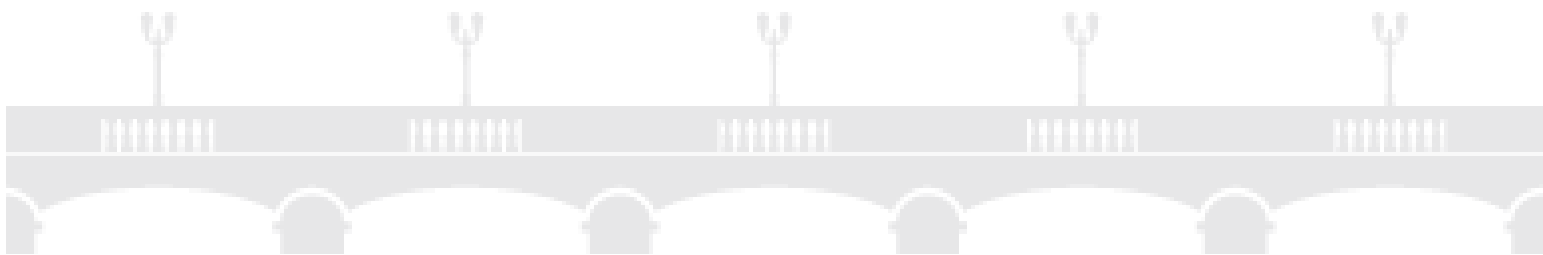




Enhanced Transfer Values



BACKGROUND

The difficulties currently faced by defined benefit schemes are well known at this stage. Low expected returns from investments and increasing annuity prices have resulted in higher contribution rates being required to fund benefits. Many employers have concluded that DB pension schemes are now unaffordable with most schemes either being closed to new entrants or, in an increasing number of cases, having benefits restructured or being wound up.

One approach being adopted by an increasing number of employers is to offer their DB scheme members an attractive transfer value to encourage them to leave their defined benefit pension behind. The offer of a so-called “enhanced transfer value” (ETV) or “uplifted transfer value” requires careful deliberation by the member before electing to accept or reject the offer. Capitalised values of pension annuities can appear very large when compared to the regular pension, however, the cost of purchasing the same benefit and other ancillary benefits such as spouses pension and indexation can make these benefits almost impossible to replace outside the scheme.

TRANSFER VALUES

STANDARD TRANSFER VALUES

In theory the transfer value of a preserved benefit in a defined benefit scheme should be the present value of your projected future pension, with allowances for future interest rates, inflation, possible future pension increases, revaluation of pension amounts pre-retirement, and mortality assumptions. In the past, the size of transfer values on offer were similar to the economic value of the future pension, based on realistic assumptions. However, in recent years, with the decline in the funding levels of defined benefit pension schemes, transfer values payable have been reduced in value.

There is a statutory basis for calculating the minimum or standard transfer value payable in lieu of a deferred pension in a defined benefit scheme, as outlined by the Pensions Authority. The assumptions that are used are set out by the Pensions Authority. Professional guidance notes issued by the Society of Actuaries in Ireland state that the minimum actuarial value must be calculated based on this statutory guidance. The standard basis has become more conservative, resulting in lower transfer value payments. Along with this, there may be a reduction in the standard transfer value payable depending on the solvency level of the scheme. As most schemes are not fully funded, this effectively means that standard transfer values are now significantly smaller than the economic value of the benefit promised at retirement.

ENHANCED TRANSFER VALUES

Some schemes may offer transfer values on a more generous basis, in comparison to that calculated using the standard valuation, e.g. 120% of the standard transfer value, for a limited time period. Schemes may employ this approach as a risk management tool with which to reduce long term liabilities and costs. The scheme would no longer have an obligation to pay out future pensions to deferred members electing to take the enhanced transfer value offered.

Enhanced transfer values have significantly increased in popularity among DB scheme sponsors over the last year as a significant reduction in corporate bond yields has resulted in a dramatic increase in the cost of defined pension schemes as reflected in the employer’s financial statements.

WHY COMPANIES OFFER ENHANCED TRANSFER VALUES

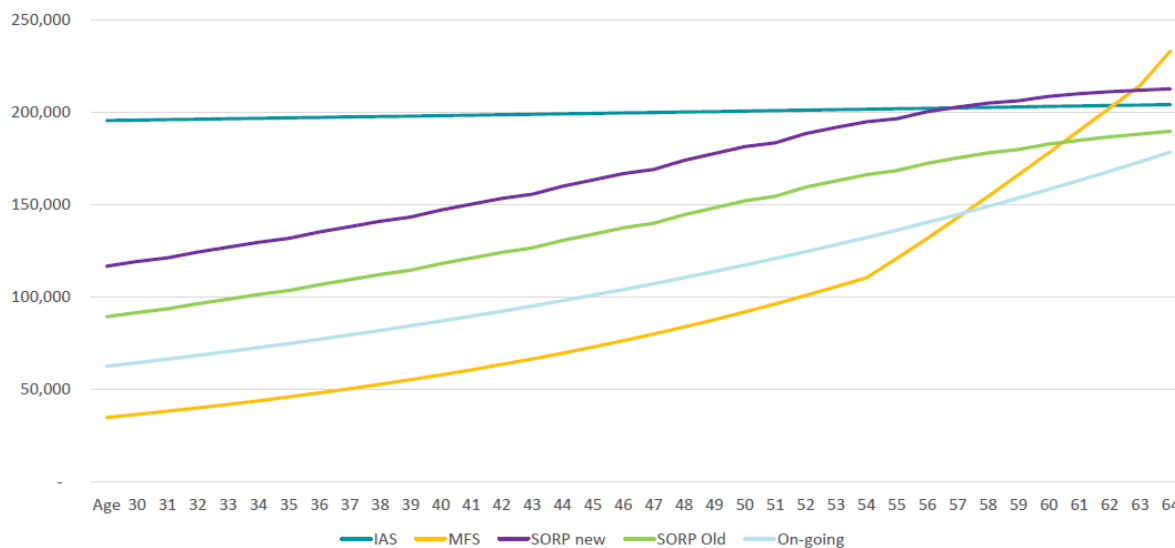
By offering ETV's, the company reduces the deficit that would exist on an annuity buy-out basis. The settlement of liabilities will be recognised as an accounting gain to the company, assuming the enhanced transfer value offered is less than the IAS liability (accounting standard of calculating the present value of your deferred pension liability). It also de-risks the plan, removing some uncertainty, as well as reducing future administration costs for the scheme.

The issue for the member is to assess if the enhanced transfer value offered is “good value”. The level of enhancement offered may vary. The MFS (Minimum Funding Standard) basis could be used as a benchmark on which to evaluate the level of enhancement being offered.

Various bases could result in different values being calculated, while it is expected that the transfer value offered will always be less than the accounting standard valuation of your liability (the company will only elect to offer the enhancement if it will improve its own financial position). Some examples of bases (sets of assumptions) that could be used by the company are:

1. MFS Basis – statutory minimum transfer value.
2. IAS Basis – the value of your pension liability in the company accounts.
3. DC SORP Basis (Defined Contribution Statement of Reasonable Projection) – a set of assumptions that would be more optimistic than MFS Basis.
4. Ongoing Basis – based on reasonable long-term market best estimates.

Example Values of a Pension on Different Bases:



- The chart illustrates the transfer value of a pension of €10,000 p.a. payable from age 65 (no pension increases)
- As the MFS forms a minimum, it is evident that this minimum would apply for older members under almost all of the bases

This chart illustrates the pension valuation varies significantly using the different bases outlined above. The uplift on the MFS Basis valuation of your transfer value would be based, amongst other factors, on the term left until your normal retirement date. The maximum uplift we would expect the company to offer you as an enhancement would be the pension valuation under the IAS accounting basis.

CONSIDERATIONS

In assessing the attractiveness of an enhanced transfer value, it is appropriate to compare the offer to the estimated economic value of your preserved pension benefit. This is the pension that you would have built up to the date of leaving the Defined Benefit scheme, with service frozen in respect to your pension after this date.

The economic value of your preserved pension benefit is calculated using current annuity rates and assumptions around discount factors from normal retirement date to today. It may be the case that the economic value of your pension is greater than the transfer value offer, in which instance it could be argued to keep your preserved benefit within the scheme and reject the ETV offer.

OPTIONS NORMALLY AVAILABLE ON ACCEPTANCE OF TRANSFER VALUE:

Should you choose to accept an enhanced transfer value offer, your options will usually be: -

- A. Leave funds invested until Normal Retirement Date:
 - 1. Within a Defined Contribution company pension plan
 - 2. Within a Personal Retirement Bond, which gives you personal control of the management of the pension and flexibility regarding when you access the benefitsⁱ

- B. If no longer an employee and over 50, you may also have the option to retire your pension immediately, with the benefit options being:
 - a) Traditional route option of a retirement lump sumⁱⁱ, based on salary and service, plus an annual pension by purchasing an annuity, OR
 - b) Alternative option of a retirement lump sum, up to a maximum of 25% of the fund value, plus the remainder invested in a post retirement fund called an A(M)RF* which you can subsequently draw down over time as you require.

*APPROVED RETIREMENT FUND / APPROVED MINIMUM RETIREMENT FUND

An Approved Retirement Fund (ARF) is a post-retirement investment fund for monies arising from certain types of pension arrangements. It is beneficially owned by the individual but is managed by a Qualifying Fund Manager (QFM). An ARF gives effective control and ownership of the pension fund to the pension contributor in retirement.

An Approved Minimum Retirement Fund (AMRF) is similar to an ARF. You must have a guaranteed minimum income of €12,700 per annum in order to avail of the ARF otherwise you have no choice but to invest €63,500 in the AMRF first and then the balance in an ARF. An AMRF then becomes an ARF on death or at age 75.

If you invest in an ARF, in the event of your death the ARF passes to an ARF in the name of your spouse or alternatively distributed with your estate

ⁱ A Personal Retirement Bond also known as a Buy Out Bond, is a single premium pension plan effected by the trustees of an occupational pension scheme in the name of a member who is leaving that scheme i.e. a Personal Retirement Bond is an occupational pension arrangement in your name rather than in the name of your employer.

ⁱⁱ Lump Sum benefit is tax-free up to €200,000, with any amount greater than €200,000 up to €500,000 taxable at the standard rate, currently 20%.

The following table sets out some of the factors that need to be considered when evaluating an enhanced transfer value offer:

Transfer Value	Preserved Benefit
The transfer value offer may or may not be considered “good value”.	The economic value of your preserved benefit may be considered greater than the “enhanced” transfer value offer.
More flexibility and control over your retirement income.	Your retirement income is fixed based on salary and service.
More control over the investment strategy of your funds. You are taking on investment and longevity risk yourself.	You may not want the additional burden of investment choice should you take the transfer value out. Leaving your preserved benefit within the scheme could be considered less of a burden to you in retirement.
Removal of uncertainty linked to future changes in the funding position of the plan.	The scheme could be wound up, and your benefit may be reduced significantly. Your preserved benefit could be reduced via a Section 50 order if trustees apply to the Pensions Authority to reduce benefits.
Consolidation of all your pensions may create a simpler structure.	You may have various pension structures in place, which could create more complexity.
Potential to access an ARF at retirement, with <ul style="list-style-type: none"> • Early retirement possible • Potential for a greater lump sum on retirement under ARF option. 	Approved Retirement Fund option not currently available.
The value of the fund, whether within DC/PRB scheme or ARF structure, is also retained in the event of your death (either pre or post normal retirement date) and is passed onto your spouse/children.	In the event of your death, the pension may cease or be significantly reduced. Should death occur prior to your normal retirement date, your benefit (death-in-service cover/spouses pension) is based on your salary.
There is a risk of funds running out if you opt for the ARF route (“bomb-out risk”).	Some form of guaranteed income for life, with less risk of funds running out due to guaranteed pension benefit.
Value of fund will increase in line with return of the investment strategy chosen	Preserved benefit may increase to retirement with statutory indexation
Diversification of some of your savings away from your employer.	A greater portion of your wealth is tied up with your employer.
Timing is important regarding transfer value calculations with a time limit applicable to each offer.	There is no timing risk with respect to your deferred pension. However, the transfer value offer will change over time as yields change, and time until retirement reduces.

SUMMARY

The valuation of the pension benefit promised by a DB scheme is complex and requires that significant assumptions be made regarding the future. The offer of an enhanced transfer value to either active or deferred scheme members requires that some comparison be made between the value of the benefits being foregone and the cash transfer value put on the table by the employer. As well as the quantitative comparison of the respective cashflows out over the period to and after retirement, the different risks associated with both options also need to be understood. These risks include the long-term solvency of the scheme and the employer, the long-term commitment of the employer to the scheme and the investment risk being assumed by the member should they accept the ETV offered. We would always recommend that specialist advice be sought when assessing the various considerations around enhanced transfer values as the individual circumstances of each member will often change the recommended course of action.

Wellesley Investments & Pensions has significant experience advising defined benefit pension schemes and their members in relation to transfer value options. Our in-house team includes specialist advisors in the areas of personal pension structures, actuarial, personal taxation and investment strategy. If you would like to discuss any aspect of the above note, please feel free to contact either Carmel or Ashley at the contact details below.

CARMEL CONSIDINE



Pension Structures Manager
B.Sc., H.Dip., ACF, ACA, QFA
t: 061 512300
f: 061 414172
e: cconsidine@wellesley.ie

Carmel is a qualified accountant specialising in the areas of technical pensions, risk reporting, taxation and actuarial. Carmel has a degree in Financial Mathematics and Economics and a Higher Diploma in Accountancy and Corporate Finance and has over ten years' experience in the areas of accountancy and financial advice.

ASHLEY MANGAN



Actuary
BAFS, MVB, FSAI, QFA
t: 061 512300
f: 061 414172
e: amangan@wellesley.ie

Ashley is an actuary at Wellesley where she works in the areas of technical pensions, risk assessment, and investment research. Ashley holds a Bachelor of Actuarial & Financial Studies degree from University College Dublin and is a Fellow of the Society of Actuaries in Ireland.

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