Edison Wealth Management

Defined Benefit Pensions – Should I stay, or should I go?

"Should I Stay, or Should I Go", so sang The Clash. It's unlikely that Defined Benefit (DB) pensions were the inspiration for the number 1 hit in 1981, but the song title encapsulates perfectly the dilemma facing DB pension savers.

In the period between April 2017 and March 2018 a total of £14.3 billion was transferred out of DB pension schemes*. The significant increase has been accompanied with a rise in the number of complaints lodged with the Financial Ombudsman. Although complaints relating to the suitability of pension transfer advice remain relatively low (approximately 2% of all complaints) some well reported cases, such as that of British Steel, remind us that this area of advice is complex and not risk free.

The starting position of the Financial Conduct Authority (FCA) is that for most people, retaining their DB pension benefits is likely to provide the most favourable retirement outcome.

This briefing note, therefore, considers some of the reasons why it could be suitable to transfer benefits from a DB pension to a defined contribution (DC) pension.

Defined benefit pensions – a short explanation

DB pensions are occupational pension schemes set up by an individual's current or former employer. They are effectively a promise from the employer to pay a specified pension income (and possibly an initial lump sum) from a certain age. The level of income is calculated using a formula applied to the individual's earnings history. They are often referred to as final salary schemes.

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These schemes are particularly valuable as they provide a secure index-linked income for life. Usually they include ongoing spousal income (sometimes up to 75% per cent) from the death of the pension holder. These promises are expensive and, in many cases, unaffordable for employers. Occasionally pension trustees and sponsoring employers look to reduce their pension liabilities. They offer members the opportunity to take a Cash Equivalent Transfer Value (CETV) in exchange for giving up future pension benefits. If accepted, the CETV can be transferred to a DC pension such as a personal pension or a Self Invested Personal Pension (SIPP).

So why are so many people tempted to give up this guaranteed income for life?

The pension freedoms introduced in 2015 provides a partial explanation. These 'freedoms' give individuals much greater control over how they may access their pension savings and how those savings are ultimately used. These freedoms, however, are generally only available to those who have DC pension savings.

High Cash Equivalent Transfer values

Over recent years CETVs have been particularly high. The CETV is an actuary's best estimate of the amount of money that would be needed to 'buy-out' the member's pension benefits. It's based on the likely return that could be expected from the scheme assets. Many DB schemes have switched to lower-risk investments, for example, Gilts. The expected return on Gilts has been low, which means a higher return would be needed to pay the pension, which in turn results in a greater transfer value. In some cases, transfer values have been 40 times greater than the pension given up.

To put that into context, the government uses only a 20 times multiple to give DB pension income a capital value to test against the lifetime allowance.

Can giving up secure income ever be sensible?

The short answer to this question is it could be, but it would depend on the individual's circumstances and objectives.
It's complicated. So much so that if the CETV is greater than £30,000 qualified advice has to be sought before proceeding with a transfer. This advice must be provided by, or at least checked by, a specially-qualified pension transfer specialist

Advisers are required by the FCA to present to the member how the CETV compares with the value of the pension potentially being given up, or in other words comparing how much income the CETV could purchase through an annuity. This calculation on its own, however, would rarely lead to a definitive answer and the individual's personal circumstances and objectives would also need to be considered.

Some reasons why a member may wish to consider a transfer, could include:

Flexibility

With a fixed retirement age DB pensions do not offer much flexibility.

It is possible to access DB pension savings before the normal retirement age, but generally it results in lower pension income.

DC pension savers can generally access their pension savings from age 55, which offers opportunities for planning around personal circumstances. It is then the individual's responsibility to ensure their pension(s) can sustain their spending for as long as necessary.

Potentially greater tax-free cash

Most DC pensions allow for up 25% of the value to be taken as a tax-free cash lump sum. The remainder is taken as income.

In a DB pension, this usually means a cash lump sum plus a lower regular pension income.

The value of the tax-free cash lump sum is usually less than a quarter of the capital value of the pension. Schemes have varying rules over how the pension given up is converted into a lump sum and in some circumstances, these can be ungenerous.

If tax free cash is particularly important, there are advantages to transferring benefits out.

Inheritance

Under a DB pension, when the member dies there is usually a pension for the surviving spouse and perhaps some pension provision for any surviving dependents, for example, children in full time education.

This usually means that when the member (and their spouse) dies, the pension dies with them, so there is nothing left to pass on.

Under a DC pension, the fund value can be passed onto beneficiaries of the member's choosing. If death occurs before age 75, the fund value can be passed on free of tax. If death occurs over age 75, the beneficiary would only have to pay income tax on any withdrawals taken. If the original beneficiary doesn't require access to the pension, it can currently be passed onto subsequent generations.

That said, if leaving a legacy is an important objective, then it may be appropriate to consider a life insurance policy as an alternative to giving up a guaranteed income for life.

Health

DB pensions work much like insurance in that they pool risk between all the members and in effect those who live the longest are subsidised by those who do not.

Individuals with below average life expectancy will benefit less from the pension than those with longer life expectancy.

A CETV loosely assumes the individual will achieve average life expectancy, it can be 'generous' to those who will not.

In a receiving DC pension plan the member could invest the funds with a view to any residual pension being paid to their beneficiaries on death. That way, the benefits have been preserved to some extent for future generations.

Alternatively, it may be possible to use the CETV to purchase an enhanced annuity. This would provide an income for life but would consider the member's health and likelihood of dying prematurely and could provide a greater income than the original DB pension.

The caveat is that if the member was in ill-health at the time of the transfer there could be IHT consequences if they died within two years.

The financial strength of the sponsoring employer

If the sponsoring employer is at risk of becoming insolvent, there could be a chance that the individual may not get all the pension they were expecting. In contrast, those with DC pension benefits are unaffected by what subsequently happens to their employer (current or former).

If the sponsoring employer becomes insolvent and there are insufficient assets within the scheme to pay all of its future promises, the scheme would be transferred to the Pension Protection Fund (PPF).

For anyone who has not reached the scheme's normal retirement age, the PPF would only pay 90% of what their pension is worth at that time. The annual compensation is currently capped at £40,020 (£36,018 when 90% cap is applied) for someone at age 65 but varies by age and length of service.

Where the member suspects that an employer may be in financial difficulties, which would put their benefits at risk, a transfer could be an option.

Summary

Advising on DB transfers is a complex area of advice. This is by no means an exhaustive list of factors that will play a part. Depending on the individual's circumstances, some factors will be weighted above others.

Any potential advantages of transferring a DB scheme must be considered in context. The ability to pass on benefits to future generations will mean taking on more investment risk. Access to pension funds sooner or as a lump sum will mean potentially losing longevity of pension income or triggering additional tax charges.

Ultimately, the benefits must be clear and quantifiable for an individual to irreversibly give up secure inflation-adjusted income.

Seeking advice

Firms have different charging options, but a recent FCA consultation paper** suggested that suitable DB scheme transfer advice would take c. 20 hours to complete. Based on a hourly rate of £250 + VAT, this would suggest a cost of £5,000 + VAT.

It is important to seek advice from a qualified Pension Transfer Specialist and even then, many will only provide pension transfer advice to existing clients.

Individuals should also be prepared to go through a comprehensive financial planning exercise, without which the advice would be inherently risky. The adviser will want detailed information on circumstances and future needs.

How we can help

At Edison, our Pension Transfer Specialists are qualified to advise on this complex area of advice.

Any questions about the content of this Insight piece, please call or email. We will be happy to provide further information or discuss how it may apply to you.

To contact us, do not hesitate to call on 0207 287 225 or by email (help@edisonwm.com).

You can read this Briefing Note on our website. To download it or view other updates please visit our Insights page.

Important Information

The above is a simplification of the legislation. It does not constitute advice. The views expressed above are subject to changes in legislation. The Financial Conduct Authority does not regulate tax advice.

* Source: The Pensions Regulator

**Source: FCA Consultation Paper CP19/25, July 2019

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