not become out of date and lead to poor outcomes for the member.
- We also found that only 10% of actuaries gave commutation rate advice *during* the valuation process, rather than once it had been completed. This also goes against the 2016 Risk Alert, which called for this where the rates have a funding impact.

Actuaries should certify commutation rates where required

- Many scheme rules require the actuary to ‘certify’ that the commutation rates set by the trustees are reasonable:

> **Example:** Under the Scheme Rules the commutation rates are “*determined by the Trustees calculated on a basis certified as reasonable by an Actuary*”.

- In most such cases, we found no language certifying that the factors are reasonable and often no discussion on what the actuary considers to be ‘reasonable’.
- The actuary should explicitly make a certification, or indicate what certification can be provided at a later date once the trustees have made their decision.
- This is consistent with the Compliance principle of the Actuaries’ Code.



Actuaries should improve how they communicate assumptions and results

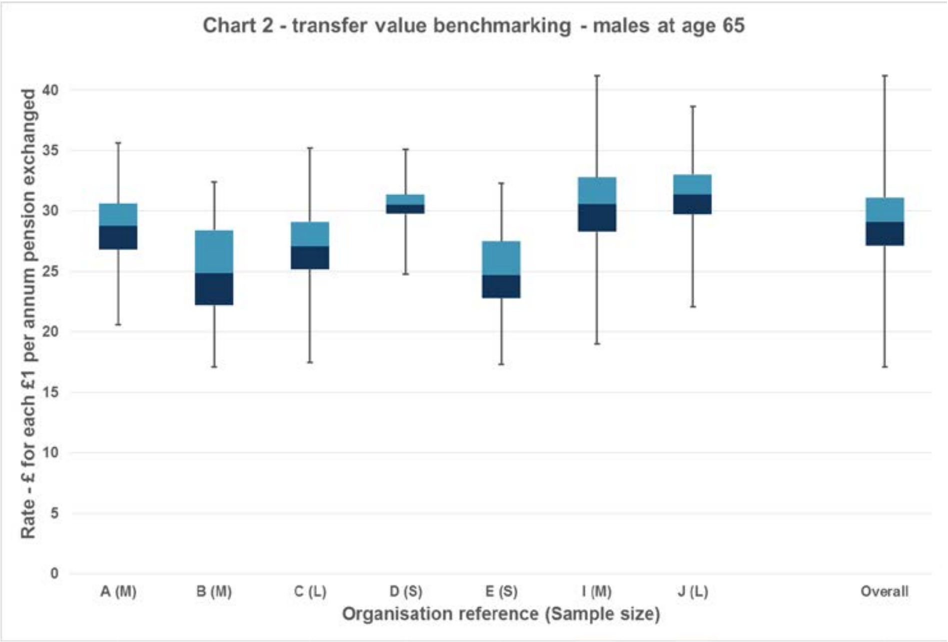
- Although many actuaries gave clear explanations of the financial impact of their advice, many did not address the typical trustee's simple questions:
  - "*what changes are being proposed, and why?*", and
  - "*how do the changes affect members and funding?*".
- Actuaries should improve how they communicate:
  - Explaining changes to assumptions
  - Explaining differences in the resulting actuarial factors
  - Showing the member impact
  - In the case of commutation rates, stating the assumptions used
- These are all required by TAS 100 and TAS 300. See appendix for overall compliance scoring.

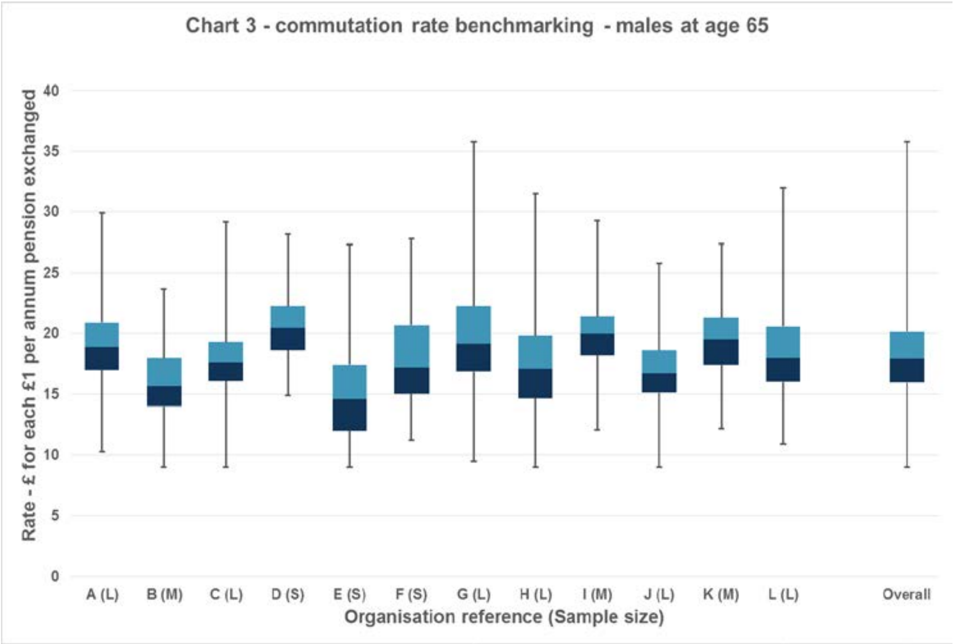
Further research should be conducted on the way commutation rates are set

- In most cases, actuaries advised trustees to set commutation rates below best estimate rates.
- We found a wide range of actuarial and non-actuarial reasons cited for the approaches adopted, including:
  - selection risk, to justify paying commutation rates below best estimate
  - market volatility, to justify not reflecting recent lower bond yields in full as it might be difficult to reduce commutation rates in future should yields rise.
- We call for further research on the appropriate adjustments to make for these and other common criteria in use for determining commutation rates.

Industry-wide benchmarking should be compiled

- We collated benchmarking on transfer values and commutation rates currently in use, covering around 1,800 pension schemes.





- This shows apparent differences between the rates set when advised by actuaries from different organisations.
- Although actuaries often explained the limitations of benchmarking in their advice, there remains a risk that an individual organisation’s benchmarking may give a misleading picture of actuarial factors generally in use.
- We recommend that a central pensions industry body collates this information to provide an authoritative source of benchmarking.

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Supporting material

Background on actuarial factors
Notes on benchmarking charts
Useful links

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Background on transfer values

- Pension scheme members who have not yet retired have the option to take a transfer value, in place of all future benefits that would otherwise be payable from the scheme.
- Transfer values are usually calculated by the pension scheme in response to a member's request to exercise their statutory right to a 'cash equivalent transfer value' or CETV. For brevity, unless otherwise stated, 'transfer value' in this report refers to a CETV.
- A transfer value should represent the expected cost of providing a member's defined benefits within the scheme, allowing appropriately for member options and trustee discretions. It is a value determined on actuarial principles, which requires assumptions to be made about the future course of events affecting the scheme and the member benefits.
- The current framework for calculating transfer values dates from October 2008, with legislation setting out the requirement for trustees to determine the assumptions to be used in such calculations. The Pensions Regulator also issued guidance to trustees to assist them with the regulatory requirements.
- The same assumptions and principles are also used to value pension benefits for the purpose of divorce proceedings.
- A quotation requested from a member for a transfer value which falls outside the statutory framework is often known as a non-statutory transfer value. An example of this is where the member is within a year of normal pension age. Such non-statutory transfer values are often, but not always, derived using the same assumptions as above.

Background on commutation rates

- At retirement a member may choose to receive an immediate tax-free lump sum in exchange for part of their pension. In legislation, this is referred to as a 'Pension Commencement Lump Sum'.
- In a defined benefit pension scheme, a 'commutation rate' is applied to convert a pension amount into a cash sum. For example, a commutation rate of 20 would result in a £20,000 cash lump sum being paid to the member in exchange for giving up an annual pension of £1,000. The member is exchanging a defined series of taxable future payments over the remainder of their lifetime for a single tax-free cash sum that is payable immediately.
- Commutation rates are sometimes also known as commutation factors or cash commutation factors (CCFs).
- The way commutation rates are determined is set out in the rules of each pension scheme (although historically the Inland Revenue also had to approve them). These rules define the roles of the trustees, the actuary and sometimes the sponsoring employer in determining the commutation rates.

Notes on benchmarking charts

- The figures shown in each chart represent the overall ranges of transfer values and/or commutation rates seen by organisations. A transfer value (TV) of 18 means that the member would be offered a transfer value of £18 for each £1 a year pension transferred. Likewise a commutation rate (Comm Rate) of 18 means the member would be offered £18 for each £1 a year given up (or "commuted").
- The median figure is shown at the border of the light and dark blue bars, the lower quartile and upper quartiles are shown at the bottom of the dark blue and the top of the light blue bars respectively. Half of the results therefore lie in the area covered by the light and dark blue bars. The minimum and maximum figures are shown at the foot and the tip of the two stems.
- For organisational benchmarking, the sample size is shown in brackets for each organisation as Large (L) for more than 150, Medium (M) for 50 to 149 and Small (S) for less than 50 schemes.

Useful links

Title	Author	Link	Description
Actuaries' Code	Institute and Faculty of Actuaries	https://www.actuaries.org.uk/system/files/field/document/Revised%20Actuaries%27%20Code%20FINAL.pdf	Ethical code for all IFoA members
Thematic Review Programme	Institute and Faculty of Actuaries	https://www.actuaries.org.uk/upholding-standards/actuarial-monitoring-scheme/thematic-review-programme	Published material on IFoA Thematic Review Programme
TAS 100: principles for Technical Actuarial Work	Financial Reporting Council	https://www.frc.org.uk/document-library/actuarial-policy/2016/tas-100-principles-for-technical-actuarial-work	Technical standards for all actuaries
TAS 300: Pensions	Financial Reporting Council	https://www.frc.org.uk/document-library/actuarial-policy/2016/tas-300-pensions	Technical standard for specified actuarial work on pensions
APS X2: Review of Actuarial Work	Institute and Faculty of Actuaries	https://www.actuaries.org.uk/documents/aps-x2-review-actuarial-work	Ethical standard setting out types of review to be applied to actuarial work
2016 Risk Alert	Institute and Faculty of Actuaries	https://www.actuaries.org.uk/system/files/field/document/Risk%20Alert_CFactors.pdf	Risk Alert: Commutation Factors
Transfer values guidance	The Pensions Regulator	https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/transfer-values	Guidance on the calculation of transfer values