Financial Reporting Council

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Joint Forum on Actuarial Regulation:

Review of transfers from Defined Benefit to Defined Contribution Schemes following pension freedoms

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Foreword

The Joint Forum on Actuarial Regulation (JFAR) was established in 2013 by the Financial Reporting Council (FRC), the Institute and Faculty of Actuaries (IFoA), the Financial Conduct Authority (FCA), the Pensions Regulator (tPR) and the Prudential Regulation Authority (PRA). The JFAR is a collaboration between regulators to co-ordinate the identification and analysis of public interest risks to which actuarial work is relevant.

In October 2014, the JFAR, through its discussion paper *Joint Forum on Actuarial Regulation: A risk perspective*, sought views on its identification of risks to the public interest where actuarial work is relevant. The publication was intended to raise awareness of the risks and potential mitigations, seek views on the risks identified, and guide the JFAR's future work.

"Rapid change in the pensions market" was identified as an issue in the discussion paper. In particular, the pension freedoms, effective from 6 April 2015, was identified as a key change which may give rise to risks. The JFAR identified Defined Benefit (DB) to Defined Contribution (DC) transfers as an area for further examination.

This report sets out the conclusions of that review.

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Summary

Legislation introduced from 6 April 2015 significantly changed the UK's retirement savings landscape. Retirees with defined contribution (DC) arrangements have been given greater freedom to decide when and how they access their retirement savings. The freedoms do not directly apply to those with defined benefits (DB), but in many cases these individuals can transfer to a DC arrangement to access the freedoms.

Actuarial work is integral to key aspects of the DB to DC transfer process, and as part of its collaborative, ongoing work on public interest risks where actuarial work is relevant, the Joint Forum on Actuarial Regulation (JFAR) has undertaken a review of the issues that have arisen out of the legislative changes which affect DB to DC transfers.

Individual regulators of the JFAR each have different roles in relation to DB to DC transfers. The JFAR was interested in the impact on actuarial practice for DB schemes in relation to transfers as a result of the pension freedoms, and the extent of any related risk to the public interest.

Through the review, the JFAR wanted to understand the extent to which transfer activity had increased since the introduction of the freedoms, and to understand any changes in the nature or volume of actuarial work as a result of the freedoms. The JFAR then considered whether any changes to actuarial regulation or guidance are needed following the introduction of the pension freedoms to mitigate any potential increase in public interest risk arising from actuarial work.

Based on data collected in this review, as at 1 October 2015, the review found:

- There has been an increase in both transfer quotations and actual transfers out since the introduction of the freedoms. However, the number of transfers remains low.
- The initial increase in activity may not have been as big as some might have expected due to the nature of the transfer process – in particular, the availability of products/providers for transferred funds, members' understanding of the options, the cost and availability of advice and the FCA's Rules underlying the advice and the value members place on DB benefits, in particular the certainty and perceived security.
- Trustees do not appear to be actively promoting transfers through changes to member communications or options in the scheme.
- Some employers with DB schemes are showing interest in the freedoms to manage the risks to them arising from DB schemes.
- There has been increased actuarial work on reviewing transfer value assumptions.

Following the legislative changes, individual regulators have implemented a number of changes and initiatives which tackle wider issues arising. These include the requirement for specialist advice; new FCA Rules for elements of that advice; updated guidance for trustees on DB to DC transfers; and consideration of the requirements for actuarial work on actuarial factors used to value members' benefits.

It is still early days, both in terms of the implementation and impact of the freedoms (including recent initiatives of individual regulators) and, although we found that the level of transfer activity had increased, the actual number of transfers is low. It is possible that transfer activity and promotion activity by sponsors will increase over time as awareness of the freedoms grows and issues with the advice process and market for transferred funds are resolved. It is also possible that over time other actuarial issues may arise in relation to changes in transfer experience.

The JFAR has concluded that it will continue to monitor the level of transfer activity and any actuarial issues arising in this area. The JFAR has discussed the findings of the review with the Department of Work and Pensions. It has also highlighted the feedback gathered as part of this review on the transfer process to the FCA.

Scope of the review

The JFAR was interested in the impact on actuarial work for DB schemes in relation to transfers as a result of the pension freedoms. Actuarial work is integral to key areas of the transfer process and the advice to trustees and sponsors on the wider potential impact of transfers. For example actuaries provide:

- advice to trustees on the assumptions used to determine the transfer value of a member's DB benefits;
- advice to trustees on the extent to which transfer values payable from a DB scheme can be reduced to reflect the funding level of the scheme. Legislation permits schemes to reduce transfer values for underfunding if the Scheme Actuary provides an insufficiency report; and
- advice to employers with DB schemes on actions to manage liabilities which might include exercises where members are encouraged or incentivised to transfer from the scheme or design of arrangements with options to transfer to DC.

Additionally, the transfer value analysis that is required as part of an Independent Financial Advisor's (IFA's) advice on transfers can use actuarial assumptions set by the FCA or more cautious actuarial assumptions.

Through the review, the JFAR wanted to gather evidence to:

- ascertain the extent to which transfer activity had increased since the introduction of the freedoms; and
- understand any changes in the nature or volume of actuarial work as a result of the freedoms.

In light of this evidence, the JFAR then considered whether any changes to actuarial regulation or guidance are needed to mitigate any potential increase in public interest risk arising from actuarial work.

Approach to the review

We sought views from a number of stakeholders involved in DB to DC transfers. We are grateful to all those who provided input to this review.

We held informal discussions with consulting actuaries, the Pensions and Lifetime Savings Association, The Pensions Advisory Service, independent financial advisors and a provider of transfer value analysis software for advice under the FCA's Rules. Additionally, we surveyed Scheme Actuaries and scheme administrators.

Scope of surveys

A JFAR designed survey of Scheme Actuaries was issued by the Institute and Faculty of Actuaries to 881 Scheme Actuaries in early September. The survey closed on 30 September 2015 and we received responses from 311 Scheme Actuaries – a response rate of 35%. These 311 respondents advise around 2090[1] schemes or 35% of DB schemes.

We contacted five of the larger firms of scheme administrators and asked them to complete a short questionnaire. We received three responses - a response rate of 60%. These respondents administer 879 schemes covering over 2.25 million memberships, 20% of the members of DB schemes. The data gathered covered the period from 6 April 2015 to 1 October 2015.

Aims of surveys

Through the surveys, the JFAR had two objectives.

Firstly, the JFAR wanted to understand the level of transfer activity and whether it reflects an increase in particular activity, for example, sponsor-led initiatives such as encouraging members to transfer.

As a result, the survey of Scheme Actuaries sought information on the level of transfer activity and actions by trustees and scheme sponsors. The survey of scheme administrators focused on:

- the level of transfer activity;
- the characteristics of those transferring; and
- issues for those wanting to transfer.

Secondly, the JFAR wanted to understand the nature and extent of the actuarial work being undertaken as a result of the freedoms.

Consequently, the survey of Scheme Actuaries sought information on:

- the impact on actuarial work - in particular identifying work performed for DB schemes which considers the pension freedoms;
- reviews of transfer value assumptions including the insufficiency reports required under legislation to reduce transfer values for underfunding in the scheme; and

[1] The Purple Book DB Pensions Universe Risk Profile 2015 covered 5,945 PPF eligible DB schemes covering 11.0 million memberships

- reviews of other actuarial factors used to calculate member’s benefits (including those actuarial factors used to convert pension to cash at retirement) that have been undertaken since the pension freedoms were announced.

When considering the evidence gathered it is important to note that it reflects experience up until 1 October 2015.

In this report the results are often framed in terms of number of schemes, thereby giving equal weight to large and small schemes. The results may be different if they were expressed in terms of the number of members.

Evidence on DB to DC transfer activity

Key findings:

There has been an increase in transfer activity since the introduction of the freedoms – both in terms of transfer quotations and actual transfers out. However, the number of transfers remains low.

The increase in activity may not have been as big as some might have expected due to the nature of the transfer process - in particular the availability of products/providers for transferred funds, members' understanding of the options, the cost and availability of advice and the FCA's rules underlying the advice and the value members place on DB benefits, in particular the certainty and perceived security.

Trustees do not appear to be actively promoting transfers through changes to member communications or options in the scheme. Employers with DB schemes are showing a moderate or considerable interest in the freedoms as a means of managing the risks inherent in DB schemes.

The detailed findings from both surveys are set out below:

Transfer activity

Scheme Actuaries reported that, for over half of schemes, there had been an increase in the level of transfer requests since April 2015, with actual transfers out increasing for just over a quarter of schemes.

There was an increase in transfer requests of 32% and an increase in transfers out of 23%[2] for schemes run by the three scheme administrators. However, the number of both transfer requests and transfers out remains low.

Characteristics of those transferring

The majority of Scheme Actuaries considered that it was too early to gauge the characteristics of those who have transferred since April 2015, but others reported that the increased transfer activity was mainly either amongst those over 55 or those with large transfer values or both. Scheme administrators also considered that it was too early to gauge characteristics of transferees.

Low levels of transfers

The survey found that the level of transfers is low and several reasons for this were suggested:

[2] Compared to annualised figures for 6 April 2014 - 5 April 2015.

- The availability of providers willing to accept transferred funds and the availability of products into which funds can be transferred, particularly for non-advised transfers, is limited.
- The range of options available to individuals under the freedoms is wide, complex and not well understood. Additionally, the cost and availability of IFA advice, which is required for all transfers over £30k, and the complexity of the process may further deter individuals.
- Under FCA Rules, a firm advising on a pension transfer is required are required to undertake an analysis assuming that the transfer value is used to purchase an annuity. A number of respondents questioned the appropriateness of these rules following the introduction of the pension freedoms. Although it should be noted that the FCA Rules do not prevent additional analysis being undertaken.
- Some individuals considering a transfer have concluded that the advantages of remaining in a DB scheme outweigh the benefits of flexibility and choice offered by a transfer to a DC arrangement.

Actions by trustees

Approach to information provided to members approaching retirement

Scheme Actuaries reported that the information provided to individuals approaching retirement for the majority of schemes indicates, or will indicate, that a transfer value can be provided. A smaller proportion of schemes are providing transfer value quotations with retirement statements.

Changes to options in the scheme

It has been suggested that the ability to transfer part of an individual's DB benefit from a DB scheme into a DC arrangement might be attractive to members who wish to take advantage of the flexibilities of a DC scheme but wish to have some certainty of income in retirement. Our survey found that the majority of schemes do not allow or intend to allow partial transfers. The main barriers to allowing such transfers are administration issues (particularly costs and the challenges for schemes if they are left with small pensions to administer) and the complexity of the calculations. There are also issues relating to:

- communications to members,
- legal uncertainty on the treatment of contracted out rights,
- the unknown demand from members.

Actions by employers with DB schemes

The majority of Scheme Actuaries reported a considerable or a moderate interest from employers with DB schemes in looking at ways to encourage members to utilise the pension freedoms. The most common motivation is to reduce the cost and risk associated with the pension scheme.

Evidence on actual work

Key findings:

There has been increased actuarial work on reviewing transfer value assumptions to ensure that trustees consider the appropriateness of the values being place on benefits of those transferring out.

Where assumptions have been reviewed, there has been consideration of the differences between the assumptions applicable on the exercise of different options and a small proportion of schemes are reducing transfer values for underfunding.

The detailed findings from the Scheme Actuary survey are set out below:

Impact on actuarial work

For approximately two-thirds of schemes, actuaries have provided advice that the transfer value assumptions should be reviewed, and for 50% of schemes the results of a review of transfer value assumptions have been provided.

For around 40% of schemes there has been advice on the need to review commutation factors which are used to convert part of a pension into a lump sum on retirement.

For approximately half of schemes actuaries have provided advice on the clarity and appropriateness of the presentation of retirement options, including providing a transfer value at or close to retirement.

As a result of the freedoms, the volume of work on reviewing trivial commutation factors used to convert small pensions below a prescribed level into cash sums and, work on insufficiency reports required if the trustees want to reduce transfer values for underfunding in the scheme, had increased.

Transfer values and commutation factors

Transfer value assumptions

Scheme Actuaries reported that most reviews of transfer value assumptions have been undertaken as part of the triennial review of scheme funding, but in some cases reviews had been prompted by the pension freedoms. Clearly several factors can influence the decision to undertake a review.

Where reviews have taken place, the key issues discussed with trustees were the consistency with the Scheme Funding basis, consistency with assumptions for other actuarial calculations, and the link to the investment strategy of the scheme. The most challenging areas in providing advice were formulating a view on the best estimate of the amount needed, if invested by the scheme, to be sufficient to provide the member's benefits within the scheme, and whether to reduce transfer values for underfunding within the DB scheme.

Where reviews of transfer value assumptions have been concluded, the most typical changes to transfer values were either a decrease for older members and an increase for younger members, or an increase for most members. Several respondents indicated that the change in transfer value factors resulted from changes in investment strategy or mortality assumptions. Several respondents noted a change in approach to determining transfer value factors and a move away from dual discount rates. The majority of concluded reviews considered the differences between the assumptions for transfer values and other calculations.

Under legislation, schemes can reduce transfer values for underfunding provided there is an insufficiency report in place. 17% of schemes covered by the survey respondents currently have an insufficiency report, and nearly 80% of these schemes are reducing transfer values.

Commutation factors

Commutation factors are used to convert part of a pension into a lump sum at retirement. Trivial commutation factors are used to convert a small pension which is below a prescribed level into a cash sum.

Most reviews of the commutation factors have been undertaken as part of the valuation cycle but some reviews have been prompted by the pension freedoms.

Where "normal" commutation factors have been reviewed, the vast majority of factors have either increased (possibly by small amounts) or remained unchanged. The changes have resulted from improvements to mortality or changing market conditions, although some respondents noted a reluctance from trustees/sponsors to increase commutation factors because of affordability concerns.

As a result of reviews, "trivial" commutation factors have typically increased and have either been aligned to the transfer value factors, or aligned to the normal commutation factors.

Implications of increased transfers from DB schemes

It was noted by several respondents that to date the impact of the pension freedoms had been much less than expected.

Given this, the JFAR concluded that it was too early to draw any firm conclusion about the impact of the pension freedoms on transfers from DB Schemes (for example, advice to trustees and sponsor on the impact of increased transfer activity on the funding, membership profile, liability profile, liquidity needs, and investment strategy of the scheme).

Conclusions and next steps

In light of the evidence gathered the JFAR's conclusions and next steps are set out below:

Transfer activity

Our findings indicated that there has been an increase in the number of transfer requests and a smaller increase in the number of transfers out compared to last year. However, the actual number of transfers is low.

It is possible that transfer activity and promotion activity by employers will increase over time as awareness of the freedoms grows. It is also possible that as issues with the advice process and market for transferred funds are resolved a greater number of transfer quotations will result in actual transfers out.

Impact on actuarial work

The legislative changes have had an impact on actuarial work for DB schemes – in certain areas there has been additional work or considerations in light of the freedoms.

Individual regulators of the JFAR each have different roles in relation to transfers. Following the introduction of the freedoms, individual regulators have implemented a number of changes and initiatives which cover the wider issues, not just the actuarial aspects, including:

- the extension of the requirement that a transfer specialist advisor provides advice on DB to DC transfers;
- the FCA's consultation *Pension reforms – proposed changes to our rules and guidance* (CP 15/30) which sought views on the need to review the rules for transfer value analysis[3]; and
- updated TPR Guidance on DB to DC transfers and conversions published April 2015[4].

Additionally, the Industry Code of Practice on incentive exercises has been updated for the pension freedoms[5] and the FRC is considering amendments to its requirements on actuarial calculations as part of its review of its technical actuarial standards (TASs). The IFoA has issued a communication to its members reminding them of some of the public interest considerations arising from pension freedoms.

It is also possible that over time other actuarial issues may arise in relation to changes in transfer experience.

Conclusions and next steps

Acknowledging that it is still early days, both in terms of the implementation and impact of the freedoms (including recent initiatives of individual regulators), the JFAR has concluded that it will continue to monitor the level of transfer activity and any actuarial issues arising in this area.

[3] http://fca.org.uk/static/documents/consultation-papers/cp15-30.pdf
[4] http://www.thepensionsregulator.gov.uk/docs/db-dc-transfers-conversions-regulatory-guidance.pdf
[5] http://incentiveexercises.org.uk/the-code-of-practice

The recently announced changes to the Pensions Regulator's scheme return mean that from Summer 2017 the Pensions Regulator will have comprehensive data on transfer activity. In the interim, the IFoA will seek further informal feedback from its members later this year.

Members of the JFAR will feed back the results of their respective next steps and, where appropriate, relevant data, to the JFAR.

The JFAR has discussed the findings of the review with the Department of Work and Pensions. It has also highlighted the feedback gathered as part of this review on the transfer process to the FCA.

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