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Scheme factors in 2023

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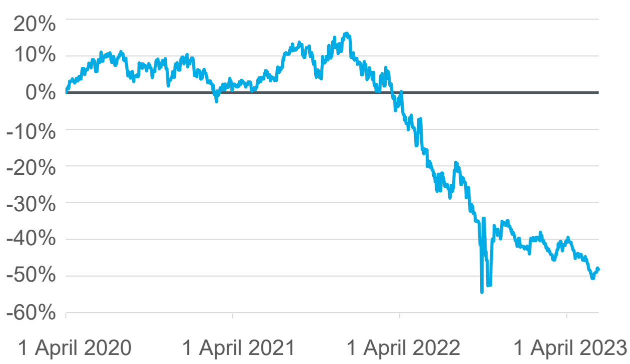
The economic environment has changed a lot over the past 12 months. With most pension schemes likely to have reviewed factors over this period, here we look at what the changes mean for schemes and the impact on members.

In March, we asked 81 schemes that we advise about how they are setting factors for members.

How factors have changed

DB pension schemes routinely use commutation factors to convert a member's pension to a lump sum. Most schemes review these factors triennially and then leave them for three years. This approach is reasonable when gilt yields are stable. However, real yields have risen by more than 3% since 2020 (when many schemes last reviewed factors), which has led to a dramatic fall in the value placed on a DB pension, as shown by the chart below.

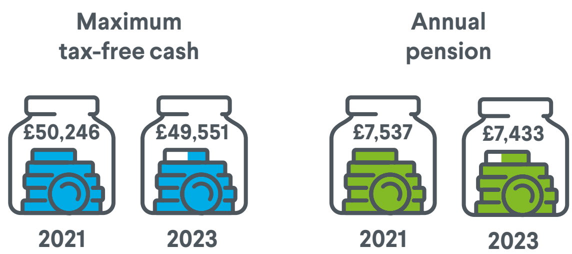
Change in value placed on a DB pension



With such material changes, many schemes have reviewed factors to ensure terms aren't too generous, and no higher than the cost of the pension on the funding basis. More than half the schemes in our survey said they reviewed factors as a consequence of the market volatility in late 2022.

The lower factors resulting from the review mean that many members are now getting a smaller lump sum for the pension they 'give up' than they would have previously. Although importantly, these reductions haven't been as significant as the 50% drop we've seen on the value placed on a DB pension.

The average factor for a scheme with pension increases linked to inflation (RPI or CPI, with a cap of 5%) for a member aged 65 is 19.3 – a decrease of around 5% from the average factor in 2021. A member with an annual pension of £10,000 who decides to take the maximum pension commencement lump sum would be paid less now, compared with two years ago.



As well as reviewing factors earlier, some schemes have started regular factor updates to ensure factors reflect changes in yields. Around a fifth of schemes routinely review factors either monthly or quarterly. Other schemes have no set timetable, but update factors in response to trigger levels being breached.

Considering member outcomes

For most schemes the starting point for calculating commutation factors is the amount the scheme needs for an even chance of providing members' benefits: the so-called best estimate basis. Setting terms with an eye on transfer values and the market avoids funding strain and achieves consistency between options. But historically commutation factors have often been lower than transfer value terms (as well as being less responsive to market conditions). As noted above, it appears at least some schemes have taken the opportunity to close any legacy gaps.

Schemes could use a basis more generous to members. Many schemes have seen improved funding levels and schemes with a funding surplus are well placed to use a more generous basis for commutation factors.

Whilst taking a lump sum tends to be popular amongst members, if they don't see terms as good value for money, fewer could commute pension for cash at retirement. Our survey showed that 86% of schemes anticipate some commutation in their valuations. However, 51% of these schemes haven't reviewed commutation take-up levels since 2020.

Schemes should check recent take-up to keep assumptions relevant. Doing so is particularly important as the new DB funding code approaches, with its requirements that take-up should be no higher than recent experience, and that projections should allow for any decreasing trend.

Keeping members informed

Many members are struggling to understand what lower factors mean for them. Financial literacy varies widely anyway, and many members may not understand the implications of taking cash in the first place.

Around 87% of schemes said that managing member expectations is a part of factor-setting, but almost all said they don't inform members when a change is made. As a result, schemes are getting more queries about why quotations have reduced from those previously received.

Trustees should ask themselves if they could do more to help members with their options from the outset. For example, member websites could include guides, or documents accompanying retirement quotations could provide more information on how commutation works.

Alignment with insurer factors

Market volatility has also affected many schemes' endgame plans. As long-term interest rates materially increased, schemes that had not fully hedged against interest rate movements found their buy-out funding levels improved. This gave schemes an opportunity to lock in asset gains and reduce the time to full buy-out funding. For some, full buy-out is a realistic short-term prospect.

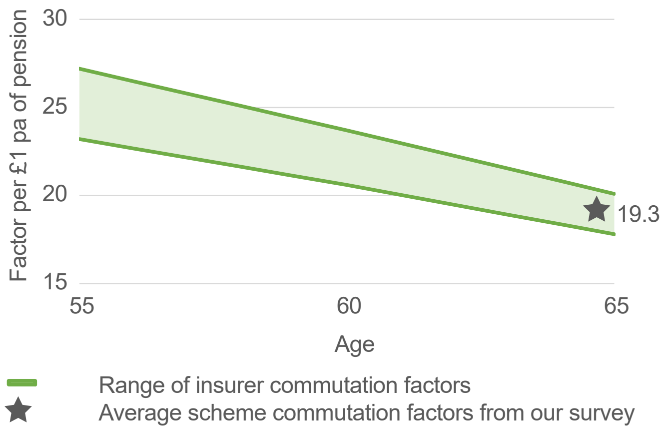
As schemes make progress on their de-risking journeys, they will pay more attention to factors that insurers offer. Once a scheme is bought out, the insurer sets terms for member options. Under a buy-in, the trustees remain responsible for setting the terms, but the insurer will use its own terms to determine how much to pay a scheme in respect of those benefits. On the journey to buy-out, schemes need to consider how best to transition from the terms on which members are currently able to exercise options to the terms which insurers will use.

Insurer factors tend to be higher than many pension schemes' factors, as they are set to be cost-neutral to the insurer and based on a prudent investment strategy. However, our analysis shows that the gap between insurer and scheme factors may have narrowed.

The chart to the right shows how insurer factors in December 2022 compared with the 'average factor' at age 65 from our survey. The 'average factor' is within the range of insurer factors. This may signify that schemes have been slower to react to the changing economic environment than insurers. Typically, insurers will update their factors on a monthly basis. However, our survey showed that around 80% of schemes use fixed factors. Otherwise, it could signify that some are already moving to terms closer to insurers' terms. In our survey, 19% of schemes said they considered how insurer factors compared at their last review (compared with 11% in 2021), and 40% would consider this at their next review.

This position will vary across schemes. However, we'd encourage schemes with endgame plans to benchmark sooner rather than later, as they might be closer to buy-out than they realise.

How insurer factors compare with scheme factors



Commutation factors are for pensions increasing in line with inflation (RPI or CPI, with a cap of 5%). Insurer factors were collected from five insurers and are based on financial conditions in December 2022.