Quattro Pensions
CONSULTING ACTUARIES

news bulletin

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Cash factors and transfer values – how long before the first complaint?

"Dear Member,

You are eligible for trivial commutation, and could receive £8,000 (receiving £16 cash for every £1 of pension).

Or you can have a transfer value of £12,500. (Hint: If you do this, you might be able to take all of this as cash – so that's £25 cash for every £1 of pension.)

Or you can take your pension, and surrender only some of it for cash. If you do this, you'll get £12 for every £1 of pension you give up.

Yours sincerely
Pensions Admin

PS the actuary thinks you'll live another 24 years."

Pension Flexibilities

The new pension flexibilities introduced in April this year have increased the number of people looking to get access to the cash value of their pension, either by transferring to a defined contribution scheme or by taking advantage of the much more generous new trivial commutation rules.

And of course, retirement quotations routinely quote the "normal" cash by commutation option.

It's only a matter of time until a member receives a letter like the one here, quoting the cash amounts available under the different options.

How would you react if given these three vastly different options, for what you might think are the same thing?

April 2016: First GMP Reconciliation Deadline

Trustees only have until April 2016 to register for HMRC's GMP Reconciliation Service, and HMRC will stop replying to scheme queries in October 2018.

It is therefore vital that schemes ensure that their contracted-records reconcile with HMRCs records before October 2018 – especially as HMRC plan to write to members in December 2018 to inform them of their GMP entitlement, which will clearly alert members to any discrepancies.

The implications of having discrepancies in your contracted-out records are:

- Disgruntled members
- Unforeseen additional liabilities, where the scheme has to increase the GMP due.
- Additional, previously unknown, members, for whom HMRC believes the scheme is responsible.

Trustees should instruct their administrators to act on this with some urgency – the process can be time-consuming, and we should expect HMRC will be busier than ever in the lead up to October 2018.

The picture painted above is not at all unusual. But is it defensible?

Transfer Values
A transfer value from a defined benefit scheme is supposed to represent a best estimate of what it will cost to provide a member with his/her pension from the scheme. In other words, the transfer value is supposed to be "fair".

Typically, the calculation of a transfer value will in some way be based around market conditions, taking into account the way the scheme actually invests and current expectations around mortality.

Why should cash factors be any different?

Cash Factors
Many defined benefit pension schemes still use commutation factors considerably lower than the "fair" value that would be implied by using the scheme's transfer value basis.

The arguments used to defend this position might include:

- *Smoothing.* Instead of reflecting current market conditions a cash factor might be set around long-term "normal" interest rates.

  Unlike a member taking a transfer value, the member taking cash is less likely to be re-investing the money.

- *Perception of fairness over time.* Trustees may have an ideal that members retiring at different times should be offered the same options on the same terms as everyone else. Therefore, cash factors should be relatively stable over time, rather than market-related.

- *Ease of communication.* If cash factors are market related, and therefore changing frequently, it can be difficult to explain to a member what they can expect at retirement.

- *Selection risk.* This is the (slightly tenuous) idea that members take cash because they know something about their health that suggests a reduced life-expectancy, so making cash a better deal for them.

- *The original purpose of the scheme – a pension scheme, not a piggy bank.* Therefore, unless the Trust Deed demands it, cash factors do not necessarily have to be fair value, and having penal cash factors acts as an incentive for members to take their full pension rather than cash.

- *Penal cash terms help underfunded schemes.*

- *For normal commutation cash is paid tax-free, so it <u>might</u> be reasonable to reflect the tax saving in the factor.*

Trivial Commutation
In our experience, since April 2015 members interested in trivial commutation often also ask for a transfer value. If the resulting amounts are different it's bound to prompt questions, and if the transfer value is higher the member can simply go through the hoops and get his hands on the higher amount by transferring out. This being the case, doesn't it make sense that trivial commutation payments should be calculated on the transfer basis?

But...

How is exchanging pension for cash under the normal commutation route any different to exchanging a trivial pension for cash in full? Surely trivial commutation factors must be consistent with normal commutation factors? (That is, shouldn't trivial factors be the same as normal cash commutation factors plus a small uplift for the value of any spouse's pension?)

The problem then is that if trivial commutation logically lends itself to being consistent with transfer values, and normal commutation is essentially the same as trivial commutation…then we conclude normal commutation factors should be calculated on the transfer value basis too. But to do this would remove a potential source of profit from many schemes.

Next steps

Trustees should review the requirements of their Trust Deed in relation to factors and seek advice from their actuary – we do feel it is only a matter of time before a member somewhere gets upset.