COMMUTATION FACTORS FURTHER ADVICE

Following the Pension Ombudsman determination in Milne v GAD we have had several queries from members around various associated issues particularly in relation to the interest payable and the amount of commutation taken at the time of retirement.
As a result of those queries we have taken further legal advice on the matters and can now update those so affected as below:

The calculation of a commutation lump sum

The way in which a commutation factor is calculated is an important component of the answer to all of the questions raised, and it is important to understand how it works.

The actuary who calculates the commutation factor assesses the monthly pension payments that will be payable to a member of the retiree's age between the date of retirement and his or her assumed date of death. That includes making an allowance for assumed pension increases; in the period 2001 – 2004 the assumed increases were in line with the assumed increase in the retail prices index (RPI). This assumption is derived from the market: it is taken as the difference between the return on index-linked government bonds and fixed interest government bonds – in other words, the expected rate of RPI increases is derived from market sentiment and not just a number that the actuary picks.

This stream of pension payments is then converted into a lump sum. If I owe someone £100 in ten years time, how much do I need to set aside today to cover the cost? The answer is not £100, because I will invest the money set aside and the investment return plus the capital set aside will (hopefully) come to £100. That means I have to make an assumption about the likely return on my investment. This assumption is called the discount rate, and in 2001 – 2004 it was set at the assumed RPI increase plus 3.5%. That rate was used for a great variety of government costing: anything from pension commutation to the capital value in today's terms of an infrastructure investment such as road-building. It is dictated by the Treasury for all of these purposes. It is now taken as the increase in the consumer prices index (CPI) plus 3%.

The result of this calculation is that the commutation lump sum will be worth the same amount of money, provided that the assumptions about life expectancy and RPI increases, and the discount rate turn out to be accurate.

The Ombudsman did not criticise the GAD RPI assumption or discount rate (he made it clear that these were for GAD to decide). GAD's error related to life expectancy and it is the improved life expectancy assumption that that was made when the 2001 and 2004 tables were reconstructed that has led to the improved commutation factors.

Members who chose not to commute when they retired

My understanding of the question raised is that some members decided not to commute when they retired; taking the view at the time that commutation was not good value for money. If they had been given an estimate based on what we now know to be the correct commutation factors, they would have made a different decision and commuted part of their pension.

The failure to produce the correct commutation factors amounted to maladministration on GAD's part: that is the core of the Ombudsman's decision in *Milne*. Any member who has suffered financial loss as a result is entitled to compensation. Proving financial loss is cases such as this, however, will be an uphill struggle.

If such a member had taken a commutation lump sum, he or she could have invested it. Would the investment return have been higher than RPI increases plus 3.5%? The usual principles for calculating compensation require the loss in question to be sufficiently proximate to the fault that gives rise to the right to compensation in the first place. In this instance, I would be sure that the Ombudsman will say that variations between the assumed and actual rates of return are too remote from the maladministration that gives rise to the right to compensation.

Similarly, since 2011, such a member's pension has actually increased in line with the CPI, and not the RPI, and CPI increases tend to be lower. If he or she had commuted, the assumption built into the calculation would have been that the future pension would increase in line with the RPI. Whilst that may well have caused a loss it is, again, too remote to say today that the actuary could have foreseen that the whole basis for assuming pension increases might change.

In short, the value of the reduced pension plus commutation lump sum derived from any actuarial commutation calculation should be of exactly equal value to the value of the pension if no commutation is made. If it is not, it is because the future is never predictable, and the assumptions made have deviated from reality. That variation is due to the nature of any actuarial exercise, and not GAD's failure to address increasing life expectances.

These members also have more fundamental problem: they will have to show that if they had been told that the commutation was *X* and not *Y*, they would have made a different decision. Given that the difference between the two numbers is different, but not dramatically so, it will be hard to prove that the member made his or her decision on the grounds of value for money rather than the more typical basis that the member thought that a higher income for life was more valuable than cash-in- hand now.

Making out such a case is not impossible. A member might be able to show, for instance, that he or she would have invested in a house, could not afford to do so with the commutation lump sum offered, but would have been able to do so if the correct offer had been made. The member would have to show that the difference between the two amounts was the only factor that inhibited the investment decision: that seems unlikely.

Excessive commutation

As I understand it, the issue raised by some members is that they chose to commute a percentage of their pension in order to obtain a lump sum of a certain amount. If the correct factor had been applied, they would not have commuted as much, and so their pension today would be higher.

These cases are likely to be unusual. As a matter of historical fact, most pension scheme members (of any defined benefit scheme) commute the maximum amount of pension. A member who did commute the maximum at retirement will find it hard to argue now that they would have commuted a smaller percentage of their pension at retirement, when the more natural inference is that they would still have commuted the maximum (and obtained a higher commutation lump sum).

These members may have suffered a loss. Imagine that they invested the excess commutation lump sum that was paid: to deliver good value for the pension surrendered, the investment would have to deliver a return of RPI+ 3.5%. Against that, the pension they surrendered (but would not have surrendered) would now be increasing in line with the CPI, and not the RPI which the commutation calculation assumed.

But making a claim on this basis suffers from the same difficulty faced by members who commuted too little (that is the members discussed above who did not commute): any loss suffered on this argument is too remote from the failure which is the core allegation made against GAD.

Interest

The argument was that Mr Milne should be paid compound interest at bank base rate plus 1%. The Ombudsman awarded simple interest at bank base rate because that is his invariable practice. I am quite sure that arguing for a different rate of interest would be futile.