Cantab
ASSET MANAGEMENT

To Transfer or not to Transfer?

Many employees have, over their working life, built up a considerable entitlement to a "defined benefit" (DB) pension. There are several key differences with personal pension arrangements, also known as "defined contribution" (DC) schemes. A DB pension commits to paying the employee a defined amount each year in retirement for their lifetime, normally based on an employee's final salary at retirement or their career average earnings, and their length of service to the company. In a DC scheme, the level of income is not guaranteed, but each individual builds up their own fund, which can then be used to provide income in retirement, either by withdrawals or purchasing an annuity.

Receiving an annual pension on retirement is not the only way to benefit from a DB pension entitlement, and indeed may not be the best way in light of recent changes in taxation and pension regulation.

It is possible to transfer out of most private sector defined benefit pension schemes, provided that you are not within twelve months of the scheme's normal retirement age. "Unfunded" public sector schemes, such as the NHS or Civil Service schemes, do not offer the possibility to transfer. In transferring, the employee will give up their right to a secure future income under the DB scheme and receive a cash transfer into a personal pension scheme. The cash value is based on the expected cost of providing the member's future benefits within the DB scheme. In practice, the value is closely linked to gilt yields. With these being very low at present, the transfer values on offer have risen, and the interest in DB transfers has grown. However, a transfer from a DB to a DC pension is irrevocable and your decision should not be made lightly. We highlight five potential advantages and risks of transferring out of a DB pension:

Potential Advantages

By transferring to a DC scheme, you can access funds as needed in retirement, giving flexibility to meet your spending needs. You may also be able to start taking your pension earlier, as DB schemes normally have a set pension age, often 60 or 65, with penalties if you access your pension early.

A DC scheme offers the potential for higher income if investment returns are strong. When comparing the potential benefits, the transfer value should not be considered in isolation, but in conjunction with the proposed investment strategy, and the risk you are willing and able to take.

Many DB schemes provide an initial tax-free cash lump sum in return for the member giving up ("commuting") some of their annual pension income, according to the scheme rules. Transferring out may offer the potential for a higher tax-free cash lump sum.

A DC scheme may offer the potential for a greater legacy to be paid to your dependents. The benefits offered on the death of a DB scheme member are often limited. A 50% spouse's pension is common, and unmarried couples may receive nothing. In addition, if you are not in good health, an income for life from a DB pension scheme might be less valuable. In a DC scheme, death benefits can normally be paid to a wider class of beneficiaries. However, arranging life assurance could replicate the death benefits under a DC scheme and retain the income security of the DB pension.

If a firm backing a DB pension scheme becomes insolvent, and the pension fund does not have enough money to meet its liabilities, the scheme will be transferred to the Pension Protection Fund (PPF). The PPF provides some protection for members, but you may not receive the full value of your pension. Those under the scheme's normal pension age would

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generally receive 90% of their pension, subject to a cap. Those who have built up large pension entitlements in a DB scheme could see a significant reduction in pension income. A transfer to a DC scheme avoids this risk.

Risks

A DB scheme offers a guaranteed income for your lifetime. By contrast, if you transfer your pension to a DC scheme, it is impossible to know with any certainty what level of income can be safely drawn without running out of money within your lifetime. On the other hand, if income is withdrawn overly cautiously from a DC pension, you may not enjoy the full benefits of your retirement savings.

Transferring out of a DB pension scheme transfers responsibility for the investment risk from the former employer onto the individual. A market downturn can have a substantial effect on your future ability to draw income, particularly if it occurs in the early years of drawing from the pension. High levels of income withdrawals are unlikely to be sustainable.

DB pensions normally include an annual increase, which helps to mitigate the impact of inflation. The level of such increases will depend on the scheme but there is a statutory minimum level. Investment returns within a DC scheme may exceed inflation, but protection against rising inflation would not be guaranteed in the same way. It would be possible to insure against inflation rises by buying an inflation-linked annuity, but these currently offer poor value and are unlikely to match the DB pension rights that were given up.

Most DB pension schemes will have good benefits. This will often include a 50% spouse pension upon death, which will be revalued to help keep the benefits in-line with inflation. Death benefits in payment may also be offered, if the scheme member dies within 5 years of taking benefits. Some DB scheme members may also be entitled to a tax-free cash lump sum higher than the standard 25%. These DB benefits will not be available if transferred to a DC pension.

Due to the increase in transfer values, a DB transfer could in some cases be treated as relevant benefit accrual, thereby resulting in the loss of Enhanced Protection or Fixed Protection in respect of the Lifetime Allowance. This could lead to a large unexpected tax charge at retirement. More generally, DC and DB schemes are treated very differently for the Lifetime Allowance rules. For those close to the limits, DB schemes are often treated more advantageously. However, the ability to take benefits earlier from a DC scheme may be advantageous for some.

Reviewing your Options

Partial transfers are also permissible, which may allow a balance to be struck between the benefits of DB and DC schemes. It is important to note that transfer values are normally only guaranteed for 3 months from the date of calculation. This may seem like plenty of time, but there are many things to consider and there is no statutory right to request a new value within 12 months.

In conclusion, now could be a good time to review your defined benefit pension. The importance and complexity of the decision highlights the need for proper analysis and good advice. *Cantab Asset Management reviews defined benefit pensions and is authorised to conduct defined benefit transfers.*

Please contact our Team on 020 3651 0570 (London) or 01223 52 2000 (Cambridge) to discuss in more detail or email advice@cantabam.com.

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