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CONTRIBUTED PAPER

The exercise of discretion on commutation factors in defined benefit schemes: time for change?

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Abstract

This paper is motivated by the findings of a review in 2020 by the Institute and Faculty of Actuaries, which found that commutation factors differed widely between schemes, they were typically significantly below transfer value factors, and that in nearly 30% of cases, trustees did not act fully on the actuary's advice. The author suggests that regulation of commutation factors, instead of factors being decided by trustees' discretion, could be a suitable way forward. The focus is commutation factors for UK-defined benefit pension schemes, having regard to the law that governs the discretion available to trustees. Relevant legal principles are explained, including the requirement for trustees' decisions to be made for a proper purpose and to be made with due care and skill, taking into account relevant considerations. These principles are applied to the setting of commutation factors. The author describes four methods trustees may use to assess the actuarial equivalence of the pension being exchanged for cash, which is ordinarily part of the process to set commutation factors. None of the four is entirely satisfactory, although it is suggested that there are some advantages in viewing commutation as a transaction between trustees and members. The possible use of market-consistent factors is one of the topics discussed. Commutation factors can also incorporate guarantee charges and/or deductions for underfunding, although the author explains the argument that the latter should not be commonly applied. The role of employers' and members' expectations is discussed and can explain why commutation factors can reasonably be less than 100% of actuarial equivalence. It is argued that the impact of commutation on employers' contributions can in some circumstances justify adjusting commutation factors. The paper also considers other reasons sometimes put forward for reducing factors: tax, utility and optionality. The author also argues that reviewing commutation factors only every three years sits uneasily with legal principles. Further enquiry is suggested as to the responsibilities in law of actuaries when certifying that factors are reasonable. The author suggests that trust law permits trustees to use their discretion in a way that can produce a wide range of outcomes, which may be regarded as unsatisfactory for determining what may be an important part of a member's reward package, and that a better approach may be for the government to introduce regulations on commutation factors, including a form of disclosure to help inform members' choice on exercising the option.

Keywords: Commutation; defined benefit pension schemes; pension trustees; trust law

1. Introduction

Most members of defined benefit (DB) pension schemes in the UK can choose, at retirement, to commute some of their pension for a cash sum. This option is usually on terms that involve an actuarial calculation. However, there is limited literature on the subject: this paper aims to contribute to an understanding of the issues.

The role of actuaries in connection with commutation is typically as advisers to the trustees of the scheme, who usually have the discretion to choose the commutation factors to apply, i.e. what cash is offered for each £1 p.a. pension given up. However, trustees are constrained by trust law in

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the exercise of that discretion. An objective of this paper is to help actuaries who are advising trustees understand the limits to the discretion that trustees can apply.

The research methodology used is to identify the relevant principles of trust law, in particular how trust law has operated in connection with DB pension schemes; and apply the findings to the member commutation option.

This study is motivated by the findings of the thematic review carried out by the Institute and Faculty of Actuaries (IFoA) on the subject of actuarial factors (commutation factors and transfer values) in pension schemes, issued in December 2020: Gordon (2020). The purpose of the review was to monitor whether actuaries complied with regulations, codes and standards. It (TPR, 2007) did not consider the merits of alternative ways of determining factors and the legal constraints applicable, which this paper addresses. In some schemes, notably many public sector schemes, commutation factors are fixed under the rules, and hence no actuarial calculations or discretion are required; such schemes are outside the remit of this paper. Neither does the paper cover trivial commutation, whether unisex factors can or should be used, commutation factors in some public sector schemes where the discount rate is the SCAPE (Superannuation Contributions Adjusted for Past Experience) rate, factors on ill-health retirement, or reverse commutation factors, when cash emerging from a DB scheme is converted to pension.

Clearly, schemes differ in their trust deeds, rules and other documentation, in their practices, and in the commercial contexts in which they and their sponsoring employers operate. This paper cannot hope to capture all of the diversity that exists, and conclusions are based on a generalised view of typical schemes and their circumstances. Faced with particular schemes and their situations, different conclusions may arise.

The thematic review is discussed in Section 2, which also covers previous actuarial work on this subject. Sections 3, 4 and 5 consider relevant principles of trust law. Section 6 compares possible ways of assessing actuarial equivalence to be used for commutation factors, taking into account trust law while Section 7 goes on to discuss additional considerations. How frequently factors should be reviewed is the subject of Section 8, while Section 9 reviews the role and responsibilities of actuaries. The paper suggests in Section 10 that commutation factors should be the subject of regulation. Section 11 provides overall conclusions.

Legal cases are referred to by brief names in italics and full references are given at the end of the paper. References to judges are J (Justice, High Court), LJ (Lady or Lord Justice, Court of Appeal), MR (Master of the Rolls) and V-C (Vice-Chancellor).

In Mettoy (1990), Warner J agreed that actuaries were not competent to testify on the construction of pension scheme documents. The author's view is that it would be helpful if actuaries and lawyers could enhance their understanding of each other's disciplines and this paper is written with that in mind. It is for educational use and to stimulate discussion and does not purport to give actuarial or legal advice.

2. Actuarial Discussion of Commutation Factors

2.1. The Thematic Review 2020

The report of the IFoA thematic review (Gordon, 2020) included benchmarking commutation factors and transfer values, as provided by 12 organisations. The commutation factors referred to a pension at age 65, increasing at RPI-based indexation up to 5% p.a., and were based on market conditions as at March 2020. The transfer values were on a similar basis, although with a 50% spouse's pension from the date of death. The review covered factors for both females and males.

The median transfer value factor was 29, i.e. £29 per £1 p.a. pension. The spouse's benefit was said to be around 12.5% of the transfer value, implying that the transfer value factor in relation to the member's pension only was around 25–26. In contrast, the median commutation factor was 18. Since both transfer value and commutation involve exchanging pension for cash, a question

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arises: why are transfer values about 40% higher? Further, the range of commutation factors was wide: they might be about 10 or might exceed 30. It should be added that in nearly 30% of cases, the trustees chose a commutation factor different from what the actuary advised, this being especially common where the factor was low. The report recommended further research, and the actuarial profession established a working party to pursue this; its report (Hilsden *et al*., 2023) is referred to in Section 6 et seq.

It is of interest to compare the commutation factors used by the Pension Protection Fund (PPF), which are designed to be actuarially equivalent. The thematic review found a median commutation factor of 18, whereas the corresponding PPF factor at March 2020 was 24.50, albeit with CPI – as opposed to the RPI-based indexation in the thematic review. From 1 October 2023 the PPF factor was 18.43.

The calculation of transfer values is subject to regulations drawn up by the Department of Work and Pensions (DWP), albeit not applicable to transfers near retirement. Transfer values are the discounted value of pension payments, using a best estimate of future mortality, and discounting at the best estimate of the rate of investment returns on the fund. The regulations make provision for paying higher transfer values if appropriate, and for reducing values dependent on the scheme funding. There is, though, no regulation on how commutation factors should be calculated.

Since March 2020, the time when the thematic review data apply, mortality rates and interest rates have increased; comparing commutation factors and transfer values today may well produce somewhat different results.

2.2. Earlier Evidence and Standards

Comments on commutation factors appearing to be lower than might be justified on actuarial grounds have appeared in the past. An article in the *Financial Times* referred to “outdated factors that do not represent the true value of income in order to reduce their [scheme] liabilities” (Harrison, 2004). Later that year, the Actuarial Profession Pensions Board (2004) drew attention to the dramatic fall in annuity rates and commented, “It appears that in many defined benefit schemes there may be a good debate to be had with trustees about the degree to which it is necessary and appropriate to move tax-free cash commutation factors in sympathy with the annuity or gilts markets.” Turvey (2005) wrote that “this brief reference … didn’t go nearly far enough,” complaining that actuaries’ typical practice of using a commutation factor of 12 was wrong. He argued that trustees were not being even-handed between members, the fund and the employer and that the practice was “clearly inequitable and contrary to members’ reasonable expectations.” His view was that commutation factors “should reflect the cost to the scheme of providing the pension given up, allowing for any uncertainties arising from the level of the funding of the scheme, and the covenant of the employer.”

The subject was addressed by the Member Options Working Party (2006). It commented that “there may be an assumption, possibly implicit, that these financial terms relate closely to the cost of replacing the benefit forgone.” In practice, commutation factors produced cash sums much less than a life insurer charged for providing the pension exchanged. Typical factors for a male at 65 where the pension increased with Limited Price Indexation up to 5% p.a. were 10–14, though some schemes had factors at market rates, such as 18 or 22. Some factors had not increased over the previous five years despite the fall in mortality rates and in long-dated interest rates.

The working party made a number of recommendations to the profession’s Pensions Board, which adopted them and circulated them to members (Actuarial Profession, 2007). These included:

- where an actuary has an explicit or implicit obligation to advise on member options, changes in market conditions (e.g. long-dated interest rates and longevity) may make it appropriate

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for the actuary to advise that the terms may be outdated and should be reviewed if not done in the past two to three years
- it may help clarify the actuary's ongoing obligation for terms of engagement to include the terms for reviewing member options and establishing a policy for future reviews.

The profession issued a press release, "Pensioners may be short-changed over cash sum." The Pensions Board also wrote to the DWP and The Pensions Regulator (TPR) to express concern that members taking cash may not have a clear idea of the benefits they are giving up and urged them to consider a risk warning, suggesting that members take financial advice if thinking of commuting a large amount of pension. They also proposed considering disclosure of the cost of replacing the benefit forgone. The Pensions Board met TPR, which expressed interest in general governance and trustee guidance rather than anything specific to cash commutation (Tompkins, 2008).

A later article in the *Financial Times* (Cumbo, 2012) was headed "'Short-changed' over pension lump sums," although those quoted differed in their views. A survey carried out in 2012 showed a third of commutation factors were below 13 and a third above 16; in comparison, the typical annuity value was 18 (Smith, 2013; the specification of the survey was not given).

Greater formality for actuaries came on 1 April 2011, when a Pensions Technical Actuarial Standard was applied to actuarial factors. This included a non-exhaustive list of relevant factors for assumptions, including the financial and economic outlook, and mortality and other demographic projections. Technical Actuarial Standard 300 (Pensions) applied from 1 July 2017: the information the actuary was to provide to trustees was to include the circumstances in which actuarial factors should be reviewed.

The IFoA (2016) issued a "Risk Alert," explaining that falls in mortality rates and yields "have emphasised the importance to trustees, sponsors and particularly members of keeping commutation factors current." The Joint Forum on Actuarial Regulation (2016) found that most reviews of commutation factors were done as part of the valuation cycle. Notable was the finding that some trustees/sponsors were reluctant to increase factors because of affordability concerns. More recently, the Joint Forum on Actuarial Regulation (2020) noted that commutation factors may not operate in members' best interests.

Hence, the actuarial profession has been aware of the need to consider mortality and financial trends and to keep commutation factors current, although without precision on the frequency of reviews, while concerns of employers about higher costs from higher factors are apparent.

3. Legal Principles: Overview

3.1. Legal Principles: Introduction

Trustees of pension schemes are subject to trust law, much of which was developed in the context of a typical trust being a discretionary trust for assets donated by an individual with a view to them being distributed to family members. However, trust law also covers commercial trusts, including pension schemes. In applying trust law, courts will consider the particular circumstances of the trust, such as its size and the relationship between the donor of the assets and the recipients of the benefits. Browne-Wilkinson V-C said in Target Holdings (1996) that commercial trusts remain subject to the basic principles of trust law, although the rationale for special rules developed for traditional trusts may not apply. The presumption remains that the usual trust law rules apply equally to pension schemes, for example as referred to in Mineworkers (1985).

Pollard (2020, 2.14) set out the principles applying to trustees' decisions as:

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(1) trustees must act honestly, i.e. in good faith
(2) trustees must act within the terms of the power: by the specified person, in the specified way at the specified time (a "power" refers to the ability to alter legal relations between parties: Law Commission, 2014, 3.14)
(3) must be done for a proper purpose
(4) there must be no unauthorised conflict: the trustees are fiduciaries
(5) the trustees must act with due care and skill: with due consideration; considering the reasonably discoverable and relevant factors; and not be perverse, capricious or fully irrational (the "no reasonable decision-maker" rule).

Items (3) and (5) are of particular importance for commutation factors and are discussed in more detail in Sections 4 and 5, respectively. Items (1), (2) and (4) are reviewed below, although the subject of "the specified time" is particularly important and is discussed in Section 8.

3.2. Good Faith

The good faith requirement for trustees is clear from case law. For example, Robert Walker J stated in National Trust (1998) (not a pensions case): "Trustees must act in good faith, responsibly and reasonably." This does not define trustees' responsibilities precisely because the term 'good faith' can be used in different ways; Pollard (2020, 3.9) used it in its subjective limited meaning of honesty.

Courts have recognised the special nature of employment contracts. In Imperial Group (1991) Browne-Wilkinson V-C referred to the comment in Woods (1981) that, in every contract of employment there is an implied term: "that the employers will not, without reasonable and proper cause, conduct themselves in a manner calculated or likely to destroy or seriously damage the relationship of confidence and trust between employer and employee." He referred to this implied term as "the implied obligation of good faith." He continued, "In my judgment, that obligation of an employer applies as much to the exercise of his rights and powers under a pension scheme as they do to the other rights and powers of an employer." This is known as the "Imperial duty of good faith."

Although Imperial Group (1991) referred to a decision of an employer, it is reasonable to think that the courts would apply the same principle to trustees acting in relation to a pension scheme. Three such cases can be referenced: in British Airways (2018) Patten LJ referred to the need for trustees to act in good faith; in Edge (2000), the Pensions Ombudsman's comment that the trustees had a duty to exercise a discretion fairly and honestly was noted; and in Mineworkers (1985), Sir Robert Megarry V-C said, "Powers must be exercised fairly and honestly."

While it is unusual to find a lack of good faith in pension cases, it can happen. Knox J considered the Imperial Group (1991) case in Hillsdown (1991), where the employer threatened to add new categories of employee while not paying employers' contributions; the judge regarded this as intrinsically a breach of the implied obligation of good faith.

3.3. The Decision by the Specified Person

The trust deed and/or rules specify where responsibility for commutation factors lies. Gordon's (2020) finding from the thematic review was that responsibility usually lay with the trustees, this being so in 95% of cases, though other parties had a role to play:

- normally having received actuarial advice, 41%
- but certified as reasonable by the actuary, 37% (in some cases, "confirm" or "consider" was used instead of "certify")
- subject to the sponsoring employer's agreement, 10%
- subject to the sponsoring employer's agreement and certified as reasonable by the actuary, 5%
- subject to the actuary's agreement, 2%.

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The actuary had responsibility in 3% of cases; the sponsor in 2%, though with the actuary certifying the factors as reasonable.

In Fisons (1992), responsibility for determining a bulk transfer value to an associated scheme was with the trustees, as advised by the actuary. This was interpreted in the lower court as the value was to be determined by the actuary and not a matter over which the trustees had any discretion. However, when the case went to the Court of Appeal Dillon LJ held that the trustees did not have to act blindly on whatever advice the actuary may give: "While, therefore, from the very nature of the problems involved they will necessarily be guided by the views of the actuaries . . . they will still in each case need to feel satisfied that the amount to be transferred is fair each way."

3.4. Trustees Acting at the Specified Time

Trustees must act within the terms of their power, in relation to commutation factors, at the proper time. Pollard (2020, 81.1) questions, in relation to commutation, "Why is there not an obligation on trustees to set rates only at the right time (i.e. when requested)?" This suggests, he concluded, that the right time to decide is when rates are requested (it may be more appropriate to say that it is when the trustees provide them).

Fisons (1992) involved a bulk transfer value, where the calculation had been done in March 1982 when a sale agreement for the business had been entered into, some months before the actual transfer. In the intervening period, share prices increased significantly. Dillon LJ's conclusion was, "In the upshot, in my judgment, it might materially have affected the trustees' decision in December 1982, if they had been properly informed as to the then current value of the fund and the implications of its value." In other words, a material change in conditions between the calculation date and the date of the decision could not be ignored.

One potential issue is "fetters." In Swales (1984) Nicholls J, as he then was, said, "It is trite law that trustees cannot fetter the exercise by them at a future date of a discretion possessed by them as trustees." If the trustees' decision has effectively been made at an earlier date owing to some fetter, that means they are not exercising their powers at the right time and considering all the relevant facts, as the relevant facts may change before the "right" time. Hence, we do not need to add to the principles in Section 3.1. Indeed, case law has established that some arrangements that might be regarded as fetters are permissible, notably if they are in the interests of the trust (Pollard, 2014).

As many pension schemes are large, trustees delegate decisions and establish policies rather than try to run the scheme on a day-to-day basis (Pollard, 2014). In the Entrust (2012a) judgement, Henderson J held that the trustees were entitled to have a general policy on applying surplus so that a decision was made on the benefits for a member leaving service at the time of leaving service rather than when he drew benefits. In the later Entrust (2012b) judgement, the same judge clarified that the trustee can lay down a policy to be followed for the future, subject to future review. It should never purport to bind itself to exercise the discretion in the future, although the policy could remain in force indefinitely "provided that the funding position of the scheme remained strong enough to justify its continued application and there were no other material changes of circumstance."

Therefore, the important duty is to make the decision at the right time, taking into account the then relevant considerations. The implications for the frequency of reviews of commutation factors are considered in Section 8.

3.5. No Unauthorised Conflict

Briefly, fiduciaries are acting for others and not for themselves. In a non-pensions case, Bristol and West Building Society (1998), Millett LJ said that "A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence." In BT (2018), a pensions case, Zacaroli J described a fiduciary power as a case where "the power must be exercised for the benefit, and in the interests,

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of the beneficiaries as a whole." In Edge (2000) Sir Richard Scott V-C and, later, Chadwick LJ in the Court of Appeal rejected criticism arising from trustees benefitting from decisions they made. The nature of pension schemes is such that the fiduciary requirement does not mean trustees cannot pay contributions and receive benefits like other members.

4. The Proper Purpose Requirement

4.1. Purpose of the Pension Scheme

The proper purpose requirement limits trustees' discretion. Millett J in Courage (1987) held, "it is trite law that a power can be exercised only for the purpose for which it is conferred and not for any extraneous or ulterior purpose."

First, consider the purpose of a scheme itself. For a general guide, we can turn to the Pension Schemes Act 1993, which defines the purpose of a scheme as providing benefits to or in respect of people with service in employments of a description and possibly other people. Pollard (2020, 14.15 & 24.2) made the point that the relevant scheme documentation must be construed to give an idea of its purpose and suggested the following as a generalisation for DB schemes: "to provide the stated and accrued relevant benefits to (and in respect of) the members at a cost acceptable to the employer." Although some may prefer to include future as well as accrued benefits, that is contentious; and he explained the reference to acceptable cost:

"This allows room for the employer to agree an action that may incur extra cost – e.g. a benefit increase or a change in investments from 'risky' equities to 'less risky' bonds. Margaret Stone J (extra judicially) commented that the intentions underlying the creation of the trust fund 'may also include (from the employer's perspective) minimising the cost of the scheme'."

As a scheme is established by an employer, its reasons for doing so could form part of the purpose, even if not set out in the rules. This may suggest the purpose is "to provide the benefits that the employer wishes to provide in a cost-effective way as part of the reward package for employees" (Cox, 2008). The rules may reflect this by defining the benefits in accordance with the employer's wishes, or by requiring the employer to consent to various matters.

Nevertheless, the accrued benefits provided must not be less than the benefits defined by the scheme rules and the law even if the employer wishes otherwise. Hence, part of the scheme's purpose is to provide the stated and accrued benefits. It is right to be cost-effective in providing those benefits and some may add this to the scheme purpose, although the cost issue is perhaps more about how the scheme purpose is met rather than what the purpose is. While trustees will exercise their discretion with reference to employers' interests, they will not be dictated by them. The purpose of the scheme will be progressed if accrual of benefits continues, but this is subject to the wishes of the employer, who will take into account whether the costs are acceptable.

I therefore suggest that the scheme's purpose can be expressed as to provide the stated and accrued benefits and to continue to provide benefits in accordance with the employer's wishes.

That this may not sometimes fit the rules of a particular scheme is exemplified by the High Court decision in BBC (2023) that members also have a right to future service benefits where that is within the scope of what the rules refer to as "members' interests." That case may be appealed.

Chadwick LJ, in Edge (2000), confirmed that it was the duty of pension trustees "to exercise their discretion for its proper purpose." In some cases, "proper purpose" has not been followed. In Courage (1987), Millett J decided that it was contrary to the purpose of the scheme to change the principal employer, enabling the surplus to be allocated to the new principal employer instead of the surplus remaining in the scheme. In British Airways (2018), the trustees amended the scheme rules to give themselves discretion on pension increases. They then planned to give an extra amount above the increase in CPI. The employer complained and the case was decided in its favour. The Court of Appeal took the view that the trustees had moved away from their role, as

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explained in the scheme rules, of administering the scheme, to deciding, without employer consent, the benefit structure.

4.2. The Beneficiaries and the Role of the Employer

The Pensions Regulator's (2007) guidance on the role of trustees includes, "You must act in the interests of the beneficiaries . . . A beneficiary is anyone who is entitled to, or who might receive, a benefit from the scheme, now or in the future."

In some cases, express provision is made for the employer to be a beneficiary, for example, where the rules allow it to receive payment of a surplus. In other cases, the position is less clear; Pollard's (2006) view was that the employer should be considered a "quasi-beneficiary." The main point, though, is that case law makes it clear that trustees must consider employers' interests.

In Edge (2000), Chadwick LJ concluded that trustees "must, for example, always have in mind the main purpose of the scheme – to provide retirement and other benefits for employees of the participating employers. They must consider the effect that any course they consider taking will have on the financial ability of the employers to make the contributions that course of action will entail. They must be careful not to impose burdens that imperil the continuity and proper development of the employers' business or the employment of the members who work in that business. The main purpose of the scheme is not served by putting an employer out of business."

This was consistent with Sir Richard Scott V-C who, in the case prior to the appeal, said, "It seems to me obvious that the continued viability of the respective employers was something that, in the interests of the pension scheme and its members as a whole, the trustees were entitled to want to promote. Otherwise, if one or more of the employers went into decline or collapsed, the financial projections, on the basis of which the actuarial calculations had been made, would become invalidated." Hence, it is relevant to consider the amount that an employer must contribute.

Asplin J agreed in Merchant Navy Ratings (2015) that it was perfectly legitimate to consider the interests of the employers, and their ability to make contributions and, as in Edge (2000), the continued viability of the employers was something the trustees were entitled to promote. She agreed that it would be incorrect to say that the interests of the employer are only relevant insofar as they benefit members. An example is the court approving plans for the employer to reduce contributions after a surplus: National Grid (2001). Further, Nugee (2015) noted that while some cases had confirmed that it was right for trustees to consider the employer when allocating surplus, "it would be bizarre if they were under no such requirement when considering how to deal with deficits, where the impact on the employer's contribution liability is that much more direct."

It is important not to downplay the importance of members' accrued rights. In Mettoy (1990), Warner J emphasised that members' benefits were earned by their service and that their rights were derived from their contract of employment as well as the trust instrument. In Stevens (2002) Arden LJ held that "members of a scheme are not volunteers: the benefits which they receive under the scheme are part of the remuneration for their services and this is so whether the scheme is contributory or non-contributory. This means that they are in a different position in some respects from beneficiaries of a private trust." Nugee (2015) wrote that while trustees owe a duty to employers in the exercise of their investment powers, this would not justify trustees in using those powers to benefit the employer at the expense of the members. In Thales (2017), Warren J said that "it would require exceptional circumstance for [the trustees] to adopt an alternative index, such as CPI, in order to reduce the costs to the company if, in so doing (as in current circumstances would be the case), they would be acting to the detriment of the beneficiaries of the scheme."

The actuary's role was referred to in Stevens (2002), a case dealing with a surplus, some of which could be returned to the employer. Arden LJ held that the actuary was to be "fair and reasonable having regard to the interests of all concerned: members, pensioners and others, such as dependants, as well as the Employer."

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Balancing conflicting interests is important. In British Airways (2018) Morgan J held that, "I accept that the trustees had to take account of the interests of BA and of the members and pensioners of the [Airways Pension Scheme]. Insofar as those interests conflicted, the trustees had to try to hold the balance between them in a fair way." The judges in the appeal on this case also drew attention to the need to balance the interests of the employer against those of current and former employees.

4.3. "Best Interests of Beneficiaries" or "Furthering the Purposes of the Scheme"?

A controversial case was Mineworkers (1985), where five union trustees refused to accept the fund investment plan unless it was amended to align with union policy, which would prohibit investment overseas or in oil or gas. Sir Robert Megarry V-C stated that,

> "I turn to the law. The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount . . . When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests."

However, Pollard (2018a, 2018b) regarded a duty to base decisions on "beneficiaries' best interests" as dangerous, imprecise, and unworkable. For example, it would literally impose a retrospective best outcome standard. In a pension scheme, it could mean requiring increased funding to improve members' security; or using surplus to increase members' benefits to the maximum permitted before any could be returned to the employer.

Case law demonstrates that there can be a conflict between "best interests" and the purpose of the trust. In Eclairs (2015), which is not a pensions case, the directors' actions, while intended to benefit shareholders when corporate raiders appeared, were inconsistent with the requirement under the Companies Act 2006 that a director may only exercise powers for the purposes for which they were conferred, this being similar to the exercise of discretionary powers by trustees.

In a pensions case, ITS (2009), the trustees used assets to enhance some members' benefits in a way that was in members' best interests, with no member being worse off when the scheme then entered the PPF. Henderson J held that it was more important to avoid undue cost to the PPF than the trustees striving to take actions to preserve the beneficiaries' best interests; the proposed enhancements would be invalid as being made for an improper purpose. This confirms that the "best interests" purpose is not an overriding duty: the "proper purpose test" has to be satisfied.

In Hillsdown (1991) the employer bought a company that had a scheme with a significant surplus, planning to merge it with its own scheme. The trustees negotiated an improvement in benefits in exchange for agreeing to a merger of the schemes. The trustees were held to have acted for an improper purpose when, in the absence of any power to return surplus to the employer, they intended to transfer funds to another scheme to enable the return of capital to be made. Members' best interests were secondary to the proper purpose requirement.

Asplin J in Merchant Navy Ratings (2015) held that the best interests duty is not a paramount stand-alone duty; at best, it is merely a shorthand covering a variety of duties owed by trustees; it is part and parcel of the proper purpose principle. She went on to agree with the view of Lord Nicholls that, "to define the trustee's obligation in terms of acting in the best interests of the beneficiaries is to do nothing more than formulate in different words a trustee's obligation to promote the purpose for which the trust was created." In Lonrho (2003), Patten J held that trustees were required to exercise their powers "so as to further the purposes of the Scheme as a whole, thereby bringing into consideration the legitimate interests and expectations of employee and employer alike."

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Pollard (2018a) concluded that pension trustees' duty does not relate to the interests of the beneficiaries but instead to the success of the trust or plan. They are not obliged, for example, to seek to maximise benefits or funding; instead, their duty is to seek to pay the envisaged or correct benefits. I would add that the purposes of the scheme are furthered by continuing the accrual of benefits, assuming this is in accordance with the employer's wishes and hence at acceptable cost.

Sir Robert Megarry V-C's "best interests" formulation would not be emphasised by a court today. I suggest it is now more appropriate to express trustees' duties via phrases such as furthering or promoting the purposes or success of the trust or scheme (Pollard, 2018b).

4.4. Purpose of a Commutation Rule

I suggest it is reasonable to think of the purpose of the commutation option as enabling members to exchange some pension for cash. The purpose of discretion is to allow trustees to take into account, in determining the terms of the exchange, relevant matters such as demographic and financial conditions, and the interests of employer and members.

5. With Due Care and Skill: Legal Principles

There are two parts to the requirement for trustees to use due care and skill in exercising their discretion: both the process the trustees use and the outcome can be subjected to legal scrutiny.

The "process" requirement is that trustees use due consideration and consider the reasonably discoverable and relevant factors (Pollard, 2020, 2.14). Studer (2016) wrote, "the duty of proper consideration requires the trustees to ask themselves, and to consider, the right questions, and their accompanying duties to inquire and to ascertain require them to furnish themselves with the right information to enable them to do so." The "outcome" requirement is that the decision must not be perverse, capricious, or fully irrational, failing the "no reasonable decision-maker" test (Pollard 2020, 2.14).

To start with a non-pensions case, Robert Walker J, in National Trust (1998), held that trustees must inform themselves of the matters relevant to the decision. That may involve taking appropriate advice from experts; he gave actuaries as an example.

It is useful to quote from another non-pensions case, Wednesbury (1948), which has formed the basis of many subsequent judgments, including pensions cases. It involved a public authority, the Wednesbury local council, when deciding whether to prohibit children under 15 from visiting a cinema on Sundays. Lord Greene MR held that the local authority had to act reasonably, but went on to explain what that implied (the two parts – or limbs – have been identified for clarity):

"The court is entitled to investigate the action of the local authority with a view to seeing whether they have taken into account matters which they ought not to take into account, or, conversely, have refused to take into account or neglected to take into account matters which they ought to take into account [the first limb]. Once that question is answered in favour of the local authority, it may be still possible to say that, although the local authority has kept within the four corners of the matters which they ought to consider, they have nevertheless come to a conclusion so unreasonable that no reasonable authority could ever have come to it [second limb]. In such a case, again, I think the court can interfere."[1]

In other words, decisions must, first, be based on all relevant and not irrelevant considerations; and second, not be so unreasonable that no reasonable decision-taker would have come to the decision.

[1]The court was deciding whether the local authority's actions were reasonable rather than whether it agreed that the condition regarding children was correct. In a previous and similar case it was held that it was relevant to consider matters relating to the welfare, including the spiritual well-being, of the community and any section of it, and that a restriction on children attending a cinema on a Sunday related to the interest of a section of the community. In *Wednesbury* no specific regulation prohibited the authority from using discretion about imposing conditions for children, and the meaning of reasonableness in the actions of the authority was developed.

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The second limb is sometimes referred to in the context that the decision was arbitrary, perverse, capricious or irrational, and it may be regarded as a high threshold (Pollard, 2020, 52.1, 52.7).

Public law cases have often been referenced in private law, and Wednesbury (1948), in both its limbs, has been applied in several pensions cases. In Edge (2000), for example, Chadwick LJ held that trustees were obliged to exercise the power for the purpose for which it is given, "giving proper consideration to the matters which are relevant and excluding from consideration matters which are irrelevant," this being the first limb of *Wednesbury*. He then referred to the second limb, quoting an earlier decision that trustees "must not arrive at a perverse decision, i.e., a decision at which no reasonable body of trustees could arrive."

Also relevant is a 2015 Supreme Court ruling: Braganza (2015). The court examined a decision by an employer as to whether an employee committed suicide (which affected the payment to be made to his widow). Hodge LJ said, "I think that it is difficult to treat as rational the product of a process of reasoning if that process is flawed by the taking into consideration of an irrelevant matter or the failure to consider a relevant matter." He continued, "While the courts have not as yet spoken with one voice, I agree that, in reviewing at least some contractual discretionary decisions, the court should address both limbs [of Wednesbury (1948)]." Braganza (2015) has subsequently been applied in many commercial cases. In IBM (2017), concerning employer powers in a pension scheme, the Court of Appeal made several references to this case. The focus was the second limb, the decision being that the irrationality test from Braganza (2015) and Wednesbury (1948) should apply to non-fiduciary decision makers under a pension scheme. Pollard (2020, 44.1) considered trustees, concluding that the *Braganza* tests almost certainly apply to discretions of a trustee or employer under a pension scheme.

It has also been said that trustees have to be impartial, fair and exercise a duty of care, although these points can be regarded as within the principles of 3.1.

For example, Sir Robert Megarry V-C said in Mineworkers (1985): the trustees are "holding the scales impartially between different classes of beneficiaries." Pollard (2016) wrote, "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 also between individuals within those classes."

Impartiality may not be a distinct requirement. In Edge (2000), Chadwick LJ held, "properly understood, the so-called duty to act impartially is no more than the ordinary duty which the law imposes on a person who is entrusted with the exercise of a discretionary power: that he exercises the power for the purpose for which it is given, giving proper consideration to the matters which are relevant and excluding from consideration matters which are irrelevant. If pension trustees do that, they cannot be criticised if they reach a decision which appears to prefer the claims of one interest over others. The preference will be the result of a proper exercise of the discretionary power."

Fairness was highlighted by Buckley J. In Newnes (1972), he held that the role of the actuary is to achieve the greatest practical degree of fairness between various persons interested under the scheme consistent with the rules. This was accepted "entirely" by Walton J in Imperial Foods (1986), when considering a bulk transfer for a subsidiary. Other examples are Megarry V-C in Mineworkers (1985): "powers must be exercised fairly" and Patten J in Lonrho (2003): "[trustees] have to take a balanced approach and to act honestly and fairly." Fairness is not a principle that is additional to those in 3.1 which, if followed, are expected to lead to a fair outcome. But fairness could well be prejudiced if, for example, trustees use irrelevant rather than relevant considerations.

A "duty of care" is defined in the Trustee Act 2000 and Pollard (2020, 47.12) referred to it as a relevant factor for trustees to consider.

There may be many relevant considerations, and they may lead in different directions. The trustees have discretion to decide the weight to be given to each consideration, subject to the decision not failing the "no reasonable decision-taker" limb of Wednesbury (1948): Pollard (2020, 50.1). This is backed up by Chadwick LJ who said, in Edge (2000), that if considerations were relevant, then it was up to the trustees to decide what weight to be given to them. Later, he

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concluded that "the essential requirement is that the trustees address themselves to the question of what is fair and equitable in all the circumstances. The weight to be given to one factor as against another is for them." Similarly, in IBM (2017), the question of whether there had been a significant change in financial and economic circumstances was a matter for the decision-taker rather than an objective question for the court to decide.

This means that trust law permits a wide range of decisions: what if the interests of the employer are given much more weight than those of employees, or vice versa? Both outcomes could be reasonable in the *Wednesbury* test, but perhaps not fair in some other sense? Some trustees may say that transfer value regulations are very relevant in determining commutation factors, but other trustees may decide to give this a lesser weight. The inconsistencies that can arise can cause concern. Some of the difficulties in deciding on and giving weight to different relevant considerations will be apparent in this paper.

6. Actuarial Equivalence Calculations

6.1. Actuarial Considerations: Introduction

The legal principles detailed can be applied to the issue of commutation factors. It is assumed that the scheme rules require an actuary to be involved. Cox (2007) has written, "Any reference to the actuary's involvement in the matter indicates that the starting point for determining commutation factors should be the actuarial value of the pension that is being commuted"; Pollard (2020, 32.2) made a similar comment. Cox added that "this would be implicit even if the actuary were not mentioned." In Firefighters (2015), the scheme rules specified, in 2015, that the cash sum available would be the actuarial equivalent of the commuted pension (a phrase open to different interpretations); schemes are usually not so specific.

I agree that the reference to an actuary means that some actuarial value is relevant (among other matters). I suggest that this implies that commutation factors will reflect, inter alia, demographic and financial conditions, since these are fields where actuaries have expertise.

Since demographic and financial conditions can change, I suggest another implication of the scheme rules stating that an actuary is to be involved is that the commutation option factors can and indeed should (subject to other relevant considerations) change, depending on changes in those conditions. Otherwise, the actuary is redundant. Indeed, the Member Options Working Party (2006) expressed concern that some valuations assumed that current commutation factors would continue for all time, which it said may be questionable if they have not yet been adjusted to take account of (then) lower interest rates and higher longevity expectations, suggesting that changing actuarial considerations was important.

I believe this is equivalent to saying that to meet the scheme purpose, which means providing the stated benefits, the scheme has, in effect, to provide a commutation option with factors that change with demographic and financial conditions, subject to other relevant considerations. Although the change may (or may not) mean higher costs for the employer, this is different from a specific new benefit increase such as that proposed by trustees in British Airways (2018), where the courts accepted that the impact on employer costs was a reason for not agreeing to the proposal.

So, part of the member's reward package from the employer can change. This is not a unique position as it is also true of share options, both for executives and as part of a savings scheme for employees. While we have become accustomed to both mortality rates and interest rates declining (at least until 2020 and autumn 2022 respectively), with commutation factors increasing, that isn't always the case: note that the PPF's factors reduced in 2006, 2009, 2018, 2021 and 2023.

Commutation factors that can change bring uncertainty for employers and scheme members. Perhaps they would prefer rules that didn't involve discretion and specified a fixed commutation factor (or set of fixed age-dependent factors). But when factors are not fixed, one element of the

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exercise of discretion is to recognise the need to manage the process whereby factors are changed (see Section 8).

Several forms of actuarial calculation of the value of the pension being commuted are reviewed, which are termed “actuarial equivalence.” Four are focused on: buy-out costs (6.2), the transfer value basis (6.3), a technical provisions basis (6.4) and a transaction approach (6.5). Other possibilities are commented on in 6.6. It is considered whether the mortality, financial and expense assumptions and discount rate used by each method are relevant for the commutation process and hence the extent to which each method is a “relevant consideration.” The methods are subject to a possible addition for a guarantee charge (6.7) and/or deduction for “asset insufficiency” (6.8).

6.2. Buy-out Costs

The Member Options Working Party (2006) and the 2012 survey reported by Smith (2013) compared commutation factors with the annuity buy-out cost. Would trustees regard that as a relevant consideration when choosing commutation factors?

The purpose of the commutation option is to exchange pension for cash. The buy-out cost is concerned with exchanging the pension for an annuity from a life insurer. These are different. In particular, the annuity buy-out cost includes the insurer’s profit margin, reflecting, inter alia, the risks it is bearing, especially mortality and investment risks that cannot be matched. But those risks do not apply to the cash for which the pension is exchanged under commutation.

The insurer’s profit margin can also reflect the competitiveness of the annuity market, insurers’ pricing strategies and regulatory requirements (such as the introduction in 2013 of Solvency II, the regulatory regime for insurers). The annuity buy-out cost also includes the insurer’s expenses in acquiring the business and paying the pension, both irrelevant for commutation.

The Pensions Ombudsman ruled in Babcock (2014) that a trustee would not be expected to continually adjust a commutation factor to match an insurer’s annuity rate, “which is based on the insurer’s circumstances (e.g. the type of market the insurer wishes to be in, economies of scale etc.).”

Hilsden *et al.* (2023) considered the buy-out cost from an insurer but were concerned that using this would cause a funding strain and reduce the security of remaining benefits. That issue could be viewed as less concerning: the implications for funding strain should not usually affect members’ commutation benefits (see 6.5).

A practical problem is that there is no unique market buy-out cost. Insurers make different pricing decisions. Further, since the working party reported in 2006 insurers have developed individual underwriting for annuities, taking into account where retirees live, their health, etc. Trustees may not have the right to use individual underwriting but, if they did, better-paid pensioners would receive more cash (per £1 p.a. pension) than others. That is likely to lead to complaints of unfairness, contrary to pension scheme philosophy and practice, and to members’ expectations. If trustees do not use individual underwriting, they could use a buy-out cost that reflects the residence, health and other attributes of typical retirees, but that adds to operational costs.

Trustees may say that buy-out cost is a relevant consideration since it is known that annuity prices reflect mortality rates and long-term interest rates (Cannon & Tonks, 2008) and these are matters affecting the value of a pension. Further, the price of an annuity may be something that retiring members are familiar with and might expect to be used. However, this paper maintains that buy-out costs are unsatisfactory for commutation factors, because of the margins included and as better alternatives are available; and, at best, are relevant only if adjusted.

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6.3. Transfer Value Basis

Are the regulations on transfer values a relevant consideration for trustees deciding commutation factors? Although they do not apply to transfers within a year of normal pension age, they do reflect an actuarial calculation to exchange pension for cash.

The transfer value calculation is based on the best estimate of what is needed, if invested by the scheme, to be just sufficient to provide the benefits forgone. TPR (2008) refers to trustees being pragmatic and reasonable since "best estimate" is not a precise concept. Trustees may also use an approach that gives higher values (which is not pursued here); and the value may be reduced for underfunding (see Section 6.8).

Further, "trustees must have regard to their investment strategy when choosing assumptions. This includes the appropriate investment returns to be expected" (TPR, 2008), leading to using expected returns on the fund as the discount rate (the "expected cost" approach). Honour (2019) found that most respondents in a survey thought that transfer values should be based on an expected cost approach.

The transfer value regulations may have an influence in other ways. Many schemes use transfer values if a member is requesting a trivial commutation sum since they could otherwise transfer to a personal pension and then take cash. Or some members seeking early retirement may be able to access a transfer value calculated in accordance with the regulations, which could act as a benchmark for converting pension to cash in commutation.

Hilsden *et al.* (2023)'s view was that commutation rates should be reviewed in the context of providing fair value for members, and the theoretical starting point for a commutation factor should be to calculate it in line with the scheme's transfer value basis. The rationale for this is:

- the working party could not see a good argument for anything other than broadly best estimate of the cost of the scheme providing the benefit
- it is reasonable to assume that members would typically expect to receive fair value for the pension given up, and using transfer values will ensure this
- equating transfer values and commutation factors provides consistency, given that both are methods of converting a defined benefit pension into a capital lump sum, and they may both be offered as concurrent and comparable options when a member reaches retirement.

I believe it is reasonable if trustees regard transfer values as a relevant consideration.

The thematic review did find that many actuaries considered the link to investment strategy when advising on commutation factors, suggesting that they may have used discounting at the estimated return on the fund, consistent with the transfer value approach.

Although the working party referred to members expecting to receive fair value, it did not explain what they meant by this. It could refer to the term used in accounting, although transfer values are not fair value in that sense as they depend on the composition of the assets held. Another possibility is the sense used by the Financial Conduct Authority for products under their jurisdiction, indicating that a product provides fair value where the amount paid for the product is reasonable relative to the benefits it provides. However, this is imprecise, and it is not clear why this should lead to using transfer values. Indeed, while the authors said that, "The theoretical starting point for a commutation rate should be to calculate it in line with the scheme's cash equivalent transfer value ("CETV") basis," if the theory underlying this is that it should be the best estimate cost to the scheme of the pension given up, this paper proposes that the theory should not go unchallenged.

I suggest that trustees thinking of using the transfer value approach for commutation factors may be concerned about using a discount rate that depends on the scheme's investments. One issue is that there is scope for significantly different views on the estimated return on investments. More fundamentally, though, members may be unhappy if trustees take increased investment

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risks and their cash sums reduce. Further, and of greater relevance, employers may have concerns that de-risking increases commutation factors and, therefore, the contributions required. Indeed, why should members' benefits depend on the investment choices of the trustees, which may reflect a variety of considerations? Cox (2007) commented that a change in investment strategy should not affect the commutation benefits. Indeed, consider an unfunded scheme. A member's commutation rights need to be valued but you can't use the expected return on the fund assets as there aren't any.

Indeed, the question of what discount rate to use for transfer values has been debated, and the Actuarial Profession, in its "Response to DWP consultation document: Approaches to the calculation of transfer values" (2006) said that, rather than the expected cost to the scheme of providing the benefits (discounting at the expected rate of return on the fund), "the better actuarial view" was to consider "value to the member" (discounting at bond yields). An explanation of why this is can be found in Cowling *et al.*'s (2012) paper, which concluded that a transfer was a transaction between scheme and member that should be completed using market-consistent terms. This, they argued, required a "matching framework" where the discount rate was the return on the assets that matched the benefits being given up, regarded as gilts, independent of the assets actually held by the scheme.

Implementing the view of the Actuarial Profession in its 2006 response to the consultation would have led to increases in transfer values compared with the previous practice of using the expected cost (as in regulations then set by the profession). The concerns raised led to regulation of transfer values being taken over by the government. In deciding what to do, the government's objectives were: to be fair to transferring and other scheme members and to scheme sponsors; to not weaken or impact the scheme funding position; and to be broadly neutral in their impact on transfer values across all schemes (DWP, 2008).

Given these objectives, it is not surprising that the government decided (DWP, 2008) that it could not accept the profession's proposal, as this would increase transfer values, be inconsistent with the funding arrangements, and lead to higher costs for business and the taxpayer (there were also concerns about a complex approach to the employer covenant). Hence, existing practice was largely retained, typically involving a discount rate where equity yields played a significant part.

Hence, the transfer value regulations largely reflect a desire to keep to the regulations previously set by the actuarial profession even if it was not, in 2006, recognised as "the better actuarial view."

The issue with commutation factors is that they are not regulated, and a variety of practices pertains. I suggest that the rationale for the current transfer value regulations does not give guidance on what is most appropriate for commutation factors.

It is understandable if trustees regard the transfer value basis as a relevant consideration. It is laid down in regulation for converting pensions into cash; and trustees may not want a commutation basis that gives different results. This may be especially true if a member is commuting for a trivial lump sum or taking early retirement benefits. However, this paper takes the view that using the transfer value basis gives rise to some unsatisfactory consequences because it uses a discount rate that depends on the composition of the scheme's assets.

6.4. Technical Provisions Basis

Could trustees use, or regard as a relevant consideration for commutation factors, the assumptions underlying the technical provisions in the regular valuation for trustees? This may be thought suitable as paying a cash sum derived from the assumptions underlying the technical provisions would leave unchanged the surplus or deficit (calculated using technical provisions).

Technical provisions have to be calculated prudently, and prudent margins will inflate technical provisions. It would seem unfair to inflate commutation factors as a result (similar to why technical provisions are not used for transfer values). Further, the discount rate chosen is usually a prudent estimate of the expected return on the scheme assets, which is a concern to those who

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believe that commutation factors should use a rate independent of the scheme assets (see 6.3). Another issue is that the discount rate may be chosen to smooth the funding ratio or the contributions payable by the employer; and is subject to change as regulations change. It may not, therefore, be appropriate for the separate purpose of determining member benefits on commutation.

I can understand trustees regarding the technical provisions basis as a relevant consideration: they may wish to take into account the implications of the commutation factors chosen for the technical provisions and hence the funding ratio, even if it is regarded as an imperfect reflection of the strength of the scheme. Nevertheless, I conclude that the technical provisions basis is unsatisfactory for commutation factors.

6.5. A Transaction Approach

Commutation is a transaction between the scheme and the member. It is a take-it-or-leave-it transaction, with the member having limited information with which to judge whether the terms are fair. The transaction approach suggested here instead asks what the price is at which that transaction would take place if carried out in an orderly way between willing parties, without either party having material advantages in terms of information or market power. This looks to avoid what might be described as unfairness or artificiality arising from the trustees or employer having greater information and/or market power than members. I believe that this is consistent with the need for fairness that the legal principles require.

In seeking such a price, I draw on Cowling *et al.* (2012), whose view was that where an actuarial calculation relates to a transaction (commutation being an example), the outcome should be market-consistent value, which is the price that would be determined in an orderly market. It uses a discount rate that is the yield on the assets that match the liability. This was the case whether the fund held those assets or not; the authors' view was that such assets are gilts. Such a method can be applied to unfunded as well as funded schemes.

This is the "value to the member" approach as in the discussion on transfer values (Section 6.3) where it was accepted as "the better actuarial view." I believe that is the case here too. The member is giving up some pension and we should assess what the value is to the member of what is being given up. The expected cost to the scheme, discounting at the return on fund assets is a different matter, depending on the investment strategy that trustees decide in conjunction with the employer.

Cowling *et al.* (2012) felt that using market-consistent value was particularly important in transactions where objectivity and fairness between the parties was paramount. I believe that is the case here: it is a relevant consideration for trustees as it reflects the requirements for fairness and for the decision to be based on demographic and financial conditions at the relevant time. This is, however, subject to concerns about practicality.

I suggest the mortality rates appropriate for this basis are the rates that are expected to apply, taking into account future changes. I believe this is best expressed as probability-weighted means, which is an accepted practice under accounting standards (International Accounting Standards Board, 2018, 6.93(a)) and preferable to a "best estimate" which, while consistent with accounting standard IAS 19, lacks clarity (mode, median or mean?). I would not expect trustees to attempt to consider mortality using individual underwriting (see Section 6.2).

To be impartial, what is relevant is the mortality of members who commute, who may have a lower life expectancy than other members, justifying lower commutation factors than otherwise. There is, at present, no specific evidence on this, and the fact that most members do commute suggests that any selection effect is quite modest. Hilsden *et al.* (2023) warned of the dangers of using some implicit assumption about selection not informed by evidence.

Turning to financial assumptions, commutation factors will reflect both inflation in the pension being exchanged and discount rates ("discount rate" is used as shorthand for a series of discount rates by term).

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What would the courts expect trustees to do? In Mettoy (1990), Warner J held that, "It was common ground that the relevant background facts or surrounding circumstances included common practice from time to time in the field of pension schemes, as evinced in particular by the evidence of the actuaries and by textbooks written by practitioners in the field."

The following actuarial papers suggest that bond yields provide the appropriate discount rate for commutation:

- Cowling *et al.* (2012) recommended a discount rate that is the return on assets matching the pension liability, i.e. bonds
- the Member Options Working Party (2006) referred to long-dated interest rates having fallen substantially
- the Actuarial Profession's letters in 2007 to the DWP and TPR referred to changes in market conditions such as long-dated interest rates
- life insurers typically price annuities with reference to bond yields (Telford *et al.*, 2011).

Recall that the liability calculations for the Minimum Funding Requirement (MFR) required pensions in payment to be valued using yields on gilts (inflation-linked if applicable), again supporting bond yields for commutation as we need to consider only pensions about to be paid. Valuing other liabilities in MFR calculations used, inter alia, equity yields, but that is irrelevant for the subject of commutation factors as we are not concerned with discount rates for the current accrual of pensions.

For example, the PPF is required to use actuarial equivalence, and has the principle that the discount rate should be a risk-free rate, which is taken as 75% of the gilt yield and 25% of the yield on a mixture of interest rate swaps less 15 basis points (PPF, 2019). Another instance is the pension scheme in Firefighters (2015) where the Government Actuary's Department referred to using interest rates in determining commutation factors, in 2015.

One paper, Hilsden *et al.* (2023), has a different approach, favouring discounting at the return on the fund assets as a whole, which may include equities. We have also seen (Section 6.3) that many actuaries link their advice with investment strategy, which can lead to the return on equities being included. If, however, a scheme has a specific investment strategy to invest in bonds for pensions in payment, it would arguably be logical to use the yield on bonds.

The thematic review identified many considerations used in advising on commutation factors, and Warner J might be disappointed by the absence of a clear view expressed in textbooks/papers or practice.

Clearly, bonds bear some credit risk, so their yield reflects both the time value of money and the default risk. For commutation factors, the time value of money is relevant together with the risks around the pension that is being exchanged: it is not clear at what level it will be paid (depending on inflation) and whether it will be paid at all (the scheme may fail to pay). The time value of money is represented by the yield on a risk-free bond: this could be the yield on UK government bonds (inflation-linked bonds where the pension inflates).

The calculations are not necessarily straightforward. Relevant issues can include the following, and addressing them may produce a variety of approaches:

- there not being gilts or other assets with cash flows that match the liabilities completely, aside from mortality.
- the use that can be made of yields on swaps or corporate bonds, or higher-yielding assets, with adjustment for credit risk (the Solvency II regime for insurance companies uses swap yields with an adjustment for credit risk).
- the need to consider minimum and maximum rates of increase applied to pensions.

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- the possibility of reflecting the illiquidity of pension liabilities in a discount rate that reflects yields on illiquid assets, i.e. including an "illiquidity premium," although quantifying such premium can be difficult.

The additional risk - that the fund has insufficient assets to pay the pension – involves consideration of the employer covenant, and is dealt with separately (Section 6.8).

Hence, I believe that, in this transaction approach, a suitable starting point for the discount rate can be the yield on gilts (index-linked where applicable). Reference may also be made to swaps or other investments but modifying for credit risk. Some other adjustment may also be justified, noting that gilts are much more liquid than pension liabilities. The outcome may therefore be a little above gilt yields.

If gilt yields rise, the commutation factor decreases. Is this fair to a new retiree? If the cash was invested in a long-term gilt, the reduction in cash is balanced by the higher interest. Of course, some will use the cash to clear a debt, others will spend it shortly after retirement, others will invest in different ways. Some investors may choose assets they think have a higher expected return, such as equities: could trustees use that higher return to justify a lower commutation factor? I say no: if using a bond discount rate produces a cash sum of £1000, the retiree would reject an argument (surely spurious) that that this is equivalent to £800 in equities and would still expect £1000 to use as they wish. I suggest that the trustees would not regard as a relevant consideration, in deciding commutation factors, either an individual's plans for spending or investing their cash; or, to be applied to all retirees, a discount rate based on some assumption about the higher returns available, at some risk, from investments that some retirees may choose.

To be fair between members who commute and those who do not, the trustees need to consider the expenses of operating the commutation facility, if these are paid from the fund. Alternatively, expenses could reasonably be ignored if they are not material.

Hilsden *et al.* (2023) have a different view on the discount rate. Calculating commutation factors using a "gilts flat" basis (which could mean a little above gilt yields) would not, they said, seem appropriate because this would lead to a funding strain and lower security for the remaining benefits.

My perspective on this is:

- the trustees should set commutation factors that are based on relevant considerations with a fair outcome. If that leads to payments to members causing a funding strain, it is up to the employer to fund the scheme so that benefits are secured. The implications for employers' contributions may be such as to make it fair to reduce commutation factors, but I believe that the circumstances where this is appropriate are restricted (see Section 7.2)
- this means that whether there is a funding strain is not necessarily relevant to commutation factors. Nevertheless, if the scheme is 100% funded on a valuation basis that discounts liabilities using gilts (or similar) yields, no strain arises; and the valuation may already take into account factors being determined using gilt (or similar) yields
- if the scheme is less than 100% funded, then some reduction in commutation factors may be justified, although Section 6.8 suggests that a deduction on these grounds would often not be appropriate.

Hilsden *et al.* (2023) did suggest that if the scheme was close to full buy-in/out it might be appropriate to advise on aligning commutation factors and insurer terms. They say that the latter are generally market-related; but they are also generally based on bond yields. They add that how close a scheme is to buy-in/out may involve some judgement. I suggest that using a discount rate that is independent of the composition of the scheme assets would be more objective.

A relevant consideration would be a transaction approach to actuarial equivalence, using a discount rate and assumptions for mortality and future inflation as with a market-consistent value

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of the pension being exchanged; and expenses in connection with commutation, if met from the fund, unless they can reasonably be ignored.

The transaction approach is not entirely satisfactory, however. The transfer value approach could produce greater consistency if a member is commuting for a trivial lump sum or taking early retirement benefits.

6.6. Review

Of the approaches discussed, I expect that using buy-out costs gives the highest commutation factors (primarily due to including insurers' margins); next is the transaction approach; then the technical provisions basis (the discount rate is higher than the risk-free yield on the transaction approach, but partially offset by the inclusion of prudent margins); lowest is the transfer value basis (as for technical provisions but without prudent margins).

Other actuarial calculations are possible. For example, trustees could decide that while they do not wish to use the composition of the scheme assets in determining the discount rate, they prefer the expected rate of return on some portfolio that includes equities as well as bonds. Or they could use the set of actuarial assumptions used by the firm in valuing its pension liabilities in its statutory accounts: in practice, this would be close to the transaction approach except for discounting at a corporate bond yield rather than a risk-free yield.

There may be concerns about using market rates for financial conditions. Would it be satisfactory in September 2022 to use gilt yields that had risen sharply after the government's Budget? At other times one could say that interest rates were unusually low, affected by quantitative easing and the limited supply of index-linked gilts. Trustees may believe that current conditions reflect some temporary "blip." One response could be to use some assumed future or "smoothed" interest rate if the trustees believe that is relevant. That may also avoid frequent changes in commutation factors, although I suggest that would not ordinarily be a main objective of the trustees (rates do vary: see Section 8).

I believe that a transaction approach is, overall, more satisfactory than the alternatives discussed in Sections 6.2–6.4. Some may say the transfer value basis is appropriate, having been set by government in a context of converting pension to cash (transfer values). Recall that the Actuarial Profession (2006), when writing on transfer values, had argued that "the better actuarial view" was "value to the member." It said that its primary concern was what was fair to the member, and it was for the government to consider wider issues. As discussed in Section 6.4, the government's concern was to preserve consistency with previous regulations on transfer values. When dealing with commutation factors, which are not currently regulated and where practice varies, that rationale does not appear applicable.

Trustees could regard any or all of the four approaches discussed as relevant considerations; the weight given to each is their decision. This is subject only to the need for the trustees' choice not to be one that no reasonable set of trustees would make.

The further elements of actuarial equivalence are a guarantee charge (Section 6.7) and a deduction for asset insufficiency (Section 6.8).

6.7. Guarantee Charge

When trustees respond to an enquiry from a member, shortly before retirement, about the benefits to be received, they may wish to guarantee that the commutation factor advised will apply at the retirement date. This helps the member plan and avoids the costs of a later re-calculation. Hilsden *et al.* (2023) suggested this might be 3 months where factors were reviewed frequently.

If so, commutation factors can be adjusted to charge for the guarantee, the main issue being the volatility of long-term interest rates. However, it may be reasonable not to make a charge if it was

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felt to be immaterial. Determining the guarantee charge is outside the scope of this paper (an option pricing approach could be used).

Difficulties may arise, whether or not a guarantee charge is included, taking into account that two members retiring on the same date can request a quotation at different times and that financial conditions can change. Both practicalities and the need for fairness will be relevant in making a decision about guarantees and a charge.

6.8. A Deduction for "Asset Insufficiency"

Commutation factors can allow for the possibility that the pension exchanged will not be paid because the fund assets are insufficient. Assessing the likelihood of that is difficult, depending on future conditions and decisions as well as the current strength of the fund. A stochastic model could be used (see Turnbull, 2014); a short-cut method could look at the scheme's risk-based levy to the PPF.

Another possibility is to use the process for transfer values, where regulations allow these to be reduced below "best estimate" values by the percentage shortfall in an "insufficiency report," which compares the fund assets with liabilities. Here, the liabilities are calculated using "best estimates" of mortality and the returns on the fund, and not the technical provisions, which may have prudent margins. However, TPR (2008) indicates that, where the covenant is judged to be strong, and any deficit is being remedied over a reasonably short period, the trustees should not normally reduce transfer values. The trustees should also consider the degree of underfunding, and any contingent assets that are available. Hence, it is not surprising to find that most schemes that could pay reduced transfer values do not do so in practice (Honour, 2019).

A similar approach could be used for commutation factors with the actuary consulting the trustees about whether the covenant and so on made an "asset insufficiency" deduction appropriate. The transfer value methodology may be adjusted; there are alternative ways of estimating "realistic" liabilities. Hilsden *et al.* (2023) also argued that if a scheme was particularly underfunded it may be appropriate to reduce commutation factors, noting that transfer values can be adjusted in those circumstances.

In practice, the potential for reducing commutation factors may be quite limited. This is because the insufficiency report recognises the prioritised needs of different groups, where the level of compensation payable to members under the PPF is important. A retiree's pension may be no more than the PPF compensation that would be received. Hence, in many cases, this asset insufficiency adjustment would have little or no effect. Further, trustees may regard it as unfair to reduce commutation factors if transfer values were not also being adjusted. Making the adjustment may also be complex, given that assets and liabilities are always changing.

A different conclusion may be that, for example, a 70% funding ratio justifies a 30% reduction in commutation factors. My view is that this does not properly recognise the security of the pension rights of a member on the point of retirement.

7. Additional Considerations

7.1. Expectations and Wishes

Beyond actuarial equivalence trustees may incorporate additional considerations. Can their discretion reflect the expectations of employers and members? In National Trust (1998) Robert Walker J was "inclined to think that legitimate expectation may have some part to play in trust law." Looking at pensions cases, in Merchant Navy Ratings (2015) Lord Nicholls said: "it was necessary first to decide what is the purpose of the trust and *what benefits were intended to be received* by the beneficiaries." In Lonrho (2003), Patten J said that it was for the trustee to bring into consideration the legitimate interests and expectations of employee and employer alike.

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The expectations of members are not easy to determine, as this is a subject on which they have generally have limited knowledge (and perhaps little interest until shortly before they retire). Members might assume they are entitled to 100% of actuarial equivalence, but there is unlikely to be documentary support for this. Indeed, the fact that 12 is the usual commutation factor in public sector pension schemes explodes any argument that 100% (or around 100%) of actuarial equivalence is universal or necessary. Past practice, even if poorly understood can, however, influence expectations.

Expectations are not, of course, decisive. In IBM (2017), a case concerning cessation of accrual, Warren J held that members' expectations were no more than a relevant factor that the decision-maker can, and where appropriate should, take into account. Expectations could, he said, be affected by changes in financial circumstances.

As regards expectations of employers, consider an employee joining a scheme. The accrual rate has been set, and the employer could decide that, for this new accrual, a fixed (or maximum) commutation factor should apply. If, however, the employer accepts that factors are to be determined by trustees on actuarial advice, and they currently use factors that are, say, 90% of actuarial equivalence (on some particular basis), it appears reasonable to assume that this reflects the employer's wishes and expectations. Indeed, if it wasn't, the employer could express its wish that factors were, say, 80% of actuarial equivalence rather than 90%.

Since one purpose of the scheme is to continue to provide benefits in accordance with the employer's wishes, those wishes are a relevant consideration: indeed, an important consideration. The employer's wishes are usually its expectation, although it needs to check that the law and scheme rules permit its wishes to be accommodated. If the trustees insist on using 90% when the employer wishes to use 80%, the employer could, in principle, close the scheme to future accrual (assuming that this does not breach the *Imperial* duty of good faith). The trustees may then feel able to continue with the 90% proportion that applied for accrual when the scheme was open. A different outcome could be the employer insisting on changing the scheme rules to specify an 80% proportion or a fixed factor that gives about the same result. I suggest that it would apply only to future service; otherwise, would the employer be reducing a benefit for past service?

Given the concerns about trustees' discretion that this paper raises, I believe that if the discretion can be replaced by a formula (x% of actuarial equivalence) or specific factors being defined in the rules, that could be beneficial. Employers still have an incentive to set factors that are not "too low" since that would reduce the number of members taking cash and increase the cost of the scheme. However, this approach is of limited value as it would not affect schemes that are already closed.

In principle, if the employer's wishes for commutation factors change, say from 90% to 80% and then 70% of actuarial equivalence, and if trustees set factors accordingly or they are reflected in the rules, a member might retire with some accrued pension having a commutation option with 90% of actuarial equivalence, some with 80%, some with 70%. I call this approach the "benchmark expectations" approach. This is not, of course, the way that DB schemes have operated, and I do not think it practical to apply it now, although I believe it is a useful perspective to consider.

An employer may say it expects any new factors to apply to both past and future accrual, and trustees may regard this expectation as a relevant consideration. I regard this as unsatisfactory. Surely, the original commutation factors reflected the employer's wishes, intention and expectation at that stage. Further, if members have expectations from past practice and the demographic and financial conditions that have applied (in the sense of x% of actuarial equivalence), they have no protection if the commutation factor is suddenly reduced just before retirement without reference to demographic and financial conditions. The *Imperial* duty of good faith could be an issue here, as well as whether it can be argued that an accrued (commutation) benefit is being reduced.

When looking to ascertain what factors have been in the past, it is noted that up to 2006 trustees' decisions were restricted by the Inland Revenue (2001), and maximum commutation factors were below 100% of actuarial equivalence, at least using either the transaction or buy-out

cost basis. The maximum factor for a male retiring at 65 and receiving a level pension was 9. This was equivalent to an annuity valued using UK Interim Mortality Tables 1998-2000 (without future improvements, as was then typical practice of pension actuaries) and discounted at 6.7% p.a., above gilt yields at the time (about 5%). For pensions inflating at a fixed rate the discount rate had to be at least 8%; if inflating at above 5% but limited by the RPI then a "real" discount rate of at least 3% was to apply (inflation-linked gilts yielded 2%-2.5%). The Inland Revenue also constrained factors in earlier years. This suggests that a scheme with factors below 100% of actuarial equivalence may justify that as being consistent with past practice, although precise calculations depend on, for example, what illiquidity premium is used.

Potentially relevant are changes in 2006 in the scheme rules and/or the role of the actuary, who had perhaps been satisfied with Inland Revenue maximum factors in a wide range of circumstances. Practice in some schemes has changed, in some cases to around 100% of actuarial equivalence, others (with limited updating for changes in demographic and financial conditions) to below 50%.

A range of ways of determining expectations is available to trustees. I believe it is useful to consider the benchmark approach to expectations. I suggest it reflects what the employer has, implicitly, intended over time. It also ensures that members' rights are consistent with past practice and with changes in demographic and financial conditions. It means that an employer's new wishes can be applied for future accrual while protecting the past expectations of members. While not an approach that is now practical to implement, I believe that trustees can benefit from thinking through what it involves in order to take a view on what expectations should be given weight as a relevant consideration.

7.2. Implications for Employers' Contributions

The effect of commutation factors on employers' contributions is certainly something for trustees to consider.

Reflecting employers' concerns about the cost to them of commutation factors, trustees may take into account the following potentially relevant considerations:

(a) The purpose of the scheme, it can be said, is to provide benefits at a cost acceptable to the employer, who may say that the contributions are unacceptable (perhaps in the context of other developments that are affecting the business), hence the benefits should be adjusted.

(b) The employer's original purpose of the scheme may have been to provide benefits on the basis that it could discontinue the scheme (for example if pension costs had increased, leading to a deficit), so that the benefits were not fully legal liabilities (this position being changed in 2003); the employer may argue that this justifies a stance that the trustees should respect its intention not to be subject to mortality and financial risks that increase commutation costs.

(c) The employer may argue that it is the significant or unexpected nature of the demographic and/or financial changes that means that the higher contributions are unacceptable, especially if they were not budgeted.

(d) Some schemes have taken investment risks which, when beneficial, have been used to increase members' benefits; it is therefore arguable that adverse investment outcomes could reasonably impact members' benefits.

(e) The employer may regard higher contributions as unacceptable because of the potential that the firm will be weakened and the scheme's ability to pay the stated benefits will be threatened.

(f) The consequence of higher contributions may be the employer reducing jobs or wages or worsening working conditions. Members may also be disadvantaged for other reasons, such as the sustainable growth of the employer being affected (TPR has a statutory objective to minimise such impacts) or because the business is put at higher risk, with the potential for adverse effects on wages etc. in the future. These may not strictly detract from

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the scheme purpose. Note, though, Arden LJ's remarks in Stevens (2002): "the relationship of members to the employer must be seen as running in parallel with their employment relationship. This factor, too, can in appropriate circumstances influence the interpretation of the scheme." Hence, trustees should consider such potential outcomes as relevant, although it can be tricky to take into account differing interests of retiring members, who are not subject to cuts in wages, etc., whereas other members are (and non-member employees are also potentially affected).

Now it is surely the case that an employer with a scheme open to future accrual, and keen to reduce its costs, could express a wish to restrict commutation factors for future accrual. This is naturally subject to the provisions of the scheme rules and the *Imperial* duty of good faith. Such a wish is clearly something for trustees to consider; and indeed is an important consideration, especially if the scheme rules could be altered to formalise that restriction.

The employer may also suggest that the contributions it makes are a relevant consideration for commutation factors for the past accrual of benefits. However, potentially relevant considerations can be put forward to emphasise the importance of scheme members' rights:

(g) The obligation to pay accrued pension benefits continues even if the employer regards the costs as unacceptable, and it can be argued that expectations of commutation factors in relation to accrued pension benefits should be similarly protected, even if they are not strictly accrued benefits in accordance with Section 67 of the Pensions Act 1993. This takes into account that members' benefits are derived from their employment and form part of their reward package, and are unlike discretionary benefits under a family trust (see Mettoy (1990) and Stevens (2002): Section 4.2);

(h) It is wrong for trustees to now acknowledge some benefit for employers from the ability they originally had to discontinue a scheme, without the benefits being fully legal liabilities because that right was ended in 2003, having been felt to be unfair to scheme members; and if employers did not then reduce their exposure to demographic and financial risks (by, for example, insurance, hedging and asset-liability matching) that implies they were willing to bear those risks

(i) This is a DB scheme, under which:
   - the employer chose to have variable, not fixed, commutation factors
   - with variable factors, the role of the actuary implies that, subject to other relevant considerations, commutation factors should reflect changes in demographic and financial conditions
   - the employer was exposed to uncertain costs; it could have chosen to mitigate the demographic and financial risks involved. Where investment risks remained and turned out successfully, the employer may have benefitted from lower contributions
   - if costs increase to a level the employer then regards as unacceptable, that reflects its choices about bearing risk

(j) While members' accrued rights may have been increased when risks turn out well (although it is typically many years since this has happened), accrued rights may not be reduced when risks turn out badly, and arguably the same applies to expected commutation factors in relation to accrued pensions.

My view is that the arguments in (g), (h), (i) and (j) negate those in (a), (b), (c) and (d) respectively. Trustees may, of course, disagree.

However, I believe that (e) and (f) are relevant considerations: if it is expected that members would be worse off because of the higher contributions (including there being a reasonable likelihood of being worse off), it would be sensible to adjust commutation benefits. There is a

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caveat: Pollard's (2006) comment that the employer "will be mindful of not making a threat that could breach the [*Imperial Group*] implied mutual duty of trust and confidence" is relevant here.

It is difficult for trustees to assess if they expect members to be worse off, and there can be tricky issues for differing categories of members. In practice, it is for trustees' judgement rather than objective calculation. Trustees may take the view that, in these circumstances, they would not increase factors if that was expected, owing to new demographic and financial conditions (avoiding a reduction, which could produce a greater conflict with members' expectations).

One other relevant consideration should be mentioned. Employers' contributions attract tax relief which means the employer's wish to pay benefits in a cost-efficient way is not helped by restricting commutation benefits, as the cash is tax-free to members (7.3).

Of course, trustees may come to a variety of conclusions about the relevance of the effect on the employer's contributions.

7.3. Tax

The lump sum being tax-free is a product of history, as recognised by the report of the Millard Tucker Committee (1954), which supported their remaining tax-free (with an exception for trivial commutation). The government did not accept their recommendation that approved schemes should not provide tax-free cash of over £10,000 (equivalent to £209,000 in 2022 using the Bank of England inflation calculator). Views about the tax-free status of cash continue to differ (see Adam *et al*., 2023).

Should commutation factors be reduced because the cash is tax-free? McLeod (2005) asked why the employee, and not the employer, should enjoy the tax concession, and mentioned the withdrawal of tax relief on equity dividends in pension schemes in 1997, which increased employer costs. Pollard (2020, 46.39) included tax as possibly a relevant factor; the thematic review report suggested that some actuaries may have taken it into account (Gordon, 2020).

Could commutation factors reflect each individual's tax rate, so that a member with a high marginal tax rate would be given a lower factor? There are practical issues such as whether the relevant tax rate relates to income excluding or including the cash sum and, if the latter, is it assumed to be spread over several years? Income tax rates differ between Scotland and England: is that relevant to trustees' discretion? Problems would also arise if a nil tax rate band applied. I suggest that the trustees should not regard individuals' tax rates as relevant, given that this is not mentioned in scheme rules, is not consistent with pension scheme past practice and philosophy and raises serious practical problems.

Some may argue that commutation factors should be reduced by the basic tax rate because the cash is tax-free. However, this still raises issues of fairness for individuals with a nil or lower tax rate; and some would query the tax-free cash being an advantage only for higher rate taxpayers. Similar concerns apply to other suggestions for reducing factors because the cash is tax-free.

Further, it may be that reducing commutation factors for tax reasons is contrary to public policy. HM Treasury (2015) has said that the tax-free lump sum is an incentive for people to save more. In DC schemes the employee benefits. In DB schemes it provides an incentive to join in the first place (although not now relevant for closed schemes). I suggest that this implies that the government thinks members, rather than employers, should benefit from the lump sum being tax-free.

In ITS (2009) the need to preserve the public interest led to the court ruling that trustees' actions were not acceptable in view of the implications for the PPF. A similar point can be made here if we deduce that public policy favours members, not employers, benefitting from the tax break.

Members may well recognise that the lump sum they receive is tax-free: this status is long-established and referred to in the press periodically. Some trustees mention it in scheme literature. This is, of course, true whether members or employers receive the benefit of the tax break. However, some members might be surprised if trustees then allocate the tax break to the employer so that they do not actually gain.

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Hilsden *et al.* (2023) did not regard the tax break as relevant for commutation factors. This was because a member's tax status is an individual matter; and the lump sum is usually described to members as being tax-free.

Trustees may regard the tax break as a relevant consideration, but I do not regard that as satisfactory if it leads to restricting commutation factors to benefit the employer. This takes into account that government tax policy is designed to encourage saving, potential issues of unfairness, the inconsistency with DC arrangements, and the expectation of some members that they will gain after being told the cash is tax-free.

Indeed, both employer and scheme members could gain from the tax-free status if trustees chose higher rather than lower commutation factors. If we think of the purpose of the scheme as enabling an employer to provide benefits in a cost-effective way as part of a reward package (Section 4.1) then we take into account that the employer receives tax relief on both salary payments and pension contributions, whereas employees pay tax on salary but not on cash sums (within limits). Higher cash sums, indeed possibly with lower salary, offer a net benefit. It is, of course, His Majesty's Revenue and Customs that loses.

This exemplifies again that trustees' discretion in choosing the relevant considerations and applying them may lead to quite different outcomes for employees in their reward package.

7.4. Utility

Trustees may decide to offer cash, the utility of which matches the utility of £1 p.a. pension. They may say this is, say, £18 if that is what, in practice, members have chosen in commutation. Cash provides flexibility and liquidity, enabling members to spend, invest or repay debt as desired instead of the level or inflating pattern of a pension (although they are losing the pension guarantee). This can lead to factors below actuarial equivalence.

I suggest that viewing commutation in this light is rather different from viewing it as a transaction carried out on a well-functioning market, which I believe is more appropriate:

- members may be inadequately informed to make a decision. People tend to underestimate how long they are likely to live; this pessimism may mean they do not buy annuities (O'Dea & Sturrock, 2020) and may value cash unduly highly in comparison. They may also have inadequate financial ability to appreciate the impact of discounting, especially over a period that may exceed 20 years.
- trustees are taking advantage of an effective monopoly. If it was practical for members to exchange pension for cash with a financial institution (mortality risk is an obstacle, of course), it would be at market rates, i.e. around actuarial equivalence, but with charges to cover expenses and risk, and make a profit. Since other institutions cannot, in practice, offer commutation, it enables pension trustees to offer terms that are unfavourable (especially so when we consider that they do not have the same credit risk or expenses).

In practice, it would be difficult to estimate utility factors, as past practice under different financial conditions would not be relevant, and factors would differ between members.

Trustees' views may differ - I believe that using the "utility" argument is unsatisfactory.

7.5. Optionality

The thematic review suggested that some actuaries have taken into account that commutation is only an option; a member who judges that the terms are unsatisfactory can just take the full pension. In Nissan (2019), the trustees took into account that commutation was a personal decision for individual members; the Pensions Ombudsman agreed that it was relevant and rejected a complaint about a factor of 11.73 (the member's age was not stated).

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I have concerns about the use of the optionality argument to justify lower factors than would otherwise apply. First, while a member could take all benefits as pension, this is less advantageous with regards to tax, and also the liquidity and flexibility that cash provides. Second, how can the optionality principle guide trustees other than suggesting lower factors are more appropriate than higher factors? I question whether trustees doing so would be using their discretion for the purpose of reducing employer contributions rather than furthering the progress of the scheme (the proper purpose requirement).

Further, Hilsden *et al.* (2023) did not believe that the optionality (or otherwise) of the commutation benefit was relevant to setting commutation factors, given how commonly members opt for this benefit.

Incidentally, the trustees' relevant considerations in Nissan (2019) included, as well as members' interests and the scheme funding position, the planned re-design of the plan. It is not clear to me why such a re-design affects the terms for exchanging pension for cash; and if it does, why are the factors not reviewed when the re-design is introduced?

7.6. Market Practice

In Edge (2000), Chadwick J held that the trustees must consider benefits relative to benefits under comparable schemes or the pensions market generally. It was argued that the main purpose of the scheme is not served by contributions and benefits that deter employees from joining. This argument is less relevant to schemes that are already closed.

The variety of commutation factors used indicates that there is no clear "market practice." A response to a complaint about low factors might be that other schemes had low factors, although the complainant could then draw attention to comments such as "pensioners may be short-changed."

I also agree with Hilsden *et al.*'s (2023) concern that there are dangers in using benchmarking data because of risks such as herding and group thinking.

Hence, while trustees may consider market practice as potentially relevant, I think it is unlikely to play a part in most trustees' decisions in a satisfactory way.

8. Frequency of Review of Commutation Factors

The thematic review (Gordon, 2020) found that, in a very high proportion of cases, the commutation rates advised "were to be fixed for the period up to the next review, which may be up to three years away… typically [for] administrative simplicity and member understanding" (p.17); helping members plan for retirement was also a reason. Some cases acknowledged market volatility and therefore suggested annual reviews; and in a small number of examples the factors "were to be adjusted according to monthly or quarterly market conditions, which is similar to the way transfer values are calculated" (p.17).

There is a stark contrast with transfer values, often updated monthly as market conditions change (Gordon, 2020). Cowling *et al.* (2012) referred to commutation as a transaction, indicating that it should reflect market conditions (presumably not conditions up to 3 years ago). When the IFoA (2016) emphasised the importance of keeping commutation factors current, did it think that factor that were nearly 3 years old were current?

Hilsden *et al.* (2023) identified that some schemes had commutation factors that were market-related and set out advantages and disadvantages of such an approach. They agreed with Gordon (2020) that three years should be the maximum time between reviews rather than the default, "especially where factors are not updated regularly (e.g., every 3 months) for changes in market conditions," and suggested a high-level review annually.

Market conditions can take precedence over traditional practice. The commutation factors used by the PPF changed thirteen times over 2005-2023; seven changes were increases, six were

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decreases. In October 2012 the increases over twelve months before were (for males retiring at 65) 15.0% (level pension) and 18.3% (inflating). Changes were mostly at about annual intervals, but March 2023 saw new figures after just five months, with a 15.5% reduction in factors for inflating pensions. This was presumably a response to higher gilt yields; sticking to the usual review timetable was not appropriate.

If factors were updated monthly, members retiring a month apart may receive different cash sums: are the trustees acting impartially in that case? I suggest yes. If interest rates reduce, a higher commutation factor compensates for this; the value of the pension being exchanged has altered. While this is clearly true if the retiree invests the sum in a long-term bond, the fact that others will spend or invest differently does not negate this (see Section 6.5). Hilsden *et al.* (2023) thought it a benefit for factors to be set closer to market value relative to market conditions at the retirement date. However, they also suggested that a disadvantage was that, for a member, "cash was cash" and the value of the cash sum should not depend on market conditions. I would instead argue that the actuary's role is to reflect changing financial conditions (see Section 6.1).

I also suggest that changing factors in line with market conditions helps maintain impartiality between members and employers. If interest rates, instead of falling in the years to autumn 2022, had risen, would all employers have let pension funds pay out cash sums that were too high for those financial conditions? Perhaps not.

Infrequent reviews may increase the likelihood that the employer exerts pressure on the trustees not to implement what may be a large change in factors if that leads to substantially higher costs. It may also not appear impartial between two members retiring immediately before and after the change.

A legal perspective leads in the same direction. If a member retires in October 2023, are financial conditions in November 2020 a relevant consideration? This looks very strange, especially if, for a member retiring in November 2023, conditions in November 2023 are suddenly relevant.

Frequent reviews may mean higher costs and challenges for communication, but it should be possible to learn from the way that transfer values are reviewed monthly. Note also that members in DC schemes can be exposed to (and have to cope with) late changes in market conditions, which suggests that a long guarantee period for factors in DB schemes is not essential.

That the circumstances and financial conditions at the time of decision are important is evident from Browne-Wilkinson VC's judgement in the Imperial Group (1991) bulk transfer case: "In my judgment the obligation of good faith resting on the company as employer requires that it should consider each proposal for amendment under clause 36 put forward by the committee at the time it is put forward in light of the circumstances that then exist." This surely remains true and Lloyd J, giving the judgement in IBM (2017), a case concerning scheme benefits, said, "it is clear from [Imperial Group (1991)] … that the employer must take into account all the *circumstances existing at the date of its decision*." Although these cases referred to discretionary decisions of an employer, I believe it is reasonable to think that the conclusions also apply to trustee decisions.

I suggest this implies that financial conditions up to three years before a member requests a factor are irrelevant. Using irrelevant considerations may lead to unfair outcomes.

Pollard (2020, 81.1) noted that trustees often set a policy in advance on commutation factors but asked, "Why is there not an obligation on trustees to set rates only at the right time (i.e. when requested) or to consider the policy again once requested? He added that policies can be a good thing but risk becoming too rigid.

The commutation process needs to operate in practice, and not only in the courtroom. In Courage (1987) Millett J held that the provisions of a scheme "should wherever possible be construed to give reasonable and practical effect to the scheme, bearing in mind that it has to be operated against a constantly changing commercial background." In Stevens (2002) Arden LJ held, "If the consequences are impractical or over-restrictive or technical in practice, that is an indication that some other interpretation is the appropriate one." Hilsden *et al.* (2023) discussed

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some practical issues and whether commutation factors should be reviewed as part of or after the valuation process (outside the scope of this paper).

In managing the commutation process, trustees have to use relevant and not historically irrelevant considerations but also need to avoid unduly high administration costs and help members with their financial planning. Compromise is needed – streamlined processes and effective communication will help.

It may be especially important to review transfer values frequently because members have a choice on whether and when to transfer. This is not the same as the commutation process, typically linked with a member's retirement date (Hilsden *et al.*, 2023). However, the case for market-related commutation factors is so that considerations are up-to-date and relevant, helping to ensure that outcomes are fair, as is required of trustees.

The Financial Reporting Council (2023) issued a new version of Technical Actuarial Standard 300 (Pensions). The question of the frequency of factor reviews is covered in:

"P3.1. Practitioners reviewing actuarial factors for a governing body or other decision-making entity must provide advice on:

(a) the circumstances in which the actuarial factors being reviewed should be reviewed again; and
(b) how the period of time until the subsequent review should be decided, with justification being required for a recommended period of more than three years between reviews."

I suggest that it would be appropriate for actuaries to indicate that they will review factors (if factors are required) if there is a material change in either the demographic or financial conditions underlying the assumptions they have used in deriving the factors.

The new TAS300 also requires actuaries to consider the relevance of various bases for calculating commutation factors, where the comments in Sections 6 and 7 of this paper may be found useful.

9. Roles and Responsibilities of Actuaries

I repeat that this is written in the context of a generalised view of schemes and their circumstances.

First, consider an actuary advising trustees and not required to certify factors as reasonable. A suitable starting point is actuarially equivalent factors, including discussion with the trustees on whether they wish the commutation factor process to include a guarantee charge and, if the scheme has a deficit, a deduction for asset insufficiency. Some actuaries may wish to (explicitly) confine their advice to such calculations, reflecting the traditional actuarial expertise on demographic and financial matters. It is likely to be helpful to incorporate the effect of expectations, which could include actuarial analysis of past decisions. Finally, some actuaries may feel able to take account of other considerations, even if not specifically "actuarial," in their advice. The thematic review found that some actuaries' work mentioned the optionality of commutation and the cash being tax-free to justify a lower commutation rate (Gordon, 2020).

The thematic review did not mention actuaries making specific reference to the employer's wishes and intentions. This paper has argued that they may be a relevant consideration. I suggest that the practice of having commutation factors that do not vary according to the accrual period they relate to explains some of the tension between actuarial advice and trustees' choice. In schemes open to future accrual, factors that were reduced for future service could help meet the employer's wishes for lower costs, without compromising members' expectations for factors applied to past service being updated in line with demographic and financial conditions.

Second, consider the very small number of cases where the actuary is the sole decision-maker. This appears to be a case where Pollard's (2020, 9.7) suggestion applies, namely that it is logical that a challenge could be brought against an actuary for a decision under a pension scheme, using the principles of Braganza (2015).

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Such an actuary has to be fair and balance different interests, as we have seen in the actuary's role in Newnes (1972), see Section 4.2; and Stevens (2002), see Section 5. Also note Robert Walker J's remarks in National Grid (2001), a case concerning surplus allocation (although his view was opposed by counsel on both sides):

"The function of certifying the general reasonableness of arrangements for dealing with surplus may be outside the specialised mathematical skills of actuaries, but it is certainly well within the experience of those actuaries who engage in pensions work. Many professionals have skills and experience that go beyond their basic professional training, but in which they are rightly treated as experts. There is no reason to suppose that Bacon & Woodrow or any firm of actuaries would be susceptible to undue pressure in deciding whether to certify arrangements for dealing with surplus as reasonable in a broad, untechnical sense."

Finally, many scheme rules require an actuary to certify the factors as reasonable (in some schemes, "confirm" or "consider" is used instead of "certify"). Is the actuary here, along with trustees, a decision-maker and subject to the *Braganza* test? I suggest yes, as the actuary has the power to decline to accept factors that the trustees may wish to use.

Could such actuaries restrict their role to actuarial matters? I suggest not. It is certainly understandable if the actuary initially puts forward factors on the basis of actuarial considerations only (and may certify them as reasonable). However, the actuary should know that trustees have a range of relevant considerations to take into account and accept that if the actuary's factors used actuarial matters only, the trustees may not accept them. What if the trustees decide that, given the employer's financial position and intentions, lower factors would be reasonable and ask the actuary to certify this to be the case? Actuaries in this position surely have to understand that the trustees' standpoint covers a wider set of considerations. To assess the reasonableness of the trustees' proposals means balancing the different interests and exercising judgement about the fairness of what is suggested.

Perhaps some actuaries will feel that the trustees, who are in frequent dialogue with the employer, are in a better position to make such judgments. They may prefer a role that avoids certification. On the other hand, actuaries may not find it onerous to certify since "reasonable" can cover a wide range of outcomes.

Of course, scheme members may be disappointed if they thought the actuary's certification would be for a calculation based only on actuarial considerations without reference to the employer's interests and wishes. But there is no fixed actuarial rule, guidance or established practice to follow. Even 100% of actuarial equivalence can be interpreted to favour members (buy-out cost approach) or the employer (transfer value approach). Hence, "using only actuarial considerations" is not easily defined, and may cover a wide range.

While I have expressed my views above, the actuarial profession may wish to seek formal legal advice on the legal responsibilities of actuaries who are responsible for decisions on commutation factors or who are certifying factors as reasonable.

In any event, I suggest that actuaries working in this area need to be aware of relevant trust law, including recognising the requirement for decisions to be made "at the right time." This is particularly important for those actuaries who are determining commutation factors or certifying that they are reasonable, where a range of relevant considerations, including the employer's intentions, is important.

The responsibilities of the actuary will, in any event, take into account the trust deed and rules, and the contract between the trustees and the actuary, together with how this is put into practice.

10. Regulation Instead of Trust Law?

The flexibility of trust law provides discretion, which can be particularly valuable when a trust faces uncommon or unpredictable situations, which may well arise in a DB pension scheme lasting several decades and with a large number of beneficiaries. However, I do not believe it is satisfactory

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for commutation factors. This is because cash commutation, while an option, is largely not uncommon or unpredictable. It is a benefit used by the vast majority of scheme members and is often a significant part of the reward package to employees, perhaps worth more than a year's salary.

Yet, unlike the pension, which is defined, the cash sum is subject to the trustees' discretion, which can be influenced by a range of relevant considerations, with potentially different views on which are relevant and the weight they are given. Actuarial equivalence can be assessed in several ways; expectations are open to different interpretations. The weight to be given to the interests of employers and members is a matter of judgement. Trustees may differ in the way they regard tax, utility and optionality as relevant or not. Outcomes can therefore vary across a wide range, with much inconsistency, and I believe this leads to the potential for results that may be thought to be unfair, even if reasonable in the *Wednesbury* sense.

I therefore suggest that, where currently subject to the use of discretion (of trustees, actuary or employer), the calculation of commutation factors should be defined more precisely. It could be achieved by new regulations that DWP draws up. It is acknowledged that trust law has shortcomings in the pension scheme context, and regulation provides support to address these (Donald, 2019). The discretion available to trustees on commutation factors may be regarded as anomalous in comparison with the regulation on transfer values; commutation may be a missing link in pension regulation.

Indeed, DWP (2008) stated, in relation to transfer values: "complete deregulation was not an option because amounts of transfer values can be quite large and this is therefore an important issue for both members and schemes. There needed to be some certainty about the way that transfer values were calculated." I suggest that many cash sums from commutation are quite large and similarly justify regulation.

One approach would be to prescribe the commutation factors (or, possibly, minimum factors) that a scheme could use; the starting point could be the transaction approach to actuarial equivalence as I have suggested. Although Section 7.5 raised several questions about how that could operate in practice, regulators could adopt some simplifications. For example, they could mandate use of the same discount rates as the PPF uses for commutation factors. Or they could use the suggestion of gilt yields plus 0.25 to 0.5 percentage points as referred to by TPR (2020), although that was for a different purpose and did not aim to be a risk-free rate. Permitting a guarantee charge and, in restricted circumstances, an asset insufficiency adjustment, would also be appropriate. Regulation could also address issues of consistency with benefits from trivial commutation and early retirement.

However, I suggest it would be wrong to prescribe commutation factors as always 100% of actuarial equivalence. Scheme rules differ; past practice, expectations and the employer's interests need to be taken into account. Balancing the interests of all parties is difficult, especially if, in principle, there is a case for commutation rights varying according to the date of pension accrual, but which it would be challenging to put into practice. Regulations might instead refer to a code of conduct that TPR designs and monitors compliance with. To cater for schemes with unusual features, DWP would be able to disapply some requirements.

Other approaches are possible. For example, for transfer values the government mandated the use of a discount rate that is the estimated return on the scheme assets, and it could do similarly for commutation factors. While this could have some benefits, it is likely to provoke disagreement (in addition to the concerns in this paper), since some schemes do use long-term interest rates to guide them on commutation factors, and several references in Section 6.5 draw attention to bond yields rather than the expected return on scheme assets. Assuming that the latter is higher, members are likely to object to a new rule that reduces their cash sums. Here, "members" refers to almost all retiring members of DB schemes; a stark contrast to the smaller number of members affected when transfer value regulations were introduced.

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In any event I suggest that regulations should require trustees' decision-making to reflect circumstances when the trustees make their decision, and not potentially three years out-of-date (but taking into account practicability concerns).

I believe that regulators should also consider disclosure to assist members in better understanding the commutation terms; the Actuarial Profession (2007) has suggested this. It is particularly important where a deduction for asset insufficiency applies, or commutation is significantly below 100% actuarial equivalence. I also mention the Pensions Ombudsman's view in a determination, Simons (2018), albeit not concerned with commutation, that trustees "had a fiduciary duty to provide Mr R with the relevant information to enable him to make a fully informed decision about his options under the Scheme."

A first step could be for TPR to survey trustees to find out what relevant considerations they use to set commutation factors and which were given most weight. Of particular interest would be responses from trustees where factors were particularly low relative to actuarial equivalence.

The regulation suggested above would not apply to schemes where commutation factors were defined in the rules and not subject to discretion.

11. Conclusion

This paper has suggested that it would be satisfactory to use, as relevant considerations in determining commutation factors:

- actuarial equivalence, where the "transaction approach" is regarded as, overall, the most satisfactory. Although some may point to advantages of the transfer value basis, which was set by government in a similar (not identical) context, it was not "the better actuarial view" as expressed by the Actuarial Profession (2006)
- incorporating, if applicable, a guarantee charge and/or a deduction for asset insufficiency (although I would not expect the latter to be commonly applied)
- additional considerations: the expectations of the employer and members and the impact on employer contributions if members would expect to be worse off.

I also believe that the process for updating commutation factors should use relevant demographic and financial considerations, where "relevant" means close to the time when a factor is advised to a member, not calculated up to 3 years earlier. This could mean monthly reviews, as is typical for transfer values. A practical method for implementing this should bear in mind administration costs and members' needs for financial planning.

I suggest that actuaries working in this area should be aware of relevant trust law and the constraints on trustees' discretion. Trustees need to take into account non-actuarial considerations, which is particularly important for actuaries who certify factors as reasonable to understand.

I suggest that the flexibility of trust law is not well suited to the determination of commutation factors, and that regulation is, at least in principle, preferable. Some form of disclosure to help members choose should also be considered.

The thematic review found that commutation factors varied widely across schemes and were typically well below transfer value factors. Further, trustees often chose factors different from what actuaries advised. The Joint Forum on Actuarial Regulation's (2020) view was that commutation factors may not operate in members' best interests. Some practices do not sit easily with the requirements of trust law. I suggest that something needs to change.

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