Letter from Director General of Fair Trading to the Institute of Actuaries

From the Director General of Fair Trading
John S. Bridgeman TD DL

Martin Slack, Esq.
Chairman
Current Issues Committee of the Pensions Board
Institute of Actuaries
Staple Inn Hall, High Holborn
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Dear Mr. Stack:

OFT INQUIRY INTO PENSIONS

When we replied to your letter received on 6 October commenting on various aspects of my pension report, we said we would consult the specialists who compiled the technical appendix on transfer values. I have now had the benefit of their carefully considered views upon your various points which I now enclose and I am satisfied that they effectively deal with the points you raised.

David Blake and Michael Orszag have more than 20 years' experience between them of examining the UK pensions industry. I was therefore very pleased when they agreed to undertake a study of transfer values using the official publications of the Institute and Faculty of Actuaries (IFA). Their work received extensive comments from the Government Actuary's Department prior to publication of my report. Whilst I welcome the clarifications contained in the IFA commentary, I note that the IFA has not challenged the size of the portability losses they estimated using the IFA Guidance Notes. As a further corroboration of their correctness, these estimates were of the same order of magnitude for portability losses estimated by actuary Bryn Davies in his report `What's Wrong With Transfer Values?', published by Pension Investment Research Consultants in 1990. I understand it is on the interpretation of these results, and the nature and extent of actuarial discretion, where David Blake and Michael Orszag disagree with the assertions in your letter.

Drs Blake and Orszag are happy to accept the IFA's clarification on points relating to actuarial discretion and they discuss these in more detail in the response attached. However, while they fully accept the IFA's explanation that the extent of actuarial discretion in respect of minimum cash equivalent transfer value calculations amount to little more than the flexibility `to calculate the transfer value using the member's age in years and months, or years and days', the Coopers & Lybrand Survey of actuarial assumptions (August 1997) would nevertheless appear to indicate a somewhat wider degree of discretion. For example, this survey `shows a surprisingly diverse range of assumptions about what will be a shared economic future for the country. For a given liability backed by investments with a market value of £100 in the average scheme, the most optimistic actuary surveyed required £71, while the most cautious actuary required £136.' These appear to be very substantial differences. The survey recognised the `need for transparent actuarial information', clearly a supportable assessment. It is because there is no adequate source of publicly available information on the extent of actuarial discretion that Drs. Blake and Orszag believe that a study of actuarial discretion at this time would be most valuable.

Their main disagreement with the IFA concerns the interpretation of the portability losses that they have estimated. This disagreement appears to be based, in part, on the actuarial profession's lack of familiarity with the methods of valuation of losses and costs used by economists. Economists assess losses and costs in terms of objective benchmarks that measure the best alternative outcomes. Economists also distinguish between `positive' (is, does) and `normative' (ought, should) valuations. Our analysis was conducted entirely in terms of positive valuations and not in terms of what we feel employers `should' take into account. Drs. Blake and Orszag separated portability losses into two components: a cash equivalent loss and a backloading loss. These losses were calculated objectively and precisely using actuarial methods. Backloading costs are well recognised in economics (as indeed are frontloading costs) and yet the IFA, remarkably, dismisses them as `misconceived'. There also appears to be a serious misunderstanding of what they have actually done, since the IFA makes the curious assertion that the cash equivalent and backloading losses estimated are not `in any way relevant to the calculation of the cash equivalent'. Drs. Blake and Orszag did not expect them to be.

In response the IFA, talks of `fairness' and `reasonableness'. But these terms are not defined and one is left with the impression that fairness and reasonableness are what an actuary says is fair and reasonable. There are two telling passages in the response. The first is from para 1.2: `In a final salary defined benefits structure, a member who leaves service before retirement age receives less value for his service than a member who stays to retirement would receive for the same service. Transfer values, designed to provide a reasonable sum in exchange for an early leaver's benefits, neither exaggerate nor reduce this. To do so would introduce a degree of unfairness - between those who opt to transfer and those who opt to retain their pension in the scheme'. The second is from para. 4.2: `the cash equivalent aims to place a fair value on the preserved benefit which the leaver would otherwise leave behind in his former employer's scheme. It is completely independent of the funding plan (ie, PUM, CUM, or indeed, any other funding method which might be used). To calculate cash equivalents in any other way would be bound to introduce some degree of unfairness between those who opt to transfer out and those who do not.' These passages state explicitly that actuaries believe that the transfer value (cash equivalent) taken by early leavers from defined benefit schemes are both fair and reasonable, and that, as a consequence, the portability losses (of up to 30% for the average person who changes jobs six times in a lifetime) that have been calculated with reference to objective benchmarks are also both `fair' and `reasonable' It is not expected that most people would find this acceptable.

I share David Blake and Michael Orszag's belief that there is a great deal that actuaries and economists can learn from each other. I understand that their Pensions

Institute actively encourages interdisciplinary research and many academic actuaries are beginning to apply the techniques of modern finance theory to actuarial problems. Their Institute already publishes the results of some academic actuaries' research in its discussion paper series and has indicated a willingness to work with the IFA on examining the consequences of actuarial discretion for portability losses. These seem to me encouraging signs for the future.

Yours Sincerely,

JOHN S. BRIDGEMAN
DIRECTOR GENERAL OF FAIR TRADING