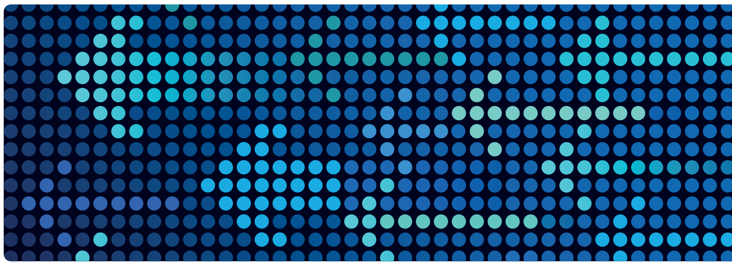

Cashflow Awareness: Transfers out

Managing transfers out of DB pension schemes

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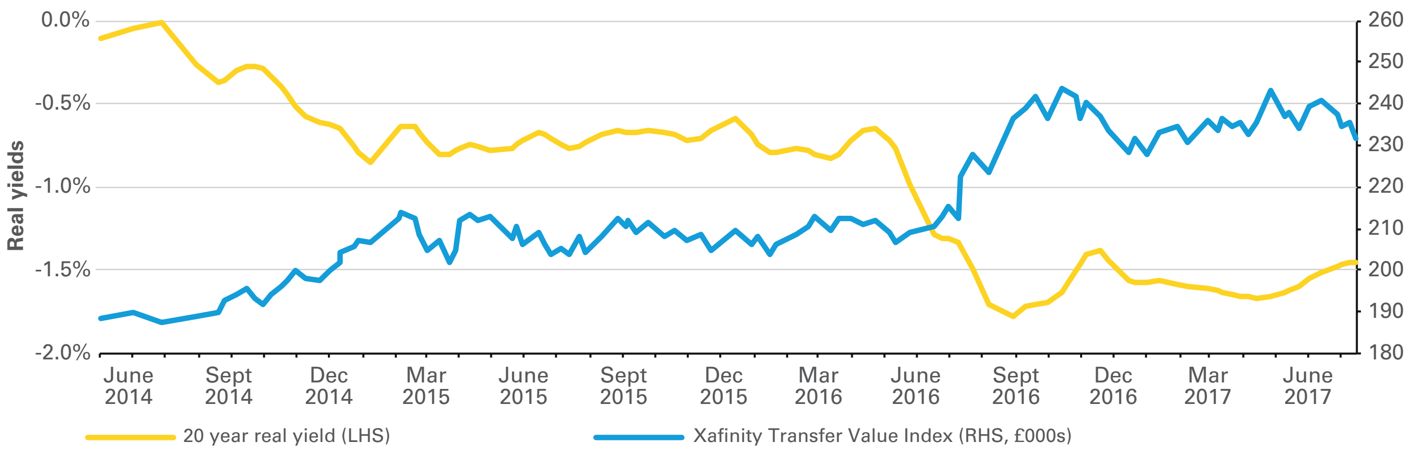
EXECUTIVE SUMMARY

- We consider the implications of transfers out of pension schemes in the short and long term and how schemes can best prepare
- Although unpredictable, transfers out are likely to benefit the solvency of most schemes. They can also be managed effectively within a framework that includes cashflow matching
- However, transfers do require careful liquidity management to help reduce the impact of forced sales and high transaction costs

Figure 1. Yields have fallen and transfer values[1] have risen over the past few years



Source: Xafinity, Bank of England, LGIM calculations

1. The Xafinity Transfer Value Index tracks the transfer value that would be provided by an example DB scheme to a member aged 64 who is currently entitled to a pension of £10,000 each year starting at age 65, increasing each year in line with inflation.

BACKGROUND

Since Freedom and Choice in 2014, which allows individuals the right to access their pension savings more flexibly, there has been a substantial uptick in transfers out of DB schemes. As gilt yields have fallen, transfer values have risen (Figure 1), offering large and attractive sums to members. There was 50% growth in the volume of transfers out in 2016 alone. Around 2% of scheme assets on average were transferred out[2] with transfers out exceeding pensions in payment for some schemes.

Much has been written in the press on the factors members should think about when deciding whether to transfer. But what about schemes themselves – how should they prepare?

TRANSFERS OUT – NOT A PROBLEM?

In one sense, paying transfers shouldn't pose any problem. In principle a scheme has assets reserved for members to back this option, so the scheme can simply sell the slice of the assets backing those payments.

To calculate how much to pay, an actuary uses a set of assumptions (including the return on assets and how long people will live) called a Cash Equivalent Transfer Value ('CETV') basis. The CETV basis is normally[3] a 'best-estimate' basis, meaning there is no prudence.

On a prudent basis, such as Technical Provisions ('TP') or Buyout, the deficit of a scheme improves following a transfer as the assets transferred are less than the liability removed. For example, the CETV for a member aged 64, entitled to a pension of £10,000 each year starting at age 65 (increasing each year with inflation), could be around £240,000[4]. In contrast, buying the same benefit out with an insurance company could cost around £305,000[5]. From this perspective transfers out don't sound like a problem for DB schemes at all – quite the opposite!

However, caution is needed because a scheme that is underfunded on a CETV basis[6] suffers a hit to its CETV funding level following each transfer out, even though the CETV deficit stays the same. This is because the assets and CETV liabilities reduce by the same amount on each transfer out but the deficit becomes larger as a proportion of the liabilities. The funding levels on other bases, such as TP, fall in line. This can be concerning, particularly for schemes that are mostly reliant on investment returns, rather than contributions, to repair their deficit.

However, where the trustees take the view that paying transfers at full value would prejudice the security of remaining members, the trustees may commission an 'insufficiency report' from the scheme actuary that allows them to reduce transfer values to an extent.

The upshot is that there should, at least in principle, be no threat to the long-term health of the scheme from members choosing to transfer.

NOT SO FAST

However, there are some practical points that mean life isn't quite so simple. In particular, if markets are currently stressed this may not be an ideal time to sell assets. The funding level may have fallen following a market downturn but an insufficiency reduction may not have been applied to reflect this. It could also be inappropriate to apply a reduction given, for example, a strong employer covenant. Transaction costs may also be high, particularly for illiquid assets.

In our paper **'Raising Cashflow Awareness'**[7], we explored how to manage cashflows effectively in DB schemes. This moved the discussion beyond cashflow matching to also using the cashflows from other assets. We suggested trustees make a plan for meeting expected cashflows and be prepared for unexpected cashflows such as transfers out.

2. Source: FT Advisor

3. Although the legislation sets a floor on transfer values, it also provides a basis for paying higher amounts. Trustees might set CETVs at a higher level than under the 'best estimate' basis if, for example, the scheme's rules require it.

4. Xafinity Transfer Value Index at 31 October 2017

5. Based on Hargreaves Lansdown best buy annuity rate tables at 16 November 2017

6. This is not normally actually a problem - most schemes are overfunded on a best-estimate basis. As at 31 July 2017, First Actuarial calculated an average best-estimate funding level of 125% across the 6,000 UK DB schemes, although we note that First Actuarial's expected returns are generally higher than LGIM's strategic assumptions

7. http://www.lgim.com/uk/en/insights/our-thinking/client-solutions/raising-cashflow-awareness.html

As such, it is important to ensure there is sufficient liquidity in the scheme. As we explain in **Raising cashflow awareness** (see footnote 7 on the previous page) there are pre-emptive steps schemes can take to prepare for unexpected cashflows. These include:

- **Increasing the flexibility and efficiency of leverage and collateral –** leverage (via either LDI or synthetic equities / credit) can be used to gain more efficient exposure to markets than physical allocations
- **Tailoring assets to generate more natural cashflow –** eg. taking dividends as a source of cashflow
- **Using uncorrelated funds as a collateral safety net –** eg. absolute return funds

Transfers – like any human choices – are hard to predict. However factors that increase the chance of a large number of transfers include:

- Lower interest rates, which make transfer values appear more attractive
- A smaller scheme will have a greater level of uncertainty around the amount of transfers
- More members approaching retirement
- A weaker sponsor causing members to worry about the security of their pension

Monitoring these factors may help identify a need for additional pre-emptive action.

IMPLICATIONS FOR CASHFLOW MATCHING

It's tempting to believe that cashflow matching is a red herring in the context of hugely uncertain cashflows such as transfers out of the scheme. But, whilst cashflow matching is not a silver bullet, we believe that transfers do not materially damage its advantages (as part of a cashflow aware solution) for several reasons:

(1) A slice of asset cashflows should already be held to back any particular member. If that slice is cashflow matched, there is less mismatch between the value of that slice and the transfer value when market conditions change[8]

(2) If a transfer occurs this is actually likely to be beneficial in terms of reducing the long-term risk of insolvency of the scheme. As such trustees should arguably be more worried about what occurs if transfers out don't happen and focus on reducing reinvestment risks and transaction costs in that instance. We believe it makes sense to focus on the journey plan and make it flexible enough to cope with transfers, rather than construct an approach based around transfers necessarily occurring

(3) Transfers are only possible for as long as there are deferred members. As schemes mature, these deferred members retire and cannot transfer. Given that there is no harm in structuring bonds to match benefits, trustees should do so now rather than restructuring later at a cost – it is good to be pro-active.

Like all cashflows, transfers may form an opportunity for the portfolio to be rebalanced towards its target position, allowing for any active views currently held and transaction costs.

TO SUMMARISE:

- Transfers should not be a problem in principle as a slice of assets should be held to back each member and trustees can reduce transfer values in some cases
- Transfers out may offload scheme liabilities relatively cheaply, reducing risk
- Transfers out require good liquidity management. This can involve monitoring the likelihood of their occurrence and taking pre-emptive steps, such as increasing the flexibility and efficiency of leverage
- The unpredictability of transfers can be allowed for effectively in a well-constructed approach that includes cashflow matching.

8. This is a good reason to allow for dynamic credit spreads in the CETV basis, not just gilt yields. Related to point (1), note that an increase in future expected transfers does not substantially reduce the interest rate and inflation sensitivity of a scheme. This is because the transfer value itself has interest rate and inflation sensitivity; it is not a fixed number. For example a transfer expected in five years' time has a duration much higher than five years because if interest rates fall, the expected transfer value itself will rise. A transfer out itself can alter the characteristics of a scheme after it has occurred so this needs monitoring and could prompt a change in investment strategy. However there is, in general, no need for trustees to reduce their liability hedges now just because they anticipate more transfers in the future.