Summary
Pension schemes often include options for members – in particular for commutation of part of the pension to a (tax-free) lump sum on retirement.

In this briefing we consider trustee duties and the role of the actuary in this area, and the factors they each need to consider in order to make reasonable decisions that will withstand scrutiny from members.

Employers and trustees should consider reminding members that they need to consider the implications of their decisions carefully (and consider if they should take financial advice).

Introduction
The recent Pensions Ombudsman determination in Squibbs (discussed in an annex to this briefing) has illustrated the pitfalls for trustees involved in setting actuarial factors in respect of member options such as:

- cash commutation;
- pension restructuring (e.g., an enhanced bridging pension or surrender of member pension for an enhanced spouse pension);
- exchange of a member’s deferred pension and other attaching benefits for a transfer value to another scheme (in most cases, members with more than a year to normal retirement age have a legal right to a transfer value); and
- in-scheme purchase of pension using member additional voluntary contributions (AVCs).1

Cash commutation – an option to exchange accrued pension payable from retirement for an immediate (tax-free) cash lump sum – is a common feature of many occupational pension schemes. It is perhaps less common to see other options such as an opportunity to ‘shape’ pensions, for example by providing a bridging pension up to state pension age in return for a reduced pension thereafter.

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1 Cash commutation factors and factors applied to the conversion of AVCs into pension were also considered in the Prudential case on the implied duty of trust and confidence: Prudential Staff Pensions Limited v The Prudential Assurance Company Limited [2011] EWHC 960 (Ch).
In both of these cases, members face a financial decision. The right questions for them to ask themselves are:

- ‘Should I take an up-front lump sum or increase in my benefits now?’ or
- ‘Should I look more long-term and hope to gain better value from regular pension payments in the future?’

The answers to these questions are likely to depend on an individual’s personal circumstances and would be best talked through with an independent financial adviser.

Members need to make their own decisions on this at the relevant time (retirement). They may later come to the view that, in retrospect, they made the wrong choice.

When members choose an option which eventually results in a negative outcome, it is perhaps inevitable that some will look to blame or at least question:

- the information provided; or
- the party (the trustees, employer or actuary) involved in setting (or advising on) the relevant actuarial factors.

It is important in such cases for trustees to feel comfortable that they have exercised such powers properly.

In this briefing we consider trustee duties and the role of the actuary in this area, and the factors they each need to consider in order to make reasonable decisions that will withstand scrutiny from members. As the most common, we focus principally on cash commutation.

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The Code provides voluntary objectives for employers and trustees to follow to help ensure that members make informed decisions.

The Code of Good Practice for Incentive Exercises was published in June 2012.

It provides voluntary objectives for employers, trustees and others to follow to help ensure that members make informed decisions about Incentive Exercises that seek to change the form of a member’s accrued defined benefit rights in UK registered pension schemes.

The Code is clear that it does not apply to:

- ‘Member options ordinarily available on certain events, such as retirement or leaver processes, including early retirement and options to commute pension for a tax-free lump sum.’

However the Code does go on to say:

- ‘However, employers, trustees and advisers should be mindful of the principles of the Code and seek to ensure that changes to benefit options offered by the scheme will maintain suitable protection of members’ interests. In some cases it may be appropriate to apply some aspects of the Code to exercises that fall outside the scope of the Code. For example changes to defined benefits for current employees such as introducing restrictions on pensionable pay may impact accrued rights over time. Employers, trustees and advisers are encouraged to consider the extent to which it would be appropriate and helpful to members to apply some or all of the Code in such situations.’

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2 Supporting Information section.
Reasonableness

In the context of member options such as cash commutation, it is difficult to advise on how the reasonableness (or at least absence of unreasonableness) of the relevant factors should be determined. This is because (somewhat surprisingly) there is no clear guidance or case law on the issues to be taken into account.

What is clear is that fixed rates or rates based on (say) 9 to 1 commutation are seen increasingly as being inconsistent with annuity rates and commutation or capitalisation rates in other areas (e.g., for the lifetime allowance (20 to 1), annual allowance (12 to 1), commutation of money purchase assets to pension etc). Although note that some rates deal with the whole pension (e.g., including spouse), while others only deal with the member pension.

What do the trust deed and rules say?

This is the first question that needs to be asked.

A fairly common sort of commutation provision might provide:

‘The trustees shall convert pension into lump sum at a rate determined by the trustees and confirmed by the actuary to be reasonable.’

Usually the commutation reduces the member’s pension only (any spouse or dependant pension payable after the member’s death usually remains unaffected by the commutation).

The reference to the actuary’s involvement is a clear indication that the starting point for determining commutation factors should be the actuarial value of the pension being commuted (although this would likely be implicit in any event). In this type of provision there is no requirement for employer consent (but in some schemes consultation may be necessary and increasingly the issue is likely to fall for discussion in any event in connection with funding, since unfavourable commutation terms can represent a saving to the scheme).

The valuation basis is not specified and the trustees are likely to wish to consult the actuary from the outset. A reasonable basis may perhaps be the scheme specific funding basis, but perhaps after removing the margins for prudence required in calculating the technical provisions (but this is untested).

What are the general principles on trustees exercising discretion?

A trustee discretion or power must be exercised in a fiduciary manner. This means that it must be exercised:

- for a proper purpose (with respect to pension schemes, usually described as being in the best interests of the scheme – but see further below); and
- having taken advice where appropriate and considered all relevant factors (and ignored irrelevant ones). Note that in light of the recent Supreme Court decision in the jointly heard cases of Futter v HMRC and Pitt v HMRC the scope of this duty (or ground of challenge) is more limited than previously thought.

These are in practice two sides of the same coin – i.e., to exercise a power for a proper purpose, it is necessary to consider all relevant factors and ignore irrelevant ones.

Reference to the actuary’s involvement is a clear indication that the starting point for determining commutation factors should be the actuarial value of the pension being commuted.

3 See the article in Investors Chronicle: ‘Up to 3.6m retirees in line for “rip off” lump sums’, available at http://www.investorschronicle.co.uk/2013/05/28/your-money/pensions-and-sipps/retirement-income/up-to-m-retirees-in-line-for-rip-off-lump-sums-8H6NwejcvyP2IzJW5fdSK/article.html

Where trustees have a discretion, usually a fairly wide margin of appreciation is given by the courts. Subject to the points above, the Courts or Pensions Ombudsman will often only intervene if it can be shown that the trustees acted in a way that no reasonable trustee would act. In the context of commutation or transfer, more recent judgments have emphasised that in some cases an approach for no more than ‘a share of fund’ is required.

### Proper purpose

Acting in the best interests of the scheme does not necessarily mean that trustees must use their powers to maximise payments to some/all members. As a general principle, pension scheme trustees are obliged to act impartially:

- in a manner that they believe to be fair and equitable, having regard to the different classes of beneficiary and to the interest and expectation of the employer; and
- between individuals within the different classes of beneficiary.

This involves maintaining:

> ‘a balance between assets and liabilities… so that, as far as can be foreseen, they will be in a position to provide pensions and other benefits in accordance with the rules throughout the life of the scheme.’

Case law indicates that the courts will require trustees to take account of a pension scheme’s funding position when exercising administrative powers such as powers to buy-out benefits and effect transfers.

- In *Stannard v Fisons Pension Trust Ltd* the court held that the trustees’ determination of an amount to be transferred out of the relevant pension scheme following the sale of Fisons’ fertiliser division was flawed because the trustees had not considered the current (increased) value of the pension fund at the transfer date and its implications in determining the amount that it would be just and equitable to appropriate in respect of the transferring members.

The trustees’ duty to give properly informed consideration to the funding position was owed to the transferring members and the remaining members alike since they had both contributed to the fund. Moreover, it was the duty of the actuaries to put the trustees in a position to make a properly informed decision – by giving them information on the relevance of the value of the pension scheme to the problem in hand in relation to actuarial principles, and the implications of their decision on future contributions.

- In *ITS v Hope* the scheme was in deficit and the court considered a proposal to use a buy-out power to purchase annuities which would maximise certain members’ benefits in anticipation of entry into the Pension Protection Fund (PPF). It was held that there was a limitation, implicit in the relevant scheme rules, that the amount which may properly be applied in purchasing annuities would be no more than a fair share of scheme assets, considered in the light of actuarial advice.

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5 Eg *Wrightson Ltd v Fletcher Challenge Nominees Ltd* [2001] UKPC 23 (a case looking at a bulk transfer value).

6 Eg *Harris v Lord Shuttleworth* [1994] ICR 991 (a case looking at a discretion on an ill health pension). In the *Squibbs case* (78488/2), 7 September 2012 (King PO), the Ombudsman emphasised that the test for unreasonableness is a high one.

7 *Independent Trustee Services Ltd v Hope* [2009] EWHC 2810 (Ch) (a case on bulk transfers out of a scheme about to wind up); *Dalriada Trustees Ltd v Faulds* [2011] EWHC 3391 (Ch).

8 *Edge v Pensions Ombudsman* [2000] Ch 602.


10 [2009] EWHC 2810 (Ch).

11 Ibid. Henderson J at paragraphs 96 and 99.
Relevant and irrelevant factors

There is relatively little guidance in the authorities on how to determine whether a particular consideration should be taken into account by a trustee or not. In a leading text book on the law of trusts, the question is said to be ‘largely a matter of impression and common sense’.12

Some trustees (and their advisers) take a restrictive view of the limits on their discretions and consider that they must be exercised in the best interests of the members only (ie ignoring the interest of the sponsoring employer unless that impacts on the interests of the members).

We consider that in general this is too narrow a perspective and that trustees should also consider a sponsoring employer in its role as the funder of the scheme. A strong corporate sponsor tends to be in the interests of the scheme, because the security of the scheme (and whether it will continue to pay benefits) will depend greatly on the continued strength of the employer that is obliged to fund the scheme. It will not usually be in the interest of the scheme to drive the employer into insolvency – this is supported by statements made by the Pensions Regulator in its funding guidance.

Can the tax impact be a factor?

Pensions paid are usually subject to income tax. A cash lump sum paid on retirement is usually not taxable (subject to the lifetime allowance) if it is within the relevant limit laid down by HMRC (usually no more than 25 per cent of the fund).

Is it proper for the trustees or actuary to take the tax effect into account when agreeing a commutation rate? In other words, to reflect that a lump sum is tax free, whereas a pension is taxable? This is untested, but it seems reasonable that the trustees should consider all the circumstances and that the tax implications are relevant.

What is the actuary’s role?

Going back to our example above, the actuary is not required to determine the commutation factors; this power resides with the trustees. However, the actuary must confirm that the factors are ‘reasonable’. Guidance does not tend to be given in the trust deed and rules as to how ‘reasonable’ should be construed, but the actuary is likely to have regard to all his knowledge and experience and usual professional standards.

The actuary’s role is an important one, and may render him ‘concerned with the administration of the scheme’ and thus a ‘scheme administrator’ for the purposes of bringing a complaint of maladministration before the Pensions Ombudsman.13

However, as a general principle it is difficult to challenge an actuary’s decision, unless it is demonstrably not one that a competent actuary could have reached, or there is evidence of a mistake or improper motive: Re Imperial Foods Ltd’s Pension Scheme.14 In that case, Walton J also accepted the principle spelt out by Buckley J in Re George Newnes Group Pension Fund15 that:

‘the function of an actuary in any situation which is not governed precisely by the provisions of the trust deed is to achieve the greatest possible degree of fairness between the various persons interested under the scheme.’

Whilst the starting point should typically be the actuarial value of the pension being commuted, in our view it is not inappropriate for both the trustees and the actuary to take account of factors which are not purely ‘actuarial’ in nature, such as scheme funding.

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14 [1986] 2 All ER 802 (Walton J).


The report of the Member Options Working Party of the Institute of Actuaries\(^{16}\) was issued in December 2006. In relation to cash commutation, it notes that:

- most scheme members elect to commute pension for a cash sum at retirement. This is likely to be partly because the lump sum is tax-free, but also owing to an assumption that the financial terms relate closely to the cost of replacing the benefit foregone. However, for many schemes this is not likely to be the case in practice;
- in recent years the cost of pension benefits has increased materially, as evidenced by the costs of purchasing annuities on the open market. For many schemes, the terms for cash commutation have generally not increased by the same proportion, if at all;
- a comparison between HMRC's standard 'capitalisation' factor of 20 to compare the value of a member’s benefits with the lifetime allowance and the not uncommon cash commutation multiple of 9 is stark (and remains so, even after adjustment is made for the assumed attaching dependant’s benefit included in the HMRC factor);
- the advent of the PPF makes pensions more secure. Accordingly, members may now be giving up a more valuable right compared to the situation before the PPF; and
- some schemes limit the amount of AVCs that may be taken as cash on retirement by reference to the amount of main scheme pension taken as cash. In many such schemes, the terms for purchasing annuities with AVCs will be inconsistent with the terms for surrendering pension from the scheme.

The 2006 Report includes a statement on the legal issues and indicates the view that ‘it is appropriate that the financial terms for member options take account of other factors than actuarial equivalence’ (such as scheme funding).

The 2006 Report also sets out a useful summary of some of the financial issues that are relevant to valuing member options, as follows:

**Extract from the 2006 Report**

‘3.2 Financial issues

Financial issues that are relevant to valuing member options include the following.

(a) Discounting payments. There are different views amongst UK actuaries on how to place a value on pension scheme liabilities. These can be summarised as follows:

- discount expected payments at the expected rate of return on scheme assets, or
- discount payments at market rates (with or without allowance for credit risk).

In practice, many actuaries adopt pragmatic approaches that fall between these two philosophies.

(b) Expected frequency of exercise. Some options are exercised only rarely, eg the option to surrender pension in return for higher contingent dependants’ pensions. This may be relied on in setting terms on the basis that the risks of setting terms on too generous a basis will still be immaterial in the context of the scheme as a whole. Equally, some options are widely expected to be exercised, eg commuting pension for cash sum at retirement. This may be relied on in financing the scheme – some actuarial funding valuations assume that pension will be commuted for cash at rates that are less favourable than are otherwise implied by the actuarial funding basis.

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\(^{16}\) http://www.actuaries.org.uk/research-and-resources/documents/member-options-working-party-report
(c) Risk of adverse selection. If a scheme provides terms that are inconsistent internally or inconsistent with market terms then there is a risk that members will select against the scheme by choosing the option most favourable to them but which is consequently least favourable to the financial position of the scheme. The risk of adverse selection also exists in relation to member life expectancy if the benefit is not underwritten.

(d) Rating factors. Allowing for some of the factors that are potentially relevant for valuation such as the member's sex, the size of the pension or marital status is potentially controversial. For instance, providing higher commutation factors to members with larger pensions could result in the accusation of favouring the better paid, even though experience suggests that individuals with higher pensions live longer and therefore the pension surrendered has a higher value.

(e) Administration expenses. Providing pension benefits entails expenses. Given the general focus on scheme funding, actuaries have tended not to consider the allocation of expenses to different member benefits. Doing so could prove controversial as small benefits are not much, if at all, cheaper to administer compared with large benefits.

(f) Tax effects. The favourable tax treatment of cash commutation means that members are incentivised to take the cash sum even though the terms are not cost neutral when seen from the scheme's point of view.

(g) The sponsor covenant and the PPF. It is currently unusual to take explicit account of the strength of the sponsor covenant or the existence of the PPF in setting terms for member options (other than in the case of a scheme in winding up – see appendix D). These are, however, potentially material factors in valuing a member's benefit.

(h) Asymmetry in changing terms. Changing the terms for a member option will tend to meet resistance when the members perceive that the terms are being worsened. This tends to be more an issue where the options are reviewed infrequently and not linked explicitly and objectively to market conditions. This asymmetry means that trustee and sponsors may hold back from making changes that may only be temporary to avoid the potential pain of having to reverse them.

Examples are:

- low long-dated interest rates – the concern is that there is a material risk that these are a short-term phenomenon; and
- longevity – instead of adopting the latest expectations (as would be the case in market annuity rates), the tendency is to require substantial evidence of improvement before allowing for it in member options (where this works against the scheme).

Additional issues to consider (some of which were touched upon in the Report) might be as follows, but the extent to which weight can safely be placed on them (and the financial issues listed above) is untested.

- The fact that it is up to members to decide whether or not to take a cash lump sum (but members may not be relied upon to make a reasoned decision without independent financial advice).
- Any funding deficit in the scheme – as actuarial equivalence depends on the discount rate, that links in with funding, as does a need to consider the impact on other members.
- Whether the trustee's current investment strategy is resulting in a more valuable benefit and whether that is justified.
- A desire for consistency.
- The argument that members should share with the sponsoring employer some of the increased cost arising from economic and demographic changes.

The trustees and actuary will each need to feel comfortable that the weight accorded by them to all or any of these factors is appropriate.
History

In the absence of clear guidance on the factors to be taken into account in determining the ‘reasonableness’ of commutation rates, it may be necessary to consider how those rates have historically been determined.

Just because there has not been a history of taking into account a certain factor, this does not necessarily mean that it would be unreasonable to take it into account now.

If the trustees and the actuary wish to take particular matters into account when certifying the reasonableness of the commutation factors applicable in respect of the scheme, it would be helpful clearly to set out that this had been done and also the reasons for it.

This would assist if the issue ever came to court (or before the Pensions Ombudsman) as it would illustrate that the matter had been carefully considered and give weight to the argument that the trustees (and the actuary) had acted reasonably.

What are other schemes doing?

The Member Options Working Party Report from 2006 provided some indication of what schemes were doing in this area, but a recent (2013) update shows that practice has moved on since 2006.

If a practice was noticeable of schemes taking account of certain factors such as funding, this may be helpful in assessing the reasonableness test.

The PPF currently operates using factors of 17.43 for pension relating to pre-1997 service and 24.14 for pension relating to post-1997 service (in each case based on pension becoming payable at age 65 to a member in respect of whom 50 per cent survivor’s compensation is payable).

Dealing with uncertainty

There are several possible ways of dealing with any uncertainty as to the setting of commutation rates.

- **Amend the trust deed?** Depending on the amendment power, this could be done so as to specify the bases for setting the rate or the actuary’s certification. This would allow the factors to be taken into account in deciding whether the commutation rates were ‘reasonable’ to clearly be set out for the avoidance of doubt. Such a change would not be within the limits on amendment in section 67 of the Pensions Act 1995 as no ‘subsisting right’ would be affected. However, the trustees would need to be satisfied that any amendment was being entered into for a proper purpose and consistent with their fiduciary duties (eg to avoid uncertainty) and to that extent this does not resolve the pre-existing question as to the relevant factors to consider.

- **Set a policy for reviewing factors.** Having a clear policy on when factors will be reviewed and carefully documenting the decisions reached following such reviews will help enable trustees to mount a robust defence in the event of a legal claim – as evidenced by the Pensions Ombudsman’s decision in *Squibbs*.

- **Issue a warning to members?** Trustees may wish to consider including some risk warnings when communicating with members about their various options. Ultimately, the prospect of a legal claim is much reduced if the member has given informed consent to a particular step, fully understanding the rate available. The Member Options Working Party Report highlights this point by recommending that the actuarial profession:

  ‘...should support either a requirement for a risk warning and suggestion for members to take financial advice if they are considering commuting a large amount of pension to cash, or a meaningful disclosure of cash commutation terms to members consistent with its stance on member disclosure for transfer values (ie an indication of the cost to the member of securing an equivalent pension).’

[17 http://www.actuaries.org.uk/research-and-resources/documents/member-options-getting-it-right]
• **Refuse commutation requests?** Finally, in some schemes, whilst members have a choice as to whether or not to take cash commutation, they are unable to insist upon it and employer consent is needed (though in practice, it is rarely refused). If agreement could not be reached on appropriate rates of commutation, one option for the employer would be simply to stop allowing members to commute. But this would be a draconian step.

• **Different tranches.** Schemes should also consider the impact of commutation on different tranches of pension. If a scheme (say) has no (or discretionary) pension increases on pre-1997 service, but statutory increases on post-1997 service, it is helpful for any commutation to be clear as to which periods of service the pension being commuted relates.

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**Annex**

**Squibbs**

In the case of Captain P Squibbs\(^{18}\), the 76-year-old pensioner brought a complaint against the Airways Pension Scheme in respect of the ‘variable pension option’ (VPO) he had chosen prior to his compulsory retirement at age 55.

The aim of the VPO was to give a more even pension throughout retirement and the relevant provision in the scheme rules stated that a pension under the VPO:

> ‘shall be increased before such pensionable age and reduced thereafter in accordance with arrangements approved by the Actuary with a view to providing [the member] with a more stable aggregate pension from the Scheme and from the general social security scheme.’

In Captain Squibbs’ case it resulted in an additional £1,170.72 on his pension each year up to age 65 (state pension age), followed by a deduction of £2,734.44 from his (normal) pension each year thereafter for the rest of his life. By the time of his complaint to the Ombudsman, Captain Squibbs had already ‘repaid’ the scheme a larger sum in yearly deductions since age 65 (£30,078.84) than he had previously received in additional payments (£11,707.20).

The terms of the VPO were explained clearly in a number of letters sent to Captain Squibbs in the year leading up to his retirement and a pamphlet was provided which stated that once begun, the VPO ‘cannot be altered or cancelled under any circumstances’. Notwithstanding this, he complained to the Ombudsman that the management trustees of the Airways Pension Scheme had breached their fiduciary duty by failing to operate the VPO in a fair and reasonable way, on the grounds that:

> he had not been given sufficient information to make a fully informed decision on whether to take up the VPO, based on his personal circumstances – the VPO was wrongly presented to him as being cost-neutral to members and the scheme; and

> the management trustees had failed to ensure that, within the parameter of cost-neutrality for the scheme, the actuarial factors used for benefit calculations were fair and reasonable. Although the management trustees had considered the scheme factors and the VPO on a number of occasions, Captain Squibbs complained that they had failed to monitor them between 1984 (when new factors were adopted) and his retirement in 1991, or take account of improved life expectancy that had distorted the VPO over time. In addition, he contended that the terms of VPO pensions should have been reviewed by the management trustees after retirement to ensure the assumptions adopted reflected cost-neutrality in light of members’ actual longevity.

On 7 September 2012, the Ombudsman dismissed the complaint. It was found that the terms of the VPO were made clear to Captain Squibbs and sufficient information was provided to enable him to select the option appropriate to his personal circumstances at the time he needed to make a choice.

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\(^{18}\) (78488/2), 7 September 2012.

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In Squibbs, the Ombudsman emphasised that the test for unreasonableness is a high one.
Moreover, the management trustees had not breached their duties. It had not been shown that between 1989 and 1991, only an unreasonable body of trustees would have left the factors unaltered. The Ombudsman emphasised that the test for unreasonableness is a high one.

It is instructive to note some of the reasons based on which the management trustees had decided (both before and after Captain Squibbs’ retirement) not to change the actuarial factors/terms of the VPO. These included:

- the need to minimise anomalies in the benefits receivable by members;
- the need to maintain the conditions of the VPO as consistent between existing and future pensioners; and
- the fact that to end repayments for existing VPO pensioners after 10 years (as had been suggested by the scheme actuary in relation to a disposable surplus) would cost around £15m and there were many thousands of other pensioners who had taken up other actuarially neutral options, commutation being the main example, who might consider that they should be treated in the same way (ie if actuarial assumptions were not borne out in practice some adjustment should be made).