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PENSION CAPITAL STRATEGIES
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THE PCS ALERT
The latest in DB Pensions

TRANSFER VALUES – WHY HAS IT GONE SO BADLY WRONG ?

Dear Sid

Transfer values are a mess, but should you care? The answer is emphatically - yes. Companies are missing a major opportunity to enhance shareholder value and simultaneously give a better deal to pension scheme members, by not adopting a more carefully thought through policy on transfer values.

The UK Government is currently consulting with industry on how pension schemes and their actuaries should calculate transfer values. The Government may well act to sort out this transfer value mess – but past experience of Government policy on pensions does not make me optimistic. Whatever the Government may decide to do, companies need to take a fresh and radical look at their policy on transfer values.

Transfer values typically represent very poor value for money

What is a transfer value? Well, it is the sum of money that a pension scheme will pay to another scheme when a member wants to transfer his or her pension benefits elsewhere. But it is also used as the way of valuing pension benefits in divorce proceedings and it is the basis for disclosing the value of executive pension benefits in a company's remuneration report. If the transfer value is unfair then it is not only transferring members who lose out but also divorcees. Additionally, shareholders are presented with a misleading picture of executive pay.

In many pension schemes the policy on transfer values is a mess

Government review should be a spur for action

Companies are missing out on the opportunity to generate significant shareholder value

A policy of enhancing transfer values can have several benefits:
- Generate shareholder value
- Better deal for members
- Particular benefits for execs

But great care is needed in setting policy and communicating to members

In many pension schemes, transfer values have, for almost ten years, tracked the now hugely discredited MFR (the minimum funding requirement introduced by the Government in 1997 – recently replaced by a new regime of regulations). As the MFR declined in relevance and adequacy so transfer values became ever more deficient. In 1997 an MFR based transfer value for a typical member might represent 80% of the cost of buying the pension from an insurance company. Today that figure might be as low as a miserly 15%. If the pension scheme is paying reduced transfer values the figure could be even worse still. It is no surprise that financial advisers will now rarely recommend that a pension scheme member should take a transfer value.

Current professional guidance to actuaries on the calculation of (cash equivalents) transfer values (GN11) states that the purpose of the guidelines is "to ensure that members of retirement benefit schemes exercising a right to a cash equivalent can be assured that it fairly reflects the benefits otherwise available". It is surprising therefore that the position has been allowed to get as bad as it has.

But there are opportunities for all parties to get a much better deal

Companies need to take a fresh look at transfer values, as the nature of their pension obligations has changed. Pension liabilities are now regarded as a form of corporate debt. Successive legislation has removed any opportunity companies had to escape from their pension obligations. Moreover, changing accounting standards have put a hard marked-to-market value of pension scheme deficits on the company's balance sheet. But this means there is an opportunity to generate shareholder value if the pensions debt can be discharged at an economic rate (by means of the payment of transfer values).

If transfer values are so low that no member opts for a transfer then the opportunity to generate shareholder value is lost. So the transfer value has to be sufficiently generous and represent a fair value in order for it to be in the pension scheme member's interests to transfer.

Such a win-win situation for shareholders, companies and pension scheme members is quite possible within the current environment – but not at the transfer value levels that many pension schemes use.

So, is it as simple as that?

Do companies just need to offer better transfer terms in order to generate shareholder value? Well it's not quite that easy. Firstly getting the right level at which to pitch transfer values is delicate. Too high and there will be little or no shareholder value generated. Too low and the terms will be unattractive to members and a lack of transfer activity will again mean that little or no shareholder value is generated.

31 October 2006

Also, whilst many members would like to be able to take a transfer value out of their pension scheme on reasonable terms, there are significant obstacles to overcome. Firstly, most members of pension schemes are badly informed on the transfer opportunities that exist. So a communications exercise is necessary to improve member understanding and raise awareness of the transfer option. But care is needed. The trustees (and/or the company) cannot encourage or advise members to take a transfer value. Indeed, however generous the transfer value policy is, it is unlikely to be in all member's own interests to take a transfer value – the decision to transfer will depend on individual circumstances. Moreover, most members do not know where to begin to work out what they would do with a transfer value. They need advice. But most pension scheme members do not have a financial adviser or do not know where to find one and, in any event, probably regard financial advice as too expensive.

The solution for companies looking to generate shareholder value from a new strategy on transfer values will probably lie in contracting with a financial adviser to offer advice to all pension scheme members which is paid for in full or in part by the company. If members have easy access to (free) independent advice and can thereby conclude that a transfer makes sense for them, they will be much more likely to transfer. Of course, this makes the business of pitching transfer values at the right level, all the more complicated – if shareholder value is to be delivered. But it can be done.

There are also other benefits for executives …

A more sensible strategy on transfer values could also help to solve another major pensions headache that companies are beginning to face. Historically, generous final salary schemes have proved very successful at retaining key executive talent. But the playing field on executive pensions has changed dramatically. Changes last year to legislation on wind-up priority orders (the "small print" that directs how pension scheme assets will be distributed in the event of a pension scheme wind-up) have very serious implications for executives, which are not yet widely understood.

The Pension Protection Fund (PPF) now provides much needed security for pension scheme members, but may provide only limited security for executives with significant pensions. This is due to the cap of up to £26,050 on the maximum pension protected by the PPF (for members below retirement age). Hence if a pension scheme ends up in the PPF it could be a financial disaster for executives.

Even if a pension scheme avoids the PPF, pensions above £26,050 are likely to be only minimally protected in the event of a wind-up. Consequently, even if the pension scheme is more than 100% funded on the pretty tough PPF test, executives might only get a small fraction of any pension benefit over £26,050 if the company folds.

This means for many companies that the pension deficit, which is a corporate debt, is effectively long-term loan capital supplied by senior executives. Indeed for an individual executive this could represent a huge personal loan to the company giving very significant and uncomfortable exposure to the long-term financial well being of the company. The only option currently open to the executive wishing to spread personal risk and minimise such a large exposure would be to seek employment elsewhere (and build up another £26,050 of PPF protected pension).

So, almost overnight, final salary pensions have changed from being a strong incentive for senior management to stay with an employer to, potentially, being an incentive for executives to leave. What can companies do about this? Well one option, if combined with a sensible policy on transfer values, would be to allow employees to take a partial transfer of their pension benefits out of their employer's scheme into a separate scheme. This way, executives can lower their company pension scheme benefit to less than £26,050 and enjoy much greater protection from the PPF. Most importantly the final salary pension scheme would once again be a valuable retention tool for executive talent.

In conclusion …

Transfer values are too important an issue to leave to trustees. Companies need to understand the problems they present and put in place a strategy that will work for them. Done well, a corporate strategy on transfer values can deliver significant shareholder value and happy pension scheme members, as well as assisting the retention of executive talent. Handled badly and transfer values are a missed opportunity and a source of resentment and yet more pension problems.

Yours sincerely

Charles

For further information on the services PCS can offer you, please email us at solutions@pensionstrategies.co.uk or visit our website at www.pensionstrategies.co.uk to register your interest. Alternatively call Charles Cowling on 0161 242 5388 or Peter Redhead on 020 7309 8198.