



FINANCIAL SERVICES COMMISSION
Discussion Paper
Draft Policy on Transfer Values for Approved Superannuation
Funds and Retirement Schemes
February 2007

The following document is a discussion paper outlining the Financial Services Commission (“FSC”) draft policy on transfer values for approved superannuation funds and approved retirement schemes. Issues discussed include transfers into and out of under-funded or insolvent plans, transfers between defined contribution and defined benefit plans, and the basis for determining the actuarial assumptions to be used in the calculation of transfer values. Transfer values are the amounts that terminating members would be able to carry with them from their old plan to their new plan.

The FSC requests your comments on the issues covered in the paper as they will be instrumental to us for the review of our position regarding transfer values and the development of regulations for Phase II of Pension Reform. We also invite your contribution on any area that you believe should be included in the FSC’s policy on transfer values that have not been covered in this paper.

Kindly forward your comments by Friday, February 29, 2008 to:

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1. Introduction

An important issue in relation to employer sponsored pension plans is the question of portability or transferability. The prime objective of an employer sponsored pension plan is to provide the member with a pension at retirement that, together with income from the state pension plan, will permit the member to live at roughly the same standard of life that the member enjoyed prior to retirement. Generally speaking, international best practice would indicate that a total replacement of around 75% of income just prior to retirement would achieve this goal in most circumstances. In many plans, this objective is achieved provided the employee works for one employer throughout the member's career. The question then arises as to how to continue to achieve this objective if an employee changes employment one or more times during the person's career.

In the event that a person does not have a full career with one employer, the objective of full replacement could be frustrated for a number of reasons:

- i. Periods of employment with employers who do not have a pension plan
- ii. Periods of unemployment
- iii. Loss of value of pensions due to lack of vesting
- iv. Loss of value of vested pensions due to commutation for the purpose of transferring it into another pension plan

Enrolment and contributions to an approved retirement scheme will reduce the impact of the first cause. Unemployment, the second cause, is beyond the scope of this paper and in the case of the third, proposed legislation under Phase II of pension reform will shorten the vesting period to 5 years.

This paper deals specifically with the fourth cause and suggests ways to mitigate, if not eliminate, losses caused by a member leaving a pension plan and porting his vested pension

2. To preserve or to transfer

If a plan member leaves a plan with vested benefits, one option is simply to require the plan to preserve this benefit and pay an appropriate deferred annuity. The clear disadvantages of this approach are that the plan administrator is likely to lose contact with the deferred member as well as members might end up with a number of such deferred pensions. A more convenient solution would be to permit transfers of value of the deferred pension either to the new pension plan (if the employee is reemployed somewhere else within a reasonable length of time from leaving the previous employment), or to an approved retirement scheme, which does not depend on reemployment. The rest of this paper discusses some of the issues related to this approach.

3. Defined contribution plans

One advantage of defined contribution plans is that the value of a member's accumulation is readily obtainable at any time. Therefore, in the case of a member leaving a defined contribution plan with a vested pension, the plan trustees need only transfer the amount of the accumulation to the employee's subsequent pension plan or to an approved retirement scheme.

4. Defined benefit plans

The major issue is with defined benefit plans, as the value of an employee's entitlement is dependent on actuarial calculations and is not as easily determined as with a defined contribution plan. A further complication of defined benefit plans is that benefits for those who retire are often based on salaries close to retirement, whereas those for terminating members are determined based on salaries close to termination, with no adjustment for the inflation or salary increases between the time of termination and the retirement. This can entail considerable loss to the plan member, however, the calculation of transfer values cannot by itself mitigate this loss of value. It can only give the employee an equivalent value to the deferred pension on a fair value or market value basis. Finally, complications arise if the plan is not fully solvent at the date of transfer.

The two principal approaches to transfer values are:

- A. Transfer agreements between pension plans;
- B. Valuation and pay-out either to another pension plan or to an approved retirement scheme.

A. *Transfer agreements between pension plans*

These agreements generally take the form of reciprocal recognition of service when an employee transfers from one employer to another. They are by and large voluntary agreements, as it is difficult to legislate on such an issue. While such agreements tend to be common in the public sector, they are rarer in the private sector as private sector employers are not keen to facilitate the transfer of an employee from one competitor to another. In fact, pension plans are used as “golden handcuffs”, with the intention of impeding rather than facilitating movement from one employer to another. It might therefore be difficult to legislate such agreements, as this might threaten the existence of pension plans.

While such agreements are valuable, it is believed that in general it is preferable to let them remain voluntary and not impose any conditions on such agreements.

It is recommended that in the event that an employee transfers from one plan to another, the plan be required to disclose the terms of the transfer agreement as well as the alternatives of retaining a deferred annuity or using the transfer mechanism outlined below. The employee would then be given the right to choose the approach that appears most advantageous to him.

B. *Valuation and pay-out*

The most convenient approach to transfer values is simply to establish a basis for the valuation of the vested benefit and require that this value be paid out, either to a subsequent pension plan, or to an approved retirement scheme.

The main issues in relation to transfer values for defined benefit plans are as follows:

- a) Actuarial basis for calculating the values;
- b) Treatment of transfers from plans that are not fully solvent;
- c) Accepting transfers from other funds

Each will be discussed in turn below.

a) Actuarial basis

Clearly this is one of the key issues, and one of the most difficult to resolve. The basis should be:

- i. Fair and equitable to both the departing plan member and the fund (i.e. the remaining members)
- ii. It should be relatively straightforward to calculate and transparent
- iii. It should be sensitive to changes in the economic and demographic environment

In principle a market oriented deferred annuity calculation will meet these criteria, but in general, such values will not be readily available as an active market in deferred annuities is seldom present even in more developed countries, and would be particularly difficult in countries, such as Jamaica, where financial markets are still developing.

It is recommended that the Caribbean Actuarial Association (CAA) be requested to set a basis for the calculation of transfer values that would be acceptable to the FSC and the pension industry and that would be fair and equitable to plan members.

The formula for this calculation would probably take the form of a deferred annuity calculation, namely:

$$\text{Transfer Value} = B * v^{R-x} * a_R$$

where B is the benefit amount determined from the plan's benefit formulae, v is a discount factor, R is the age of retirement, x is the age of termination of membership and a is an appropriate annuity value, depending on the form of pension.

The interest rate used to compute the discount factor, should be based on Government of Jamaica long term bonds for an initial period and some appropriate long term rate thereafter. This basis could be reviewed on a periodic basis to ensure that it remains in accordance with interest rate expectations in Jamaica. A particular interest rate could be in effect for three months, and then recomputed each three months, if interest rates change by a given trigger percentage, which is not so large as to cause the basis to lag too far behind rates changes, but not so small as to require excessively frequent changes. Further details could be suggested by the Caribbean Actuarial Association, including appropriate mortality rates to be used, and whether mortality improvement factors should be included or not.

This approach is relatively straightforward, recognizes changes in the economic and demographic environment and also gives the actuarial profession a role to play in establishing these factors.

b) Treatment of transfers from plans which are not fully solvent

If plans are shown to be fully solvent, either by actual calculation or by means of an actuarial certification, then payment of the full transfer value will not affect the solvency ratio negatively. However, if this is not the case and the plan indicates a solvency deficiency, then paying out the full transfer value will reduce the solvency ratio further, thereby weakening the security of the remaining members. Recall that solvency ratio is the ratio of the assets of a plan to its liabilities on a

termination basis whereas funded ratio is the ratio of the assets to the liabilities calculated on an on-going basis.

Paying partial transfer values at the date of termination, and the balance some time later, conflicts with the principle of the “clean break”, so some compromises might be in order. For example, it is recommended that a full payment can be made if the solvency ratio at the last valuation was say 90% or greater, on the basis that the ratio should have improved and that if the ratio is only marginally below 100%, then the convenience of the clean break outweighs the minor breach of equity.

However, if the solvency ratio is less than 90% some kind of adjustment needs to be made. In this case it would be required that the Trustees in their recovery plan to indicate how such transfers will be handled while the solvency ratio is below 90%. An initial transfer of the full transfer value times the last reported solvency ratio would be made. Insofar as the balance is concerned the Trustees would need to establish a non-discriminatory policy that either permits or requires

- i. The full transfer value to be made if the plan sponsor contributes the balance to the fund within a reasonable period of time; or
- ii. The balance to be paid at the earlier of the point at which the solvency ratio reaches 100% or 5 years from the date of the original transfer, given that in principle solvency deficiencies are supposed to be eliminated within 5 years of the valuation date and if the plan is still not solvent 5 years after the transfer, this would be as a result of events occurring after the initial transfer had taken place

While delayed transfers are inconvenient, they are essential to maintain equity between terminating and remaining members. It might also be a further inducement to plan sponsors to try to keep the solvency ratio at least greater than 90% to avoid the administrative complexities of delayed transfers (or additional contributions when employees terminate), particularly keeping tabs on a departed member.

c) Accepting transfers from other plans

Phase II of pension reform will require plans to accept transfer values from other plans, therefore some rules regarding accepting transfers will need to be established, again bearing in mind some of the complexities for defined benefit plans.

If the receiving plan is a defined contribution plan, then the amount simply becomes an initial capital.

If the receiving plan is a defined benefit plan, then it might be possible to retain the defined contribution amount and simply add interest. Alternatively, the plan

sponsor of the receiving plan might wish to turn this into an equivalent amount of credited past service. In the case of final average plans there is the complication that the actuary would have to discount expected future salary increases and so the amount of service might be relatively small compared to the actual service. A further complication arises if the member terminates membership in the subsequent plan before being vested. It would therefore be recommended that the transfer, plus interest, be ring-fenced and that in any case this value should be available to the member on subsequent termination, either to be transferred to another plan or to an approved retirement scheme, but in any case, no cash out would be permitted. Given this approach, the calculation of equivalent service may be of less concern, as the transfer value with interest would be safeguarded. Similarly, non-vested termination would not present a problem.

It is possible that the receiving plan has a solvency ratio of less than 100%. It is recommended that the potential transferring member should be informed of this and the possible consequences, namely potential loss of benefits if the plan should wind-up in an insolvent position. Since the transferring member has options, such as transferring funds into an approved retirement scheme, the member would be transferring into a less than solvent pension plan at his own risk. Also, the ring-fencing of the transferred amount would provide some protection in this event.

5. Conclusions

Phase II of pension reform will provide for legislation that will establish the right of vested pension plan members who terminate employment and leave their employer's pension plan to receive a transfer value and similarly the requirement that plans accept transfers from other plans.

This paper outlines the main issues related to transfer values and recommends approaches for its calculation in defined contribution and defined benefit plans. The application of the approach in defined contribution plans is relatively straightforward. It is more complex for defined benefit plans, where a transfer value formula needs to be established. The paper has suggested certain principles for this calculation, but help should be enlisted from the actuarial profession to fine-tune the basis, which should be equitable to departing and remaining plan members. An issue also arises when a pension plan is not fully solvent, in which case the full transfer might be delayed, or additional funds might need to be contributed to the plan.