HYMANS # ROBERTSON

Scheme factors in 2024

September 2024

The environment for DB pension schemes changed a lot over the past three years. Many trustees are thinking about what will happen to take-up of scheme options and factors in different market conditions and with widespread funding improvements.

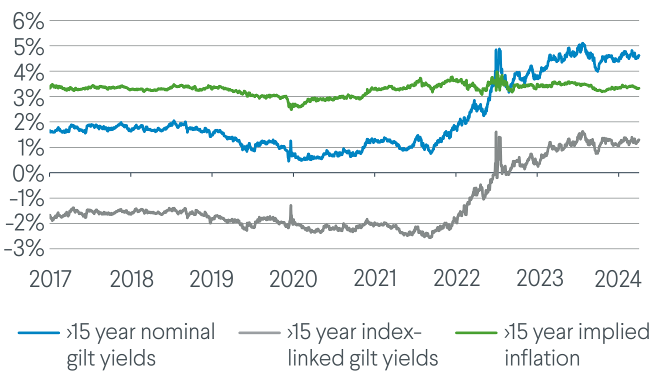
Here we look at emerging themes in three areas: transfer values, commutation factors and benchmarking against insurer factors.

Transfer values

Transfer values are at their lowest in almost a decade, and take-up of transfers is lower as a result.

Since early 2021, the long-dated gilt yields that typically drive the value placed on pension schemes' transfer values have increased by more than 3%. As a result, transfer values have fallen significantly over the past three years.

Figure 1: Market conditions since 2017



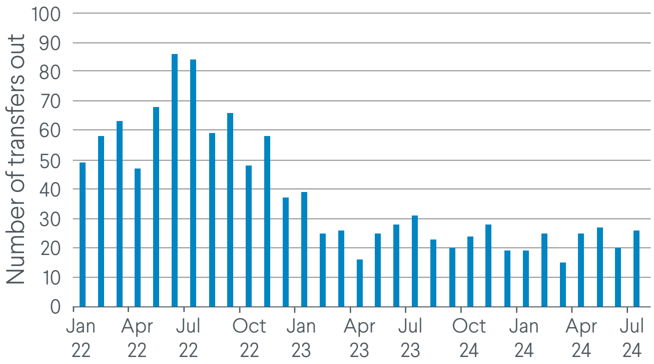
To put some numbers on this, consider a 55-year-old with an inflation-linked pension of £10,000 who expects to retire in 10 years' time. In 2021, they might have received a transfer value quotation of £300,000. In 2024 a member in the same situation would have received something closer to £150,000. That's a staggering 50% drop, caused solely by changing market conditions.

Figure 2 shows how the transfer value for a member in this situation has changed since 2017. It was around £350,000 at its highest, and around £130,000 at its lowest. The chart shows the changes caused solely by changing market conditions, but the drop could be even larger where updated longevity views are taken into account.

Figure 2: Changes in transfer values since 2017

Unsurprisingly, transfer value take-up has also dropped. Across a sample of the schemes that Hymans Robertson administers, transfers out have fallen by around 65% since 2022, when gilt yields began to fall. This level of transfer volumes has been sustained over the past 18 months, indicating a new kind of normal. We also see a lower proportion of quotes proceeding to transferring out in recent years. Back in 2022 we saw around 1 in every 7, today this is now more like 1 in every 14.

Figure 3: Transfer volumes since 2022 (sample of Hymans Robertson schemes)



Rising yields have been the main driver of declining transfer volumes, but other factors might have played a role. Firstly, DB schemes have fewer deferred members. Secondly, after funding improvements for many DB schemes in the past few years, members may have less motivation to leave. Some may be thinking about how they could benefit, for example, through discretionary increases. And finally, some members have found it hard to get financial advice. With the rules around the required advice becoming stronger members may find it harder to access an advisor in the first place and, also find that an adviser is less likely to recommend transferring out.

Declining transfer value amounts and volumes mean that schemes are likely to pay out much less in transfer values. As a result, many schemes are less concerned about the need for liquidity to meet transfer value payments than they were eight or nine years ago, when the 'freedom and choice' reforms were introduced. Lower and more stable numbers of transfer value payments will help mature schemes, which may be actively managing cash flow to meet benefit payments and trying to avoid unplanned disinvestment of their assets.

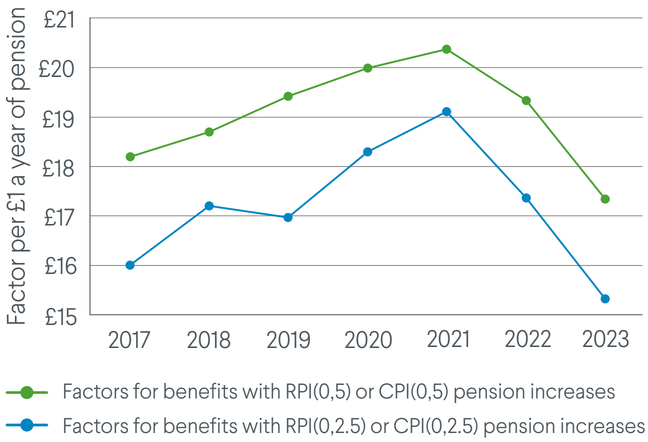
Commutation factors

As transfer values have fallen, many schemes have taken the opportunity to improve commutation factors in relative terms.

Members can convert a portion of their annual pension into a lump sum, which administrators calculate using a commutation factor. All else equal, we might expect commutation factors to change in a similar way to transfer values.

However, inflation-linked commutation factors have dropped by 15–20% since 2021. The drop is much smaller than the 50% that we'd expect to result from market changes. Figure 4 shows the change in average inflation-linked commutation factors for the schemes we advise, from 2017 to 2024.

Figure 4: Changes in communication factors since 2017



A 65-year-old who is retiring and has an inflation-linked pension of £10,000 a year could receive a maximum tax-free cash lump sum of £48,160 and an annual pension of £7,220 a year.

Commutation factors are lower than in 2021, but the difference is not as much as we might have expected. Several things could explain the outcome.

Some schemes could have been slower to automatically update factors for falling yields before 2022, taking a long-term view of yields or keeping factors fixed. Some schemes could have been improving factors only over the past few years, in turn offsetting some of the reduction from changing market conditions.

Scheme funding levels have generally improved, and so schemes can afford more generous terms without needing more sponsor cash. More schemes are on a journey to buy-out, so they're de-risking and want to manage a transition towards insurer terms.

What about take-up? We've analysed retirement data from a sample of the schemes that we administer, covering around 17,400 retirements in 2019–2023 from around 80 DB schemes. The data shows that, historically, most retirees have taken the maximum tax-free cash (figure 5). On average, about 20% of pension was converted into a cash sum (figure 6).

There is not much evidence of behaviour changing over this period. But we see evidence that people retiring earlier or on smaller pensions typically commute a greater proportion of pension than average.

Figure 5: Retirements by proportion of pension commuted for a pension commencement lump sum

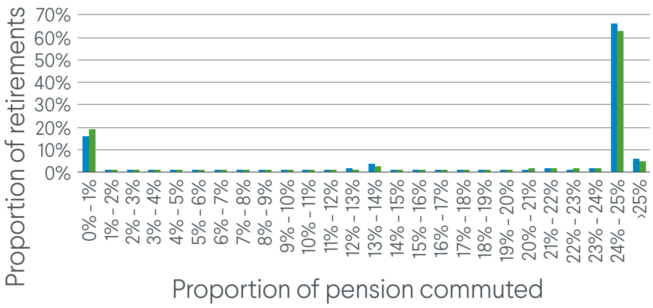
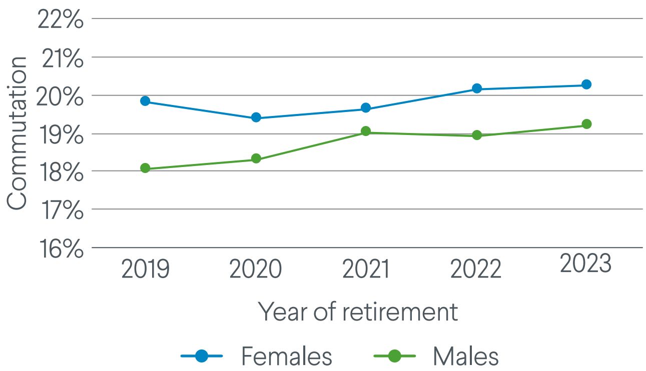


Figure 6: Weighted average pension commencement lump sum as a percentage of pension value



Looking ahead, it's important that schemes review commutation factors regularly. Most schemes still favour fixing commutation factors. However, most schemes that fix have moved to more frequent reviews or have monitoring mechanisms to review factors should things change materially before the next scheduled review.

Reviewing factors regularly helps to prevent a funding strain. And as the DB funding code comes into force for valuations with an effective date on or after 22 September 2024, schemes' funding plans should build in how they plan to set and review commutation factors as part of the low-dependency journey plan.

Schemes should consider knock-on impacts from changing commutation factors. For example, if a scheme moves to regular updates, it may want to build in the market sensitivity of lump sums into the liability hedging benchmark. More generally, schemes should review and rebalance benchmarks to maximise the effectiveness of hedging, recognising the impact of member options and experience.

Insurer factors

Many schemes are looking at how their factors compare with those that insurers offer, to ensure there isn't a large change when a scheme moves to buy-out.

As schemes focus on long-term objectives, they pay more attention to factors that insurers offer. Under a buy-in, the trustees remain responsible for setting the factors, but the insurer will use its own factors to determine how much to pay a scheme in respect of those benefits. Once a scheme is bought out, the insurer sets terms for member options.

Therefore, on the journey to buy-out, schemes need to consider how best to transition from the terms on which members can currently exercise options to the terms that insurers will use.

Historically, insurer factors were typically higher than pension schemes' factors, as insurers set them to be cost-neutral and based on a prudent investment strategy. However, our analysis shows that the gap between insurer and scheme factors has narrowed. Better scheme funding, progress with investment de-risking and changes in market conditions are all playing a part in closing this gap.

Figure 7: How insurer factors compare with typical scheme factors

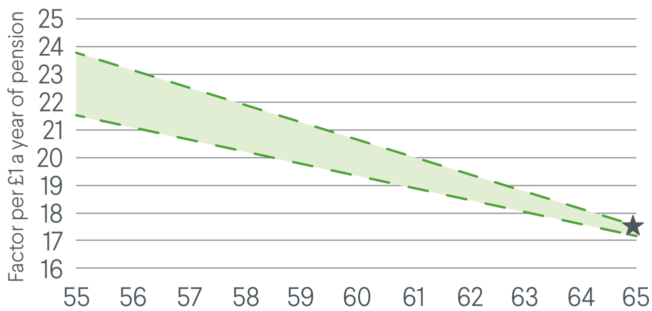


Figure 7 shows how insurer factors in May 2024 compared with the average inflation-linked commutation factor for the schemes we advise. The average factor, shown by the star, is firmly within the range of insurer factors.

It's clear that more schemes are taking insurer terms into consideration than ever before. Of the schemes we advise, 40% said they had considered insurer factors in setting their commutation factors at the last review, compared with 19% of schemes the previous year. A further 15% said they would consider insurer factors at the next review. More than half the schemes we advise are or will be looking at how their factors compare with those that insurers offer.

Next steps

In the light of these changes, trustees may want to think about what they could be doing with regards to factors.

- Review factors more often or monitor them to trigger a review if market conditions or scheme funding change materially.
- Keep member expectations in mind, and review communications to ensure they make it clear that terms are subject to change.
- Consider how insurer factors compare if the scheme's long-term objective is buy-out.
- Check whether any allowance made for transfer values or commutation in the funding basis remains reasonable.
- Consider how take-up of transfer values might affect ongoing liquidity and cash flow management.
- Think about whether they need to review the liability hedging benchmark.

To find out how we can help you, please get in touch.

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