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LCP survey of DB Transfer Value Comparators

2022

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Executive summary

- The generosity of transfer values offered by DB schemes varies considerably by scheme – some are twice as generous as others (for the same benefits).
- This is typically for good reason, following directly from transfer regulations, and is a result of different investment strategies being adopted by different schemes, but the member generally only cares about the level of generosity and is not impacted by the reasoning.
- Since we last completed this survey, transfer values for typical deferred members have become more generous by around 11% - primarily this has arisen as a result of schemes de-risking their investment strategies – we expect this trend to continue (*note: this is on top of any increases/reductions that arise from changes in market conditions*).
- As might be expected, there is evidence that more generous transfer values do indeed lead to higher take up rates.
- As more generous transfer values still generally represent a funding gain for pension schemes, this means that improving the generosity of transfer values can be a 'win' for members, schemes and sponsors.
- The introduction of the requirements around TVC appear to be having the impacts we expected, which are expected to be positive impacts for members.
- We continue to recommend that trustees and employers consider the generosity of their transfer values through the lens of the member, by benchmarking them against other schemes, particularly at the point of making changes to the way transfers are calculated.
- Given the continuing improvements in transfer values, we expect member demand for considering transfers to remain high, albeit in practice, transfer activity is likely to remain constrained somewhat by reduced numbers of financial advisors, increased costs of advice and the hurdles of new anti-scam regulations.

Background

DB transfer values remain 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 the last seven years, more than 250,000 people have chosen to transfer DB pension rights with a combined value of more than £85 billion into Defined Contribution arrangements[1].

However, in recent years, due to concerns about the quality of pension transfer advice provided by financial advisers, the FCA has implemented a series of changes to the rules that govern this advice. In October 2018, as part of a suite of changes, the FCA introduced the 'Transfer Value Comparator' ('TVC'). At that time, we 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[2].

In this paper we set out our updated benchmarking of how transfer values differ across schemes when looking through the lens of the TVC and we consider what impact this has on the take up of transfer values.

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 required all pension transfer advice to include a Transfer Value Comparator. The TVC must 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).

[1] www.lcp.uk.com/media-centre/2021/10/on-point-paper-mind-the-transfer-advice-gap/ and Pension transfers decline as FCA rules start to take effect - FTAdviser.com
[2] https://www.lcp.uk.com/pensions-benefits/publications/survey-how-generous-are-transfer-values/

What is the Transfer Value Comparator (TVC)?

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

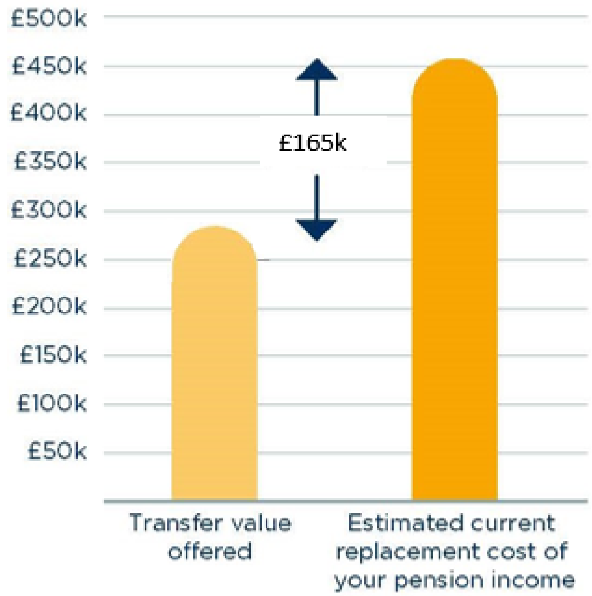
Guidance from the FCA[3] published in March 2021 states that "*If a TVC shows a loss to the client, this does not preclude a transfer. There may be good reasons why it makes sense to take this notional loss, depending on the client's circumstances. Equally, if a TVC shows a notional gain, this does not mean that a transfer is suitable. The TVC is a good starting point for discussion and comparison ahead of an objective analysis based on the client's circumstances.*"

The TVC will take no account of the client's personal circumstances (e.g. 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 (e.g. the normal retirement age, level of pension increases etc). Therefore, two different pension schemes providing the same pension benefit to two similar members (same age etc) 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.

One of the FCA's aims of introducing TVCs was 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.

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



You have been offered a cash equivalent transfer value of **£285,000** 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 **£165,000** more by transferring.

[3] https://www.fca.org.uk/publication/finalised-guidance/fg21-3.pdf

How do transfer values differ between schemes?

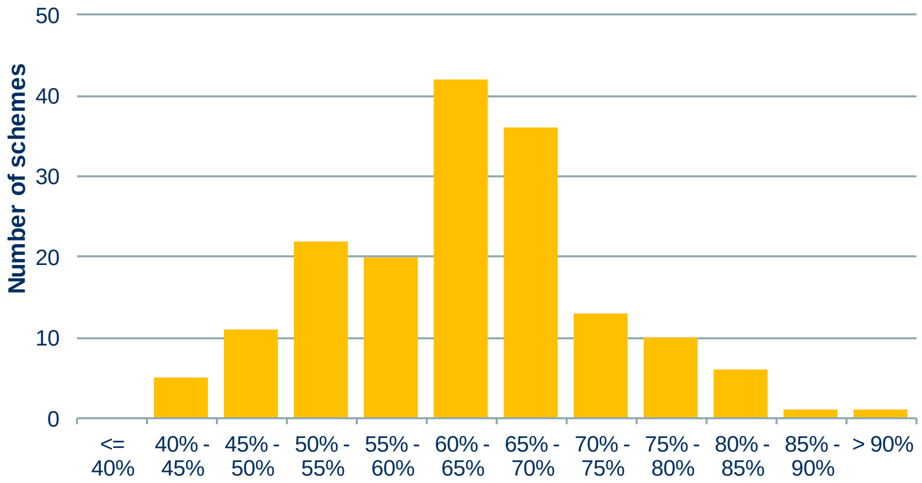
Transfer values offered by two different pension schemes are likely to differ. By law, the assumptions underlying transfer values are determined by each set of trustees, having taken advice from their own Scheme Actuary and, critically, having regard to the expected best estimate returns on their scheme's 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[4]. 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 be considerably more 'generous' to members than others and this is illustrated by the TVC outputs.

This survey looks at how transfer values differ across schemes, when looked at through the lens of the TVC and also how this compares to the results of our October 2018 survey. Similar to our previous survey, around 200 schemes have been included and these 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 show 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 – overleaf - another chart follows for members one 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.

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

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



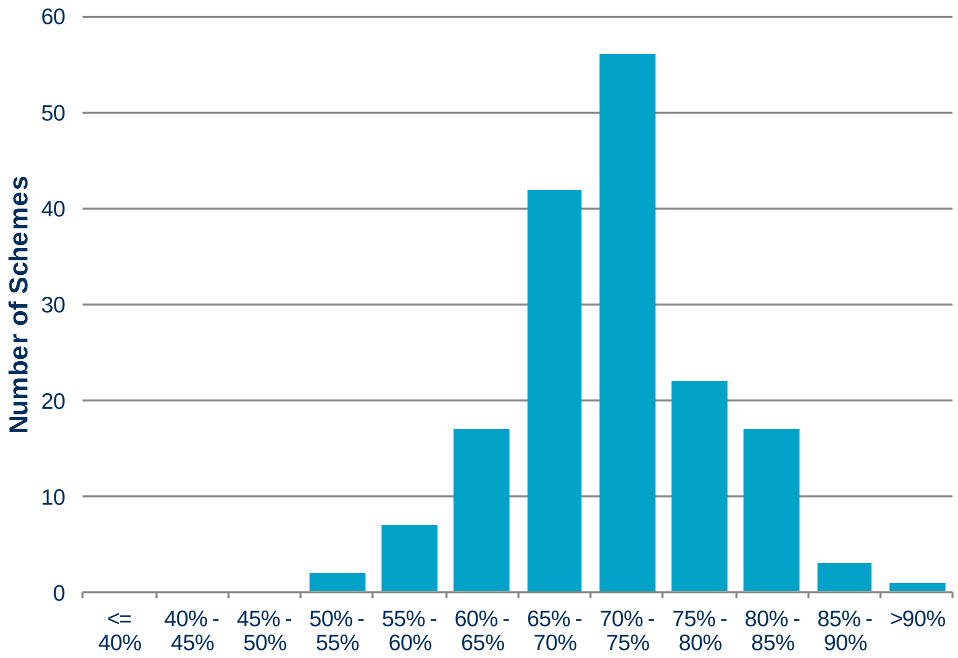
The mean ratio in our survey for members 10 years from retirement is 63%. In other words, the average transfer value across all schemes surveyed provides such a member with 63% of the estimated cost of replacing their benefit by purchasing an annuity at retirement (using the prescribed FCA assumptions).

The mean ratio in our 2018 survey for members 10 years from retirement was 57%. In other words, the average transfer has increased by 11% (i.e. 63%/57% -1) when compared to TVC replacement cost. This reflects schemes continuing the journey of reducing risk by switching from return-seeking assets to lower risk assets such as government bonds. In addition, the increase reflects schemes reducing the assumed gap between RPI and CPI due to expectations that RPI will be aligned to CPIH from 2030 (the FCA have not yet amended their assumptions) and also the FCA reducing the assumed product charge within the TVC in the period up until retirement.

How do transfer values differ between schemes?

Continued

Transfer value as a % of TVC replacement cost (1 year from 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 one year from retirement is 71%.

The mean ratio in our 2018 survey for members one year from retirement was 73%. In other words, the average transfer is broadly unchanged when compared to TVC replacement cost. This analysis suggests that the post retirement assumptions being adopted in 2018 for transfer values are broadly unchanged, and that assumption changes arising from de-risking have been focussed on 'pre-retirement'. This is in line with our experience of the approach often taken by trustees when setting transfer values. The change in the gap between assumed RPI and CPI has less impact for members one year from retirement because in our benchmarking we have assumed pension increases in retirement are all linked to RPI and not CPI.

A very wide range of transfer value generosity …

Similar to our 2018 survey, it is interesting to note quite how large the range of transfer values is – *there are a number of schemes that provide transfer values more than double other schemes for members who are not yet at retirement.*

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 and financial advisers.

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

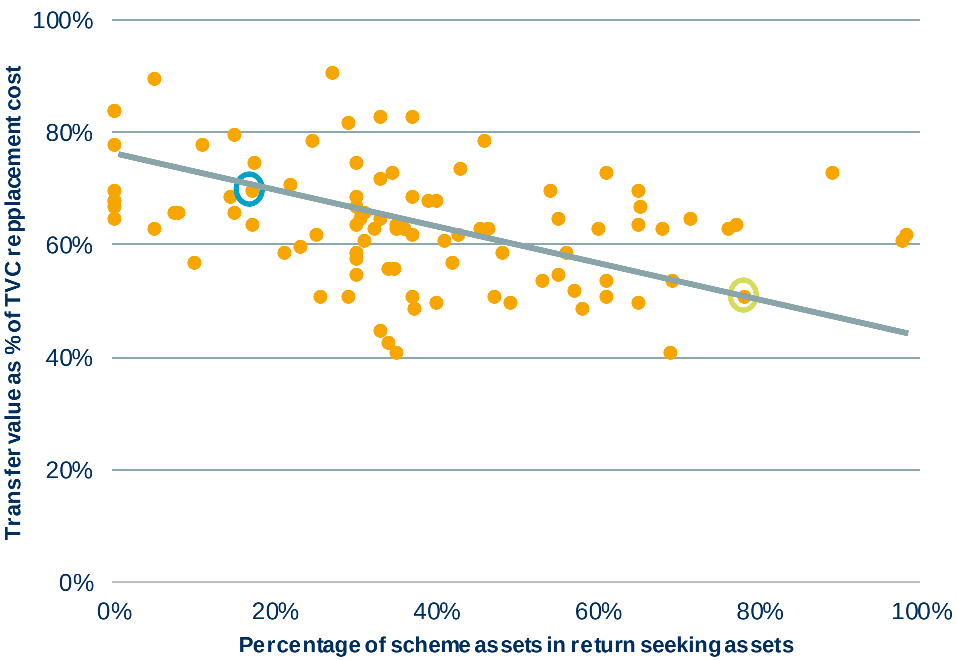
The graph on the right shows that pension schemes investing more in return-seeking assets, such as equities, typically provide lower transfer values when measured against the TVC replacement cost. This is to be expected given the legal requirements that govern the calculation of transfer values.

For example, for members who are 10 years from retirement, a scheme that is invested 80% in return-seeking assets (equities, property etc - the green 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). However, there is wide variation around this trend. This 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 or corporate bonds, it might be expected that transfer values will continue to 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); and
- Longevity expectations (generally, if expected improvements in life expectancy slow down e.g. following a pandemic, this can be expected to lead to lower transfer values).

TVC % vs return seeking assets (10 years from retirement)



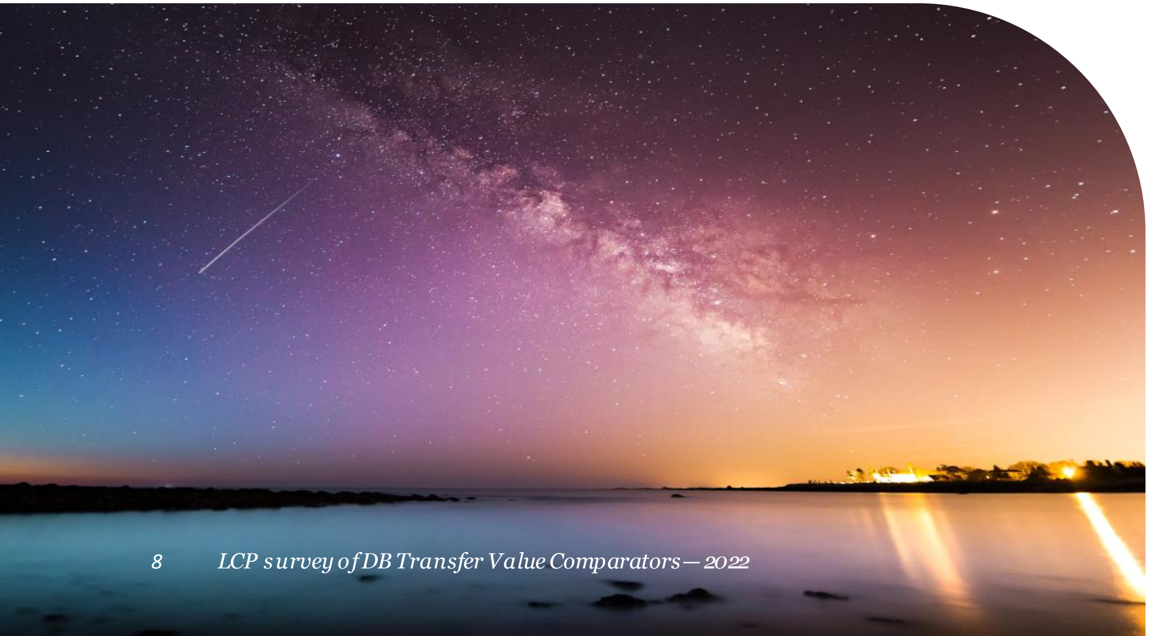
How has the TVC illustration impacted the number of members transferring?

In 2018 we predicted that once the new TVC requirements were in force, members and their financial advisers would 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 also predicted that this may have the following impacts on transfer decisions:

1. Some members and their advisers may decide that transfer values with lower TVC replacement percentages are not worth transferring;

2. 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

3. 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.



In practice, each of these points has been borne out by evidence. Taking them in turn:

1. Our latest quarterly review of the transfer experience of the schemes we administer[5] shows that 16% of all transfer values quoted in the 12 months to 1 October 2021 proceeded to payment. This compares to 28% transfer values quoted in the 12 months to 1 October 2018.

2. This same data shows that on average members are taking transfers at higher ages. The average age for payment is now 57, which compares to average age of 55 for quotations issued in the year to 1 October 2018. In particular, there has been a significant decrease in take-up rates among younger members, with only 10% of quotations now issued to members below 50 being taken up which compares to nearly 20% of quotations taken up by members below 50 in the year to 1 October 2018.

3. We have also analysed the take-up of transfer values from the schemes that LCP administers, depending on their TVC replacement percentage. The take-up rate over the three years from 1 October 2018 for schemes with a top quartile TVC replacement percentage (i.e. generous transfer values) was around 24% whereas for schemes with a lower quartile TVC replacement percentage (less generous) was around 14%. The gap over recent months also appears to have widened further, with the take up rates for schemes with the lowest TVC replacement percentage reducing.

Therefore, the TVC requirements that have now been in place for nearly four years appear to be impacting the market in the way we expected, which in each case is likely to lead to better decisions being made by members and their advisers.

[5] www.lcp.uk.com/our-viewpoint/2022/06/all-change-for-db-transfers-issue-27/

Appendix 1 - Prescribed form of the Transfer Value Comparator (TVC)

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.

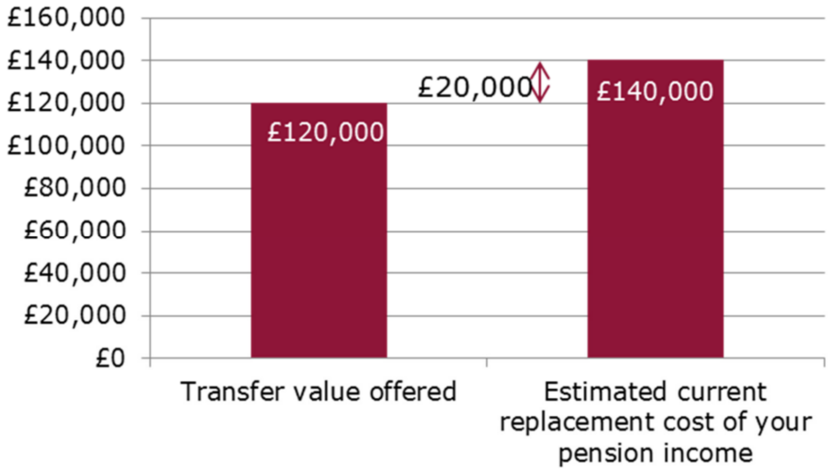
Will I be better or worse off by transferring?

• 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 (or the retirement age assumed in the calculation of the transfer value if you have passed the normal retirement age or the earliest age at which you can take unreduced benefits without consent being required) 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 risk free 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.

COBS 19 Annex 5 Format for provision of transfer value comparator - FCA Handbook

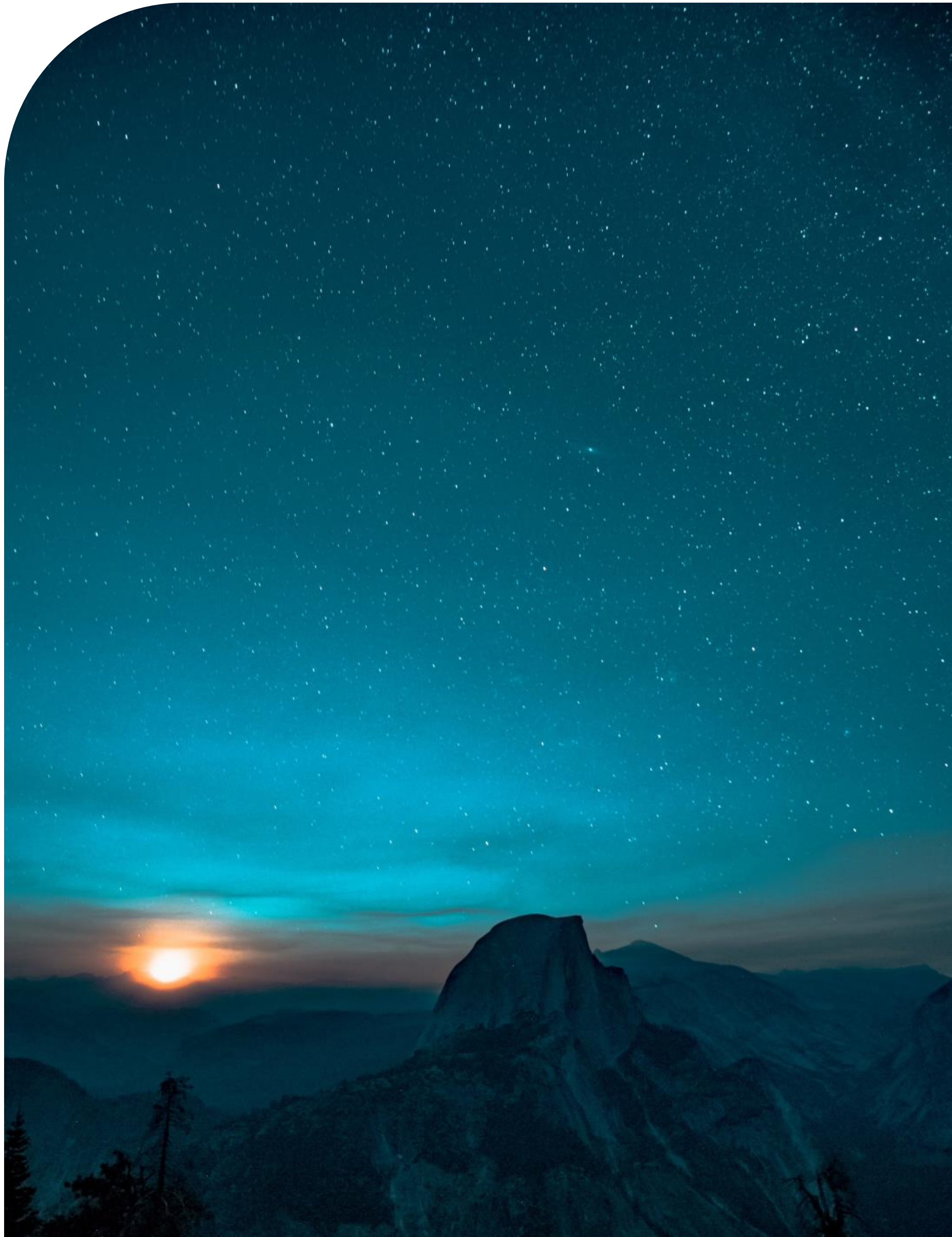
Appendix 2 – Notes to calculations

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 one year from retirement).

We have used market conditions as at 6 April 2022.



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