The Defined Benefit to Defined Contribution transfer dilemma

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One area of financial planning that has historically caused a fair degree of anxiety amongst advisers, is what to do with deferred members of private sector Defined Benefit (DB) pension schemes. That angst will be exacerbated by the fact the new pension freedoms and choices of the defined contribution (DC) world have not been extended to the DB world.

This can only put advisers in a difficult position as clients (there are 5.1 million* deferred members of private sector DB schemes in the UK), start to question how they can access these freedoms with their DB pots.

So what will you do?

Well it is unquestionably an advice opportunity but is it a welcome one? There are several considerations that need to be addressed before a decision to transfer or not should be made. This article will look at some of these and hopefully help in your discussions with clients.

Transfer drivers

Regulations require an adviser to have permissions to transact DB to DC transfers and a TVAS (Transfer Value Analysis System) report is required in most cases. Many of the considerations we examine below are included within a TVAS report.

From a Regulator’s perspective the ‘starting point’ in the advice process has always been that it will not be in the best interests of a client to transfer out of a DB scheme. PS 12/8 makes that clear. In addition to this is the need to achieve an ‘acceptable’ Critical Yield (CY) on a transfer out.

For those not familiar with DB to DC transfers, in broad terms, the CY is the annual return required (after charges), the receiving scheme, let’s say a personal pension, needs to achieve to match the ceding scheme benefits. This yield assumes an annuity is purchased at point of retirement and is calculated using assumptions regarding CPI/RPI/NAE and annuity interest rates issued each 6 April by the FCA.
However, when initial guidance was issued on DB transfers, we lived in a different world. We did not have freedom and choice. And the likelihood of anyone today transferring out of a DB scheme to purchase an annuity at retirement appears remote. It is much more likely the reason for transferring is any one of, or a combination of, those drivers in the previous graphic.

So let’s look at these drivers in more detail starting with spouse and health, together with lump sum death benefits. Why are these important? Well in most cases a transfer value (TV) issued by a scheme will include the provision for a dependant spouse/partner or children or both. This results in a higher TV than where there is only provision for a member pension.

If there is no spouse or partner then a client may prefer to look at replacing the scheme pension with a single life income stream that is likely to be higher (always remembering that the scheme pension has an underlying ‘promise to pay’) whereas unless an annuity is purchased by the TV, the income stream on transfer is unlikely to have such a promise.

Where there is a spouse, another consideration is that of the form of any death benefits. This will vary depending on whether death occurs during the deferral period or once the member retires. If we take during deferral first, it may be that the scheme only pays a spouses pension, typically 50% or 66.67% of the member’s pension.

Any lump sum death benefits may only be a ‘return of the members contributions’ with or without interest. It could be that the surviving spouse already has adequate income provision and a lump sum (tax free), would be more attractive. By transferring to a personal pension the options are open either to take an income stream or to take the entire fund as a tax-free lump sum (as shown in the following diagram), or indeed a combination of both.

**Death Benefit Comparison**

The previous diagram assumes a growth rate of 5% net investment return, interest at 2.9% and converting partners pension into a capital value.

The example shows the capital value of the death benefits of a £537,000 TV on day 1 and at year 10. It shows the death benefit payable from the scheme and from a personal pension on transfer. In this case on the day of the transfer, the scheme is providing income only, albeit for the life of the dependant spouse, of £14,000 per annum.

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The personal pension on the other hand could provide either a tax free lump sum of £526,000 (the TV less an adviser charge), or potential for income and ad hoc lump sums. As we move to year 10 the fund value of the personal pension is now £760,000 versus a pension of £17,000 per annum from the scheme. Which of the two options best meets the clients objectives? Taking this on a stage, is the potential or otherwise, for each option to help with estate planning. DB schemes have been left well behind in this area of planning. The advent of dependent, nominee and survivor drawdown options in the DC world and the ability to tailor withdrawals through retirement to plan for a legacy makes a transfer out of a scheme much more attractive than previously.

The health of the client
This can also be important particularly in retirement and where there is no surviving spouse. Should the client not be in good health, would it be in the best interest of any children (adult or otherwise), for continuity of the pension after the member’s death? A transfer out to a personal pension could ensure the fund is retained by the family and be used either for income or be taken as a lump sum as opposed to the ‘value’ being retained by the scheme.

Tax-free cash (TFC)
The following diagram shows the difference between the scheme and the transfer option. The numbers speak for themselves and a consideration for the adviser here is the cash commutation option offered by the ceding scheme. In this case (same TV as above of £531,000), the factor was 12:1, meaning for every £12 of TFC taken, £1 per annum of pension needs to be given up. This is not a particularly generous factor and some schemes do offer factors in excess of 20:1. For some clients who want to maximise TFC the reduction in the annual pension could be significant. As you can see the TFC available on transfer is much greater.

Tax-Free Lump Sum Comparison

Option 1 Age 60
Income (no TFC): £26,000
Critical Yield (CY): 5.5%
Income (after TFC): £137,000
CY: 5.2%

Option 2 Age 55
Income (no TFC): £20,000
CY: 6.6%
Income (after TFC): £108,000
CY: 6.2%

Option 3*
TFC 25% of the transfer fund at age 55
TFC £187,000
*Fund Value (FV) at 55 £747,000

Option 4*
TFC 25% of the transfer fund at age 60
*FV at 60 £954,000

The above chart is based on 5% net investment returns.
One factor sometimes given little consideration when looking at DB scheme benefits is that of the financial stability of the sponsoring employer. This can be established by obtaining at a cost, a report. This should indicate whether or not employer stability could be an issue.

Why is it important? Well if a DB scheme is underfunded and the employer becomes insolvent, the Pension Protection Fund (PPF), the compensation scheme set up by government, will consider taking over the liabilities of the scheme. The level of compensation paid is dependent on the individual employee. If already drawing benefits, they will receive 100% of their scheme pension. If still in deferment, broadly, this is reduced to 90% of their entitlement.

The PPF7800 index, published monthly by the PPF shows in August 2015, of the 6057 schemes in the PPF universe, 4,998 were in deficit and 1059 in surplus. Total deficits were around £280 billion. These numbers bring to light the need to be aware of the employers financial condition. Remember though, if the employer is on a sound footing the deficit of the scheme is not relevant as the employer will have a plan to put the scheme’s funding level back on track. A TVAS report will indicate the yield required to match a pension from the PPF. This yield can be significantly lower than the yield to meet the scheme benefits as not only is the pension potentially lower at retirement but part of that pension (that accrued pre 6/4/1997), does not increase in payment.

**Investment flexibility**

The scheme’s investment strategy is determined by the Trustees along with their advisers so no influence can be exerted by individual members. Where a deferred scheme member say has their own business, a transfer to a SIPP could help with commercial property purchase, with the company paying rent to the SIPP rather than to a third party landlord. Or indeed where the directors already personally own the property using a SIPP to buy the property could free up capital for the directors. This is a complicated area with issues around capital gains tax and various business and retirement reliefs that need to be considered never mind the risks of investing large amounts of a pension fund into a single illiquid asset class. For some clients though, being able to use transfer monies in this way could be a major influencing factor.

In summary

So where does this bring us? Like most areas of financial planning this is not easy and the transfer drivers referred to along with others, need careful consideration before any transfer is made or indeed before a decision not to transfer. The paradox of the critical yield is still with us and needs to be considered alongside client objectives, their attitude to risk, their capacity for loss and their willingness to swap a promise of a pension for life for one potentially subject to market variations but which comes with all the new freedoms that are so attractive to clients today. The DB to DC dilemma is not going to go away any time soon.