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Transferring Your Defined Benefits Pension Scheme

An Overview of the Considerations, Options and Key Factors

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Introduction

In 2015 the Government introduced legislation which changed how those saving for retirement could take their pension benefits. This is now commonly referred to as Pension Freedom.

The changes were targeted at **Defined Contribution (DC) schemes**, such as personal pensions and stakeholder pensions.

The changes did **not** apply to **Defined Benefit (DB) schemes**, such as final salary pension schemes.

This has led to many people who have DB schemes considering whether they should transfer their benefits to a DC scheme to access Pension Freedoms.

This guide explains more about the option to transfer and considers the key factors.

Transferring away from a DB scheme is a complex, irreversible decision that requires specialist qualified financial advice.

According to the Financial Conduct Authority the starting point for such a decision is to remain within the scheme and retain the guarantees it provides. This is on the basis that the pension has been built up specifically to provide an income to you for life and possibly your partner if they survive you. Therefore, a final decision to transfer should only ever be made once all factors, the advantages and disadvantages, plus the risks involved have been properly explored and understood.

Flexibility

In the context of this guide we are considering a transfer from a DB scheme to a DC scheme, in this case the main reason will normally be to access the Pension Freedom offered by a DC scheme.

The Pension Freedom rules allow for considerable flexibility and several options around how and when benefits may be drawn upon. These include:

- Taking all the benefits in one go, on one day
- Taking a tax-free cash sum of 25% upfront and then flexibly drawing income as and when required thereafter
- Taking amounts of tax-free cash (25% of the total pension fund value) in stages, and amounts of taxable income to create a highly flexible, tax efficient income stream

You can control how and when you take your benefits and this could play a role if your retirement is gradual or you have a certain tax position that you wish to manage.

A DB scheme does not have this flexibility and, normally, requires you to take a set income payable for the rest of your life.

You need to consider if you can really benefit from these options for this element of your retirement income. If you have other DC schemes you can use them to provide flexibility whilst using the DB scheme to maintain a guaranteed income for life.

If you are considering taking a higher income initially than the DB scheme provides you will need to understand the impact this may have later, maybe at a time when guaranteed income is more important.

For example, you may be considering a transfer as your scheme starts paying income at age 60 but you intend to carry on working and do not need the income.

You should be aware that it may be possible to defer taking the DB income but if not, you can take the income and save it.

Tax-Free Cash

Your DB scheme is most likely to offer a tax-free cash sum when you start to draw upon your pension, followed by an income for life.

The way the tax-free cash sum is calculated in a DB scheme is different to that of a DC scheme.

This means it could be less and this could have an impact, both in terms of a ‘bird in the hand’ and in terms of tax planning and tax efficiency.

You would need to assess the comparative levels of tax-free cash and the impact based on your own circumstances. An adviser can assist you with this.

Death Benefits

The rules are very different for a DB scheme and a DC scheme when it comes to how pensions are paid out on death.

The DC scheme allows for the full fund value that remains in place on death to be paid out. Before age 75, this is totally free of tax, after age 75 it is paid to beneficiaries with tax deducted, based on ***their*** marginal rate of tax.

A DB scheme will commonly offer a death benefit in the form of an ongoing pension to your spouse or surviving partner, usually a percentage of your income. This could be immaterial if they have pre-deceased you.

It is easy to see the 'transfer value' of the DB scheme as giving a significantly higher death benefit, which can also be more tax efficient. Whilst this may be the case if you die immediately after a transfer, what will be the position after you have survived many years and used the pension to maintain your own standard of living?

It is an over-simplification, but in some ways the DC scheme and the Pension Freedom rules mean that your pension fund can pass onto later generations, whereas the DB scheme does not allow for this, at least not in the same way. This may be a benefit if you have plenty of capital and other income to live on.

It is important not to ignore the role that life assurance can play in providing for your family so, it is important to take advice.

Transfer Value Amount

When you request a transfer value from a DB scheme, you may consider the amount offered is generous as it is a significant multiple of the income you would receive. This can happen when interest rates are low (as they are now, based on historical levels).

The reason for this is down to the way DB schemes manage their pensions for their members. To provide for the guaranteed lifetime pensions they offer, the scheme trustees will have to ensure they invest in low risk income producing assets, such as long-term government gilts.

The yield on gilts tends to be low when interest rates are low. Therefore, the equivalent value, when converted to a transfer value a sum sufficient to match the value to the scheme trustees can often be very high.

A qualified adviser will assess the transfer value and advise you accordingly. The analysis will consider how the guaranteed income may change in future and compare this against future growth assumptions.

Loss of Guarantees

Most DB schemes have valuable guarantees attached to them. **You will lose these guarantees if you transfer to a DC scheme.**

The DB scheme will provide you with an income for life and the income should also increase each year. The 'income for life' factor is especially important if you live a long time as the income will keep paying year after year.

The contrast is that a DC scheme has no such guarantee and it is entirely possible – if things don't go according to plan – that you could run out of money and income.

The increase on the income payable from a DB scheme each year is important to provide an element of protection against inflation and the cost of living. A DC scheme has no such protection.

Professional advice is required to consider how different factors could affect your position.

Personal Responsibility

Although the idea of managing and controlling your own pension (if you transfer) may seem attractive, it is worth noting that you have shifted the responsibility of investment decisions and all other aspects of managing your pension income from the DB scheme trustees to yourself.

Even when you use an adviser to help you with investment decisions, you have taken the responsibility onto your own shoulders.

The consequences in the longer-term of these decisions rests with you, and as stated above, there is no going back once you have committed to this pathway.

The future of investment returns, interest rates, inflation, government policy and wider world economic and social factors are all uncertain, especially over several decades, so this factor may be more important than it first seems.

The section below deals with investment risk but an adviser will be able to draw attention to all the issues you need to consider.

Investment Risk

Transferring to a DC scheme will mean that in many instances your pension will remain invested for a long time to come and you will need to generate a certain return on this to justify the transfer decision, from an investment perspective.

These returns may not be forthcoming, or you may find your capital loses value.

Whatever your plans for your pension pot you will be exposed to the economic factors that can impact fund values and performance. These responsibilities currently fall upon the scheme and the trustees and managers running the scheme.

Any advice will consider your knowledge and experience in investing and your desire to take on risk which will impact on the portfolio recommended.

Scheme Solvency.

All DB schemes are required to have assets to meet their pension liabilities. Some schemes are underfunded, which means they may not have the funds in place to meet these. They should have plans in place with the sponsoring employer to build up the funds to an adequate level. However, there are cases where such funding ceases and this may lead to the scheme being unable to pay out benefits in the future (including your pension entitlement).

There is protection against this happening from The Pension Protection Fund. However, benefits payable from this may not be as high and can be subject to limits and restrictions.

It is worth checking both the solvency position of your DB scheme and what you could expect to be paid if the scheme defaulted and your pension became payable from The Pension Protection Fund. An adviser can explain the impact on your own circumstances.

Your Health.

If you are in poor health, you will need to consider how differing schemes will impact you.

As your DB pension is a function of what you earned whilst in the firm’s employment, it bears no resemblance to your life expectancy. However, you will need to identify if the scheme will enhance benefits if you are suffering from serious ill health which means your life expectancy is shorter than average.

A DC scheme will allow you to consider an enhanced annuity which means you can increment your pension income level above the norm, based on your shorter life expectancy. Advice can help you compare the options, bearing in mind you may have a need to provide for a surviving partner.

Other Potentially Relevant Factors

No two situations are the same and it could be that you have **special factors** applying to your financial position, your family position or longer-term goals which could make it beneficial to transfer, based on your unique set of circumstances.

An example may be where you are in a second marriage, have children from a previous marriage and your long-term legacy wishes cannot be properly met by the DB scheme.

Or you have two very good DB schemes and want to balance between the benefits of a DB Scheme and a DC Scheme, so transferring one of the two works for you.

Personal circumstances, including your wishes for the future, could make a big difference to a transfer assessment.

The Reasons Why a Transfer May Be a Bad Idea

If you are likely to be affected by **The Lifetime Allowance (LTA)**, then a transfer from a DB scheme to a DC scheme may be a very bad idea. This is slightly technical, but in simple terms, the LTA in 2021/2022 is £1,107,100 and under current legislation will remain at this until April 2026.

Once your pension funds start to exceed this amount, you will be subject to tax penalties. This figure does not apply to DB schemes.

DB schemes are subject to an LTA but calculated differently as a multiple of the pension, plus the tax-free cash sum.

This calculation can produce a comparative figure which is effectively higher than the equivalent DB figure. The LTA could be a big factor for those close to or above this level of pension.

A further consideration is the **pension and lifetime income requirements of your dependents**.

DB schemes will commonly offer the guaranteed income beyond your own lifetime, and in some cases for a minimum period. The income amount may reduce on your death (e.g. to 50% of its previous value) but this lower amount will remain guaranteed for your dependent's lifetime.

This extended guarantee could be of great value to your spouse, civil partner or to your children, if the scheme provides for this.

How to Balance Out the Factors

Earlier, we stressed how unique each transfer position and assessment will be. This means it is important to judge each situation on its own merits.

It is also crucial to weigh up **all** relevant factors, which can include a great deal more than the details of the pension scheme. For example, your legacy wishes and what you want to happen after you die, are very important parts of assessing the transfer option.

The comparison between a DB pension and a DC pension requires consideration of many factors and possible future scenarios.

The basic difference of a guaranteed income DB scheme and its certainties versus the less certain, non-guaranteed benefits from a DC Scheme, but with greater freedom and flexibility, is a classic case of comparing apples and oranges.

The decision must be a carefully considered approach to evaluating the relative importance of each factor, both financial and lifestyle, combined with a skilled risk assessment.

Working with an experienced adviser will help you to work out what the most important aspects are and how to measure these against each other.

The Advice Process

Advice is crucial and working with an expert in this field should help you understand your position clearly. This will help you with any decision to transfer.

Once you transfer there is no going back so the risks you are taking must be fully understood.

The advice process will consider all relevant information about your existing DB scheme and your adviser can, if necessary, ask for more - if anything is unclear or needs further exploration.

They can then use this information, including the transfer value offered, to produce an Appropriate Transfer Value Analysis, a Transfer Value Comparator and overall assessment of whether a transfer is in your best interests.

A written report will then be prepared which will outline everything you need to know and the risks involved.

Your adviser will also discuss with you your overall financial position including your retirement and legacy wishes.

About Us

Heritage Independent Financial Consultancy was set up in November 2000 by Principal Jonathan Hutchins. A family-run business that has, over the past 23 years grown organically and now carefully manages the needs of a large client bank. Each advisor has their own area of specialty.

Based in Taunton in Somerset but covering the whole of the South West and further afield, Heritage prides itself on offering a service second to none and one which encompasses all areas of Financial Services including will writing, powers of attorney and close links with preferred Estate Agents and solicitor companies.

Being independent we will look after your personal interests. With access to the entire financial market, we can search thousands of options to find the most suitable products and services for you.

If you are thinking about creating and putting your financial plan into action, we may consider things you've not. Why not talk it through with us today?

Contact Us

Heritage Independent Financial Consultancy Ltd
1 Scott House
Cook Way
Bindon Road
Taunton
Somerset TA2 6BG

Tel: 01823 322222

Web: www.heritage-ifc.com

Email: info@heritageifc.co.uk

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