



30 September 2022

Interest rate volatility

Cash Equivalent Transfer Values:
trustee considerations



In this paper we address key considerations for trustees of defined benefit (DB) pension schemes in the current circumstances, when dealing with member requests to transfer away their pension benefits.

Key considerations for trustees

- Whether to (temporarily) suspend transfer quotations
- Whether to amend the assumptions for calculating cash equivalent transfer values; and
- Member issues, including increased risk of pension scams and access to quality financial advice.

Long-term gilt yields (interest rates) have been rising since the start of the year and, over the past couple of weeks, have been extremely volatile in response to the announcement by the Bank of England (BoE) that it was going to start quantitative tightening, followed immediately by the Government's "mini-budget" on 23 September. This led to a rise in 20-year nominal gilt yields, which peaked at 5% p.a. on 27 September 2022 (having been 1.2% p.a. at the start of the year), before falling on 28 September to 4.1% p.a. following the BoE's subsequent announcement that it would intervene by buying gilts temporarily.

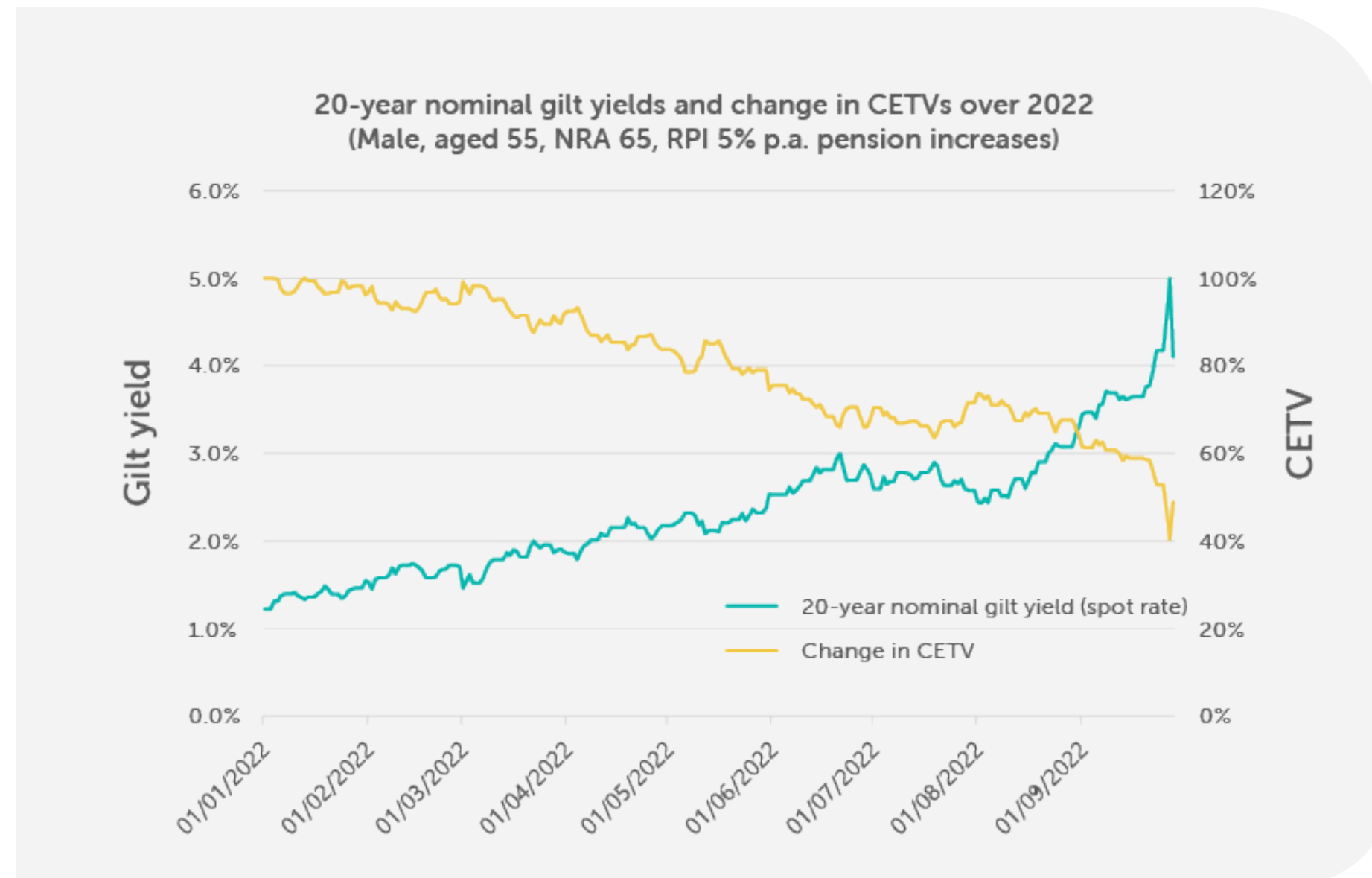




During times of exceptionally high levels of market volatility, particular care is needed when calculating and paying Cash Equivalent Transfer Values (CETVs), for the following reasons.

- For practical reasons, many schemes only update the market statistics used to calculate CETVs once per month. If there are large market movements during the month then the underlying market data used for that month's CETV calculations will become out-of-date, and CETVs could be materially over (or under) stated unless the market statistics are updated.
 - CETVs must normally be "guaranteed" for three months from the date of calculation and paid within six months of the original quotation. There is a risk that, by the time a member transfers out of a pension scheme, the CETV taken is materially higher than the funding reserve, leading to a funding strain for the scheme. This risk always exists but is higher when market conditions are more volatile.
 - For some schemes (particularly those without interest rate hedging in place), rising yields will have resulted in a significant improvement to the scheme's funding position. In turn, this may have accelerated the expected timescales for de-risking a scheme's investment strategy. Any changes to the scheme's investment strategy or underlying asset breakdown may necessitate that the assumptions underlying the CETV basis are reviewed.
 - More generally, the derivation of the financial assumptions may need to be revisited if they are not robust to the latest market conditions.
 - Disinvesting assets to pay transfer values may be more challenging if investment markets are more illiquid than usual.
 - Market volatility can also increase the risk of members making bad decisions and being the target of pension scams. This is particularly concerning now, given that many members will be worried about the current cost of living squeeze and could look to their pension for some degree of financial relief.
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- This briefing note has been prepared to assist trustees with the key CETV-related decisions that DB schemes are currently facing. Every scheme will be different and so the required course of action will depend on the specific circumstances and obtaining professional advice from your Scheme Actuary and/or investment advice will be important.

Background - volatile market conditions and CETVs



*Source: Bank of England, Barnett Waddingham calculations

The fall in gilt yields at the very end of the chart reflects the reaction to the BoE's intervention on 28 September 2022. The chart assumes that the market conditions used for calculating the CETV are updated on a daily basis.

The chart to the left illustrates the yield available on 20-year gilts since the start of the year (the green line). It shows that gilt yields have risen gradually since the start of 2022. In turn, this has reduced CETVs for most members, as illustrated by the yellow line on the chart.

However, in recent weeks, and particularly over the past week, gilt yields have become more volatile, which means that the value of members' benefits (i.e., the CETV) is changing materially from day to day. This level of volatility in the gilt market is unprecedented. This causes a particular problem for pension scheme trustees (and members) as CETVs can quickly become out-of-date.

As shown in the chart, CETVs are down by around 50% since the start of the year, and around 20% since the start of September.



Date of market conditions used in the CETV calculation

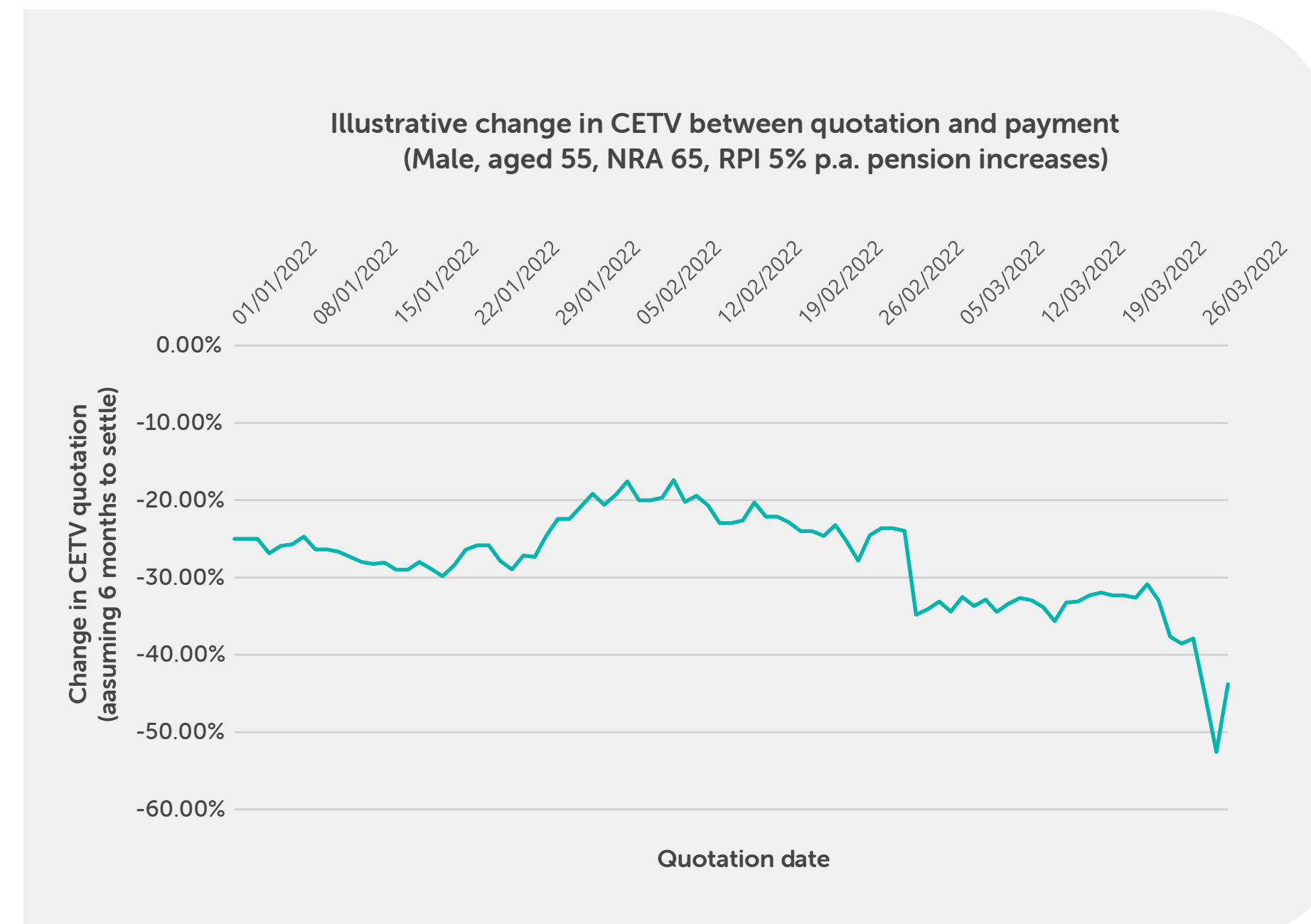
One issue for trustees is that the market conditions underlying the CETV calculation are often fixed on a monthly basis. For example, many schemes calculate CETVs using market conditions on the last working day of the previous month, or the third Wednesday of the previous month. This is usually done for practical reasons, particularly where the calculations are undertaken by the administrators rather than the actuary.

While markets remain volatile, the market conditions used in the CETV calculation may be materially different to the market conditions that actually apply at the date of calculation. For example, if a CETV is calculated on 28 September 2022 using market conditions that applied on the third Wednesday of the previous month (17 August 2022), the CETV is likely to be around 30% higher than if it was calculated using market conditions that applied on 28 September 2022. This issue is likely to persist in the short term as markets continue to react to announcements by the Government and the BoE.

Lag between CETV calculation and payment

Another issue is that even if the CETV calculation is based on the latest market conditions, CETVs must normally be guaranteed for three months from the date of calculation. This means that if a member requested a CETV in July 2022, the CETV would still be valid today, even though the CETV using latest market conditions would be around 30% lower. Further, even after the member has accepted the CETV, there is a lag between the acceptance date and the date the CETV is paid out. This could potentially span another three months. The chart to the right shows the illustrative change in CETVs between the date of calculation (assuming market conditions are set at the date of calculation) and date of payment assuming the maximum six month lag applies.

This is always a risk with CETVs, although the potential impact of the lag between the calculation and payment of CETVs is heightened when market conditions are more volatile than usual.



*Source: Barnett Waddingham calculations



Protecting the funding position – possible actions for trustees

There are a number of possible actions for trustees to consider in light of this volatility in order to avoid paying overly generous CETVs and to protect a scheme's funding position.

Temporarily suspending CETV's

Trustees may choose to suspend CETV quotations temporarily until investment market volatility reduces and a more reliable long-term calculation of members' benefits can be undertaken. Statutory CETVs must normally be issued within three months of the request from the member, although in exceptional circumstances it is possible to delay the issue of a CETV for up to six months. Therefore, any moratorium will usually need to be limited to three months, or six months at an absolute maximum.

However, suspending CETV payments and quotations is a decision not to be taken lightly. Arguments against pausing the further issuance of CETVs include:

- Wanting to avoid disruption to members and administrators;
- CETVs are usually set at a level that is below the Technical Provisions funding reserve and often significantly below the buyout cost (i.e., the cost of purchasing an annuity for the member). That is, CETVs contain a funding 'buffer';

- The numbers of members requesting transfer quotes over a short period is usually insignificant (though for smaller schemes, even a single TV may be material if it is for a high value individual); and
- The Bank of England has demonstrated that it is willing to step into the markets to provide a degree of financial stability (although the current intervention is only intended to continue until mid-October).

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Whilst suspending CETVs temporarily is likely to be the right decision for some, our expectation is that many trustees will want to ensure CETV activity continues as normal to the extent possible (as was the case during the Covid-19 pandemic).

Suspending CETVs won't affect any CETVs that have already been quoted as the member has a statutory right to take the transfer if they respond within the guarantee period.



Ensuring the latest market conditions are reflected in the CETV calculation

An alternative approach is to consider the choice of date for the market statistics underlying the CETV calculation. While markets remain volatile, the market conditions used in the CETV calculation may be materially different to those that apply at the date of calculation.

Trustees should consider with their Scheme Actuary whether the market conditions date used in CETV calculations remains appropriate. For example, trustees may wish to consider updating the market conditions underlying the CETV calculation on a more regular basis. Whilst this may marginally increase the cost of preparing CETVs, the additional costs are likely to be trivial in the context of the potential losses to the scheme or members.

Where updating market conditions underlying the CETV calculation more frequently is not practical, then trustees will need to keep market movements under close review and consider acting if conditions materially change over a month.

Non-statutory transfers

Many schemes choose to offer “non-statutory” CETVs (for example, CETVs to members within twelve months of their Normal Retirement Date). In most cases statutory and non-statutory CETVs are calculated in the same way, which is in line with The Pensions Regulator’s (TPR’s) guidance. However, trustees may choose to offer different conditions to non-statutory transfers if they wish. For example, trustees could choose to offer non-statutory CETVs without a guarantee period and re-calculate the CETV based on latest market conditions before the payment is made.

Reviewing the CETV basis

Trustees should, after taking guidance from their Scheme Actuary, consider whether the assumptions used to calculate CETVs remain robust to recent developments. Issues to consider include:

- 1 Whether the assumed returns on different assets classes remain appropriate given the significant increase in gilt yields.
- 2 Whether any funding improvements are likely to lead to accelerated de-risking, and if so, whether this needs to be reflected in the CETV basis (which, under legislation, is required to take into account the scheme’s investment strategy).



Underfunded schemes: review any reductions to CETVs

Pension schemes that are not fully funded on the CETV basis are able to reduce the transfer values quoted to members, if they first obtain an “insufficiency report” from the Scheme Actuary.

Many pension schemes (particularly those without interest rate hedging in place) will have seen their funding position improve materially since the start of the year. In some cases, schemes that were previously reducing CETVs will no longer be underfunded on their CETV bases (i.e., these schemes will now have enough assets to pay full CETVs to all members), or the extent of underfunding will have materially reduced. Schemes in this position should consider whether it remains appropriate and fair to members to continue to reduce CETVs, or to continue to reduce CETVs to the same extent.

In some cases, the scheme’s funding position may have deteriorated (for example, where interest rate hedging was reduced due to collateral challenges, or due to poor returns on growth assets). For schemes in these circumstances, trustees should review whether it is necessary or desirable to reduce transfer values to protect the security of remaining members’ benefits.



Paying transfer values

In some cases, a disinvestment will be required to pay a CETV to a member (or multiple members). Members would usually expect the payment to be made promptly (and indeed, trustees would usually prefer to pay the CETV as soon as possible after acceptance to reduce the risk of market conditions moving against them between the date of acceptance and the date of payment). Following the recent fall in LDI funds and collateral calls being made by investment managers, it is possible that the scheme's asset portfolio is less liquid than previously. Trustees should consider whether they have sufficient liquidity to pay CETVs to members, particularly if there are further collateral calls in coming weeks.

How can schemes help members?

Despite transfer values falling materially in recent weeks, many members will be concerned with the current cost-of-living crisis and may look to transfer the value of their DB pension to a DC arrangement so it can be accessed flexibly. This may not always be in members' best interests. In addition, recent stories in the mainstream media suggesting that DB pension schemes could go insolvent may have alarmed members into thinking that their existing DB pension is no longer safe, and this may encourage members to transfer out of the scheme. Both of these issues are also likely to elevate the risk of members being a target of pension scams.

Issue a member communication

Trustees may wish to send a communication to members to:

- reassure them that the situation is being monitored closely (and in many cases, that the funding of the scheme is better than ever);
- remind them to remain vigilant with regard to pension scams; and
- point them in the direction of MoneyHelper if they would like some guidance

Helping members with decision making

In addition, where they haven't already, trustees and sponsors may wish to consider putting a support framework in place for members who wish to investigate transferring, ensuring they're offered independent and trusted advice which supports their short and long-term financial needs.

If a scheme already has a support framework with a Financial Adviser in place, trustees and sponsors may wish to check the Financial Adviser's approach to vulnerable customers, in light of the current financial challenges faced by many members.



Summary

Transfer value requests are fairly infrequent in many schemes and so urgent action may not be necessary. Nevertheless, trustees should establish a plan of action for when/if a request is received.

Trustees may wish to consider temporarily suspending transfer values in the hope that market volatility will reduce in the coming weeks. In any case, trustees should ensure that the CETV basis remains appropriate and robust under current market conditions.

Trustees may also wish to give special consideration to offering non-statutory CETVs where there is an established practice to do so. It may be appropriate to treat these differently to statutory CETVs in current times.



Need to know more?

For further information, or to discuss any of the issues raised in this briefing, please speak with your usual Barnett Waddingham consultant. Alternatively get in touch via the following:

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