KNOWLEDGE BASE

O&M PENSION SOLUTIONS

General Information

Transvas Report: Hurdle Rates

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What is a Hurdle Rate?

In the O&M Transfer Analysis Report, the hurdle rate is the growth required each year to match the starting pension in the existing scheme, assuming it does not increase in payment or have any attaching spouse's pension or guarantee period.

An explanation of the hurdle rate is shown in report immediately above the critical yield and hurdle rate table.

How is it calculated?

The hurdle rate is calculated by taking the projected scheme pension at retirement age at the mid-rate of return and calculating the capitalised value of this pension based on a level, single life annuity with no guarantee period. The hurdle rate is the corresponding rate of growth required in an individual plan to achieve a fund value that is equal to this capitalised value, allowing for product charges etc.

How can it be used?

Using an example of a case where the Critical Yield is 7% but the hurdle rate is 2%:

1 – To highlight the value of the existing scheme's escalation and spouse's pension

This demonstrates to the client the value of all the extra benefits they would be giving up within the scheme on top of the pure nominal starting pension. Effectively, the value of the extra benefits is the equivalent of an extra 5% per annum in growth. Therefore, these benefits are very valuable.

2 – To help discuss the implications of reshaping of benefits

If a member is single, with no dependants and maybe has a shorter life expectancy, the spouse's benefits in the scheme and the effect of inflation might not be of importance to them. In these circumstances, most individuals would consider opting for a single life, level pension. Therefore, although the 7% growth rate would reflect the full value of the benefits they would be giving up in the scheme, if this were not achieved, anything above 2% would provide a level of benefit at least equal to the pension in the existing scheme at the point of retirement. The greater the improvement on 2% that is achieved, the more options they would have to increase their starting pension above that of the existing scheme.

3 – To help quantify capacity for loss

The difference between the Critical Yield and Hurdle Rate provides a basis for discussing capacity for loss in a quantitative manner. If the client were to transfer, and did not achieve the 7% growth rate, they would be able to achieve at least a level pension equal to the projected retirement pension in the scheme, provided they achieved at least 2% per annum growth.
The adviser can use this to help their client evaluate the effects of not achieving the required growth and how this would affect their future retirement planning needs.

These are just three examples of ways the hurdle rate can be used to enhance the advice given, depending on the member's needs and circumstances.

Further Considerations

As the hurdle rate is based on starting pension, any future adjustments such as step ups at GMP age, temporary pensions that start after retirement age etc. will not be taken into account.

In contrast to this, if there is a temporary pension which starts at retirement age but ceases after a short period, the hurdle rate would not take into the account the fact that the temporary pension ceases and therefore, could potentially be higher than the Critical Yield.

By looking at the Pension Projection graphs, it can be seen whether the existing scheme benefits include a step up or temporary pension.