

Pensions Newsletter No 10 : Cash equivalent transfer values

The Government today announced a major step forward in resolving the long running debate over the calculation of cash equivalent transfer values (CETVs) by publishing its response to last summer's consultation on the subject (www.dwp.gov.uk/consultations/2006).

CETVs are calculated for members wanting to move their benefits from one pension scheme to another. They are also used for valuing pension rights on divorce.

A transfer value is calculated by firstly estimating the amounts of a member's future pension payments, taking account of the amount of the entitlement which the member has built up, assumed rates of future increase and expected longevity. The second step of the calculation involves discounting these expected future payments to a present day value. This represents the amount which, if invested now, the scheme expects to be sufficient, on the assumptions made, to meet the benefit payments as they fall due. The discount rate used should therefore equal the return expected from the assets which are held by the scheme to back the pension entitlement.

It is this discount rate, and the consequent assumption about the asset backing for the benefits, which has been the subject of much debate. To date policy in this area has been delegated by Government to the actuarial profession. In the wake of increasingly divergent views the actuarial profession decided that it should be for Government to determine policy going forward. At one extreme some believe a transfer value should be sufficient to guarantee the pension benefits in an alternative pension arrangement. This implies using the discount rate implicit in insurance company buy out rates with correspondingly high transfer values. A more commonly held view is that the discount rate should reflect the return expected from the assets the scheme holds to back the entitlement as this is effectively the cost to the scheme if the transfer option is not taken. This approach is consistent with that in current actuarial guidance.

Today's announcement by the Government has confirmed that, for private sector schemes, the latter approach will be incorporated into legislation, thus providing a statutory framework which is compatible with the current structure. Each scheme's policy will be set with regard to the investment policy adopted by the scheme, taking account of the scheme's asset mix and the expected returns this will yield. Trustees will be expected to use a 'best estimate' approach to setting the appropriate discount rate and other actuarial assumptions so it would seem that the margins for prudence incorporated for statutory funding purposes would normally be disregarded when calculating CETVs.

The existing provisions which allow reduction of CETVs where schemes are underfunded at the time of transfer will be retained.

The Government is considering how best to adapt the proposed framework for private sector schemes to reflect the distinct nature of public sector schemes and plans to publish its decisions on this matter shortly.

Draft regulations are expected to be published for consultation in coming months and the Government plans to bring the new provisions into force in April 2008.