

Pension Post

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For financial advisers only

How defined benefit transfer values are calculated

When a deferred member of a defined benefit (DB) scheme gets a transfer value offer, a common question is 'is it value for money'? Is it a 'good' transfer value or a 'bad' one?

In this issue of Pension Post, Tony Gilhewley, Technical Guidance Ltd, explains how DB transfer values are calculated and how to assess value of money.

The standard '100% transfer value

Guidance issued by the Pensions Authority under the Pensions Act sets out a standard basis for the calculation of a minimum 'standard' transfer value of a deferred DB pension; this is sometimes referred to as the '100% transfer value.

The broad assumptions used to calculate the 100% transfer value are these:

Revaluation of deferred pension prior to NRA	<ul style="list-style-type: none">• 1.5% pa
Post NRA discount rate	<ul style="list-style-type: none">• 4.25% pa for those with over 10 years to NRA• Reducing from 4.25% pa in phases from 10 years to NRA to the current yield on a long term French Government Bond (currently 0.02% pa) by NRA
Pre NRA discount rate	<ul style="list-style-type: none">• 6.00% pa up to 10 years prior to NRA• Reducing over the last 10 years to 4.25% just before NRA

You can see from above that those within 10 years of NRA get a higher transfer value than those with more than 10 years to go to NRA, because of the lower discount rates used.

Example 1

15 years to NRA

Let's take an example of a deferred member of a DB scheme with 15 years to go to NRA and a current deferred single life pension payable from NRA 65 of €10,000 pa:

Step 1 It's assumed the current pension of €10,000 pa will be revalued or increased at 1.5% pa between now and NRA in 15 years' time, so that by NRA the estimated pension will be €12,502 pa. The actual revaluation rate each year will be CPI change (positive or negative) to a maximum increase of 4%.

Step 2 Because the member has more than 10 years to go to NRA, a capital value at NRA of the €12,502 pension is calculated using a discount rate of 4.25% pa and mortality rates specified in the Pensions Authority Guidance.

Currently this might assume an annuity rate of circa 7.0% and so value the €12,502 pa assumed pension at about €178,000.

Of course annuity rates today would place a much higher value on this single life pension of circa €343,000. So compared to current annuity rates, the capital value placed on the pension for this example is low.

Step 3 The final step is to discount this €178,000 back to today using a discount rate of 6.0% pa for the first 5 years reducing uniformly over the last 10 years prior to NRA to reach 4.25% just before NRA. This is equivalent to an average discount rate over the 15 years of circa 5.4% pa, so that the current standard or 100% transfer value offered might be around €81,000 or so.

Example 2

5 years to NRA

Let's take an example of a deferred member of a DB scheme with 5 years to go to NRA and a current deferred single life pension payable from NRA 65 of €10,000 pa:

Step 1 It's assumed the current pension of €10,000 pa will be revalued or increased at 1.5% pa between now and NRA in 5 years' time, so that by NRA the estimated pension will be €10,773 pa.

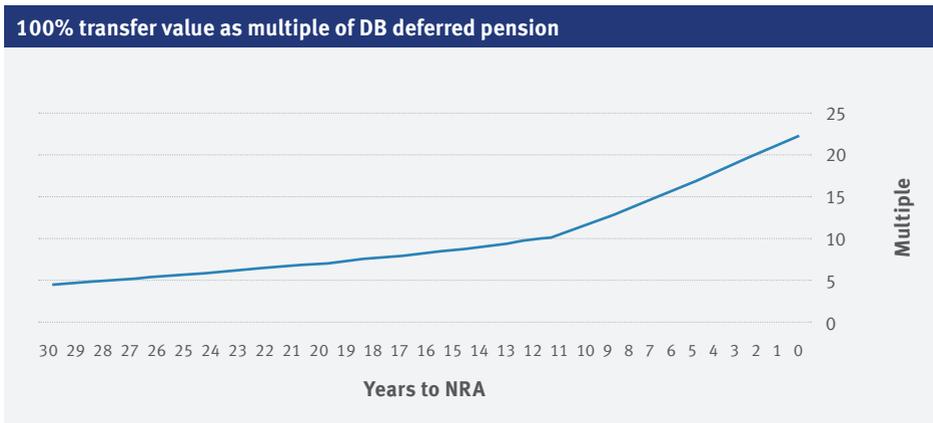
Step 2 Because the member has less than 10 years to go to NRA, a capital value at NRA of the €10,773 pension is calculated using a discount rate of between 4.25% pa and current French Government Bond yield of 0.22%, averaging around 1.4% pa currently, and mortality rates specified in the Pensions Authority Guidance.

Currently this might assume an annuity rate of circa 5.5% and so value the €10,773 pa assumed pension at about €195,000.

Step 3 The final step is to discount this €195,000 back to today using a discount rate of between 6.0% pa and 4.25% pa, or an average discount rate over the 5 years of 4.7% pa, so that the current standard or 100% transfer value offered might be around €155,000 or so.

100% transfer value as multiple of DB deferred pension

Take an example of a single life deferred pension with no post retirement increases or spouse's death in retirement pension, payable from NRA 65. This chart shows the current 100% transfer value as a multiple of the deferred pension:



Note

- If the scheme stays solvent and can pay out 100% transfer values, the transfer value should increase each year, as the member gets closer to NRA
- the significant increase in transfer value starts to kick in when the member comes within 10 years of NRA. This is currently the 'golden zone' for transfer values

Better value of money transfer values

Transfer values which represent better value for money are:

- those within 10 years of NRA; the closer to NRA you get the better the value becomes as the post retirement discount rate falls close to current French Government bond yields which are near zero
- Enhanced transfer values, where the employer adds to the transfer value as an incentive for a limited period, e.g. 120% of the normal transfer value

Reduction in transfer value

If the scheme at the time fails to meet the statutory minimum funding standard, the standard transfer value is reduced to reflect the level of underfunding at that time, eg 90% transfer value.

Tax free lump sum

The standard transfer value calculation assumes the full pension will be taken at NRA and that none will be commuted to provide a tax free lump sum.

In reality most clients would opt to take a tax free lump sum if they stayed in the scheme to NRA, and therefore a more accurate comparison of the transfer value might be with the tax free lump sum and reduced pension rather than only the pension.

Discretionary benefits

Transfer values will normally not allow for any discretionary benefits the scheme may provide which are not set out in the scheme rules, e.g. discretionary increases in pensions.

Revaluation

As pointed out above, the transfer value calculation assumes the deferred pension will be revalued or increased by 1.5% pa between now and NRA. However actual revaluation increases have in recent years been much lower than 1.5% pa:

Year	Revaluation increase
2018	+0.5%
2017	+0.4%
2016	+0.0%
2015	-0.3%
2014	+0.2%

The transfer value in effect pays for a 1.5% pa increase in pension before NRA but in reality the deferred member, if he or she stays in the scheme, will be unlikely to get such an increase unless inflation takes off substantially in excess of current rates.

Keeping track of transfer values

For those within 10 years of NRA, the transfer value calculation becomes closely linked to French Government Bond yields. The Society of Actuaries publish a factor, MVA1, which is included in the transfer value calculation for those with less than 10 years to go to NRA. The higher the factor the higher the transfer value, and vice versa.

The factors can be seen at: <https://web.actuaries.ie/standards-regulation/actuarial-standards-practice/section-34-prescribed-guidance-mva-factors-may>

The all-time high standard transfer values for those within 10 years to NRA were in August and September 2019, reflecting negative yields on French Government Bonds.

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