AWFM Fact File

"Defined Benefit Pension Transfer Overview"

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Every financial decision is personal, and you want to "get it right", but when it comes to "taking my pension" there is now so much to consider. The 'Pension Freedom' legislation has brought with it a myriad of choices and options, some of which were never a consideration before; for example, where should I take my income from, as it is not just your pension that might be the right choice. There are now so many other potential issues, not least of which is tax, that needs to be considered. This Fact-File specifically deals with issues around Defined Benefits Pension Transfers as a generic guide to what is a highly complex issue (hence the length of this document).

There is a lot of technical information in this guide and we have sought, where possible, to provide a straightforward explanation to complex products. All information contained within this document is based on current legislation, which may change in the future.

1. What is a Defined Benefit Pension Scheme?

A defined benefit (DB) pension is one type of workplace pension scheme.

It is a type of pension plan in which an employer promises a specified pension payment, lump sum (or a combination of both) on retirement. The payable benefits are predetermined using several factors, typically including: an employee's earnings history, tenure of service and age, as opposed to relying directly on individual investment returns. This type of pension scheme is also commonly known as a 'final salary' scheme. A typical DB pension scheme usually continues to pay a pension to your spouse, civil partner or dependents (for a restricted period) when you die.

It is important to understand that whilst the pension is set up by your employer, it is not their money. It is held separately, normally by trustees in a trust on behalf of the members. The employer's responsibility is to ensure that there is enough money within the scheme to meet the promised benefits. The trustees will invest the money with professional fund managers in a wide variety of investments with the aim of ensuring that the promised benefits will be able to be paid to you. DB pensions do not always work as they should. News stories in the recent past regarding the British Steel, BHS and House of Fraser, schemes reveal the common theme in each of these cases was that the employer standing behind the pension was unable to meets its financial commitments. Individuals did not "lose their pensions" but will probably have suffered a period of worry over what they would get, and their retirement income will almost certainly be lower than it would otherwise have been. This is where the Pension Protection Fund (PPF) comes into play – see point 7 below.

2. Transferring from a Defined Benefit Pension Scheme

Our regulator, the Financial Conduct Authority (FCA), is clear that we should start by assuming that a transfer would not be expected to be suitable.

You cannot transfer from a DB pension scheme if you are already taking your pension. There are also some types of DB pension schemes where transfers are not usually possible, for example, public sector schemes for teachers, nurses, emergency services, military and civil servants. However, individuals in the Local Government Pension Scheme can transfer if they wish.

If your DB pension is valued at more than £30,000, you will be required to seek financial advice.

Once you stop working for the company behind your DB pension scheme, the benefits you've built up still belong to you and they can remain there, and (for the most part) will be revalued to take into account inflation, until you retire, or you transfer them to a different type of pension scheme. Retirement benefits options would then be:

- Wait until the scheme's designated pension age and draw the benefits (probably tax free cash and taxable pension income) from the scheme.
- Ask the scheme administrators for early retirement benefits if you have reached at least the age of 55.
- If you have transferred the fund and have reached age 55 and want access to your pension fund; a flexi-access drawdown account will allow some or all of the benefits to be taken (either in lump sums or as regular income) and the rest, remain invested.
- If you have reached age 55 and want to access your pension fund by purchasing an annuity (guaranteed income for life) you must still transfer to a personal pension plan to enable the purchase of the annuity.

Most DB pension schemes will allow you to transfer the pension you have built up to another pension scheme which could commonly be either:

- Your current employer's workplace pension scheme
- A stakeholder pension scheme (SHP)
- A personal pension scheme (PPP)
- A self-invested personal pension (SIPP)

You can normally transfer your DB pension benefits only after you have stopped building up benefits in the scheme. You have a statutory right to request a transfer at any time up until you are within 12 months of the DB scheme normal retirement age (NRA), the date when you would be expected to start taking retirement benefits under the DB pension scheme, typically somewhere between age 60 and 65.

If you are considering a transfer, the first step will be to request your cash equivalent transfer value (CETV), also known as the transfer value. Some schemes provide an estimated CETV on an ongoing basis. The formal CETV is only guaranteed for three-months from the date it is issued. Schemes are obliged to provide only one CETV free of charge in a year, so if you have already requested a CETV and we have to request a more up to date one you may incur an additional charge. If the transfer process is not complete within the three-month period, the actual amount transferred may be higher or lower than the amount shown in the Statement of Entitlement.

The scheme administrator will provide you with a Statement of Entitlement. If you are eligible for a CETV this must be provided within three months of requesting a transfer value. It's a written document that sets out your transfer value, together with details of the benefits you have built up under the scheme, and information that your new pension scheme administrator will need, if you decide to proceed with the transfer.

If you decide to transfer to a new pension scheme, the DB pension scheme administrator must pay the benefits across to the new pension scheme within six months from the start of the transfer process.

2.1 Points to Consider

It is worth thinking about the following:

- Your DB pension scheme may offer a *partial* transfer, so depending on your specific objectives and needs, and if allowed, you may not need to transfer the whole of your benefits.
- Your DB pension scheme will pay benefits not only to you, but if you are married or in a civil partnership (or even sometimes if you are co-habituating as a couple) will continue

to pay pension benefits after you die to your surviving partner. Therefore, if this is relevant to you, any decision you make could affect them, so it is recommended that you discuss your intentions with them first.
- Sometime DB pensions schemes and the employer funding them will offer exercises whereby they will offer:
  - To pay for financial advice as to whether you would benefit from transferring out of the DB pension scheme, or
  - Offer to pay an increased or enhanced transfer value as an encouragement for you to transfer your DB pension out of their scheme.
- You might well ask why would an employer do this? In simple terms, a DB pension scheme is an unknown financial commitment or liability that is “on the company’s balance sheet” and it is potentially in their interests to encourage individuals to transfer out.

3. Advantages and Disadvantages of a DB Pension Scheme

As with any decision, there are pros and cons to consider. Below we highlight some of the major factors to take into account before deciding to proceed further.

3.1 Advantages of a DB Pension Scheme

- Your pension lasts as long as you do. Therefore, there is no risk of you having no pension income.
- Although each scheme varies, there will be something for your surviving spouse / civil partner/dependants. Typically, a survivor’s pension is half of your pension income and will be paid for the duration of your spouse’s/civil partners lifetime, however, a dependant’s pension may only be paid for a limited period, for example until they reach the age of 23.
- Some protection against inflation is *typically* provided to help you maintain your spending power.
- Your day to day pension income does not rely on the ‘rise and fall’ of the stock market.
- You do not need to manage or look after your pension; once it starts, you can sit back and enjoy the income without undue worry or further decisions.
- You can obtain some flexibility over the benefits in most cases by choosing a reduced pension in return for a Pension Commencement Lump Sum (PCLS – also know as tax free cash lump sum).

3.2 Disadvantages of a DB Pension Scheme

- The death benefits of a DB pension scheme are extremely rigid; if you are not married and have no financially dependent children, your pension will probably die with you.
- If you are concerned with your life expectancy, your DB pension scheme may not deliver you “value for money”.
- It is not possible to vary the level of income you receive from the scheme, once in payment.
- If your employer becomes insolvent there may not be enough assets in the pension scheme to pay your pension. The Pension Protection Fund may, however, provide compensation. Please see section 7 below for more details.

4. Retirement Options

If you have transferred your CETV to a SHP, PPP or SIPP (your personal pension fund, also known as a “Defined Contribution” or DC pension fund) you will then have to decide when and how you will take

your benefits from your new pension. This is referred to as “crystallising” your benefits. Normally you can only do this once you have had your 55th birthday. The two main options you have are:

- To take ad-hoc lump sums (part tax-free and part taxable)
- A larger one-off (maximum?) lump sum with taxable income

The following assumes your benefits are not greater than your available Pension Lifetime Allowance (PLTA) – see section 5. If you exceed the PLTA, special rules will apply to the excess. Please also note that not all pension plans offer all of these options.

4.1 Uncrystallised Funds Pension Lump Sum (UFPLS)

You can withdraw a single lump sum (or a series of lump sums if the product allows) from your pension without the need to move the funds into a drawdown plan first. 25% of the lump sum is tax free with the balance subject to income tax under an emergency tax code. This will normally result in you paying more tax than is due and having to reclaim the overpayment from HMRC.

4.2 Lump Sum and Taxable Income

You can generally take up to 25% of your fund value as a tax-free lump sum with the remaining 75% of your fund value has to be used to generate an income. This income can range anywhere between £0 and the full value of the remaining fund!

The two most common ways in which you can choose to provide your pension income is:

4.2.1 Flexi-access Drawdown

Flexi-access Drawdown pension is a method of withdrawing benefits from your pension fund without purchasing a lifetime annuity.

Holders of money purchase pension plans can defer taking their pension in the form of an annuity and instead make withdrawals directly from the pension fund. With flexi-access drawdown the amount of income that can be taken from the fund is not subject to any specific limits therefore this method offers great flexibility. This can be useful for tax planning or where other sources of income are available.

You will be liable for income tax under PAYE on all withdrawals you make.

4.2.2 Pension Annuity

A lifetime annuity pays a guaranteed income for your life from the funds you have built up in your pension plan. Your annuity provider will pay you a regular income taxed in the same way as earnings. The amount of income payable is dependent on your age and health, the size of your pension fund, economic factors, the type of annuity and the options you select. You should also be aware that once you have purchased an annuity you cannot cash it in or make changes to your selected options.

You will be liable for income tax under PAYE on all annuity income payments you receive.

5. Lifetime Allowance

If the total value of your pension benefits exceeds the ‘Lifetime Allowance’, the excess benefits will be subject to a tax charge of 55% on the excess if taken as a lump sum or 25% if the excess is taken as a taxable income. For the 2019/20 tax year the Lifetime Allowance is £1,055,000 but it may be possible to keep a higher lifetime allowance if necessary as follows:

- Individual Protection 2016 (IP2016)
  - This is available to those with total pension savings greater than £1 million on 5th April 2016. IP2016 will allow those individuals meeting certain criteria to fix their lifetime allowance at the value of their pension fund as at 5th April 2016, with the maximum protection being £1.25 million. Pension funding can continue but further funding is likely to be subject to a lifetime allowance charge.
- Fixed Protection 2016 (FP2016)
  - This doesn't require a minimum fund value but is aimed at those who expect their pension funds to exceed £1 million at retirement. It fixes the individual's lifetime allowance at £1.25 million but doesn't allow any further pension funding after 5th April 2016.

Where you may have already applied for and have protection in place in relation to your pension benefits, this will be retained on the transfer of your pension. These earlier forms of protection are:

- Enhanced Protection
- Primary Protection
- Fixed Protection 2012 or 2014
- Individual Protection 2014

We have a whole additional Fact-File entitled "Pension Lifetime Allowance" which is available via our website.

5.1 How is a DB Pension Scheme Valued for PLTA Purposes?

A DB pension scheme is valued based upon the starting level of benefits it will pay you. The annual pension is multiplied by a factor of 20 and the tax-free lump sum is valued based upon the amount paid.

5.2 How is a Defined Contribution (DC) Pension Scheme Valued for PLTA Purposes?

This is simply the value of the fund that is crystallised, whether that be:

- The amount of the PCLS or UFPLS
- The amount designated into a drawdown pension
- The capital value used to secure a lifetime annuity

5.3 The impact of a DB transfer on the PLTA

The following example will help demonstrate the potential PLTA implications of a transfer:

David has the option of an annual scheme pension of £20,000 when he retires or a reduced pension of £14,117 plus a one-off tax-free lump sum of £94,118.

The PLTA value placed upon these benefits is £400,000 if David takes the full pension (20 x £20,000), or, if he takes the reduced pension and lump sum, the PLTA value is £376,458 (20 x £14,117 plus £94,118).

However, the CETV offered to David is £560,000. David needs to consider that by taking the transfer value this will mean that his pension benefits will now use up a greater portion of his PLTA. Now, that might not be important if this is David's only pension, but if he has other pensions, he will need to be aware of their combined values for PLTA purposes.

6. Death Benefits Under a SHP/PPP/SIPP

Generally speaking, once you die, any remaining value in your SHP, PPP or SIPP is available to be passed on. If you have used some of your fund to secure an annuity income, you will have made choices as to what death benefits you want when you set it up. If you have taken money out of your DC pension fund as a UFPLS, the money withdrawn is no longer in your pension so there are no death benefits as it has been paid into your bank account.

If your DC pension fund has not been crystallised (i.e. it is uncrystallised) one set of rules will apply to it. If you have moved some of your pension fund into Flexi-Access Drawdown or it has been crystallised, it will have slightly different rules applied to it.

Any part of your DC pension fund that has not been crystallised can be paid out:

- If you die before age 75, it will be assessed against your available PLTA and any excess taxed, but otherwise it will be tax free in the hands of the recipient(s). It can be used to pay the recipient(s) a one-off lump sum, or to provide them with an income by means of an annuity or flexi-access drawdown.
- If you die once you have reached 75 the benefits are not tested against your available PLTA, but they will be subject to income tax in the hands of the recipient, whether paid as a lump sum or income.

Any part of your DC pension fund that is unused flexi-access drawdown can be used to pay the recipient(s) a one-off lump sum, or to provide them with an income by means of an annuity or flexi-access drawdown. If you die before age 75, the recipient(s) will pay no income tax on what they receive, but if you die once you have reached 75 the recipient(s) will be subject to income tax on any amounts they receive.

It is also possible to leave death benefits in certain circumstances to a company or a charity. Also, the DC pension fund that is passed on, on your death, can also be passed on once the first recipient has died and so on. However, these rules are complex and outside the scope of this document.

7. Pension Protection Fund

DB pension schemes are protected by the Pension Protection Fund (PPF).

7.1 What does this mean?

Whilst you are a member of your final salary pension scheme, if your employer becomes insolvent and there are not enough assets in the pension scheme to cover the level of compensation that the PPF would provide, the PPF may compensate you in the following ways (provided the pension scheme is accepted by the PPF):

- If you are over your scheme’s pension age:
  - If you have reached the normal pension age set by your pension scheme or, irrespective of age, are either already in receipt of a survivor’s pension or a pension on the grounds of ill health, the PPF will generally pay a level of 100% compensation. This normally means a starting level of compensation equal to 100% of the pension in payment immediately before the assessment date. The part of this compensation that comes from pensionable service on or after 6 April 1997 will be increased each year in line with inflation capped at 2.5%. This could potentially result in a lower rate of increase than the scheme would have provided.

- If you are not yet at your scheme's pension age:
  - For the majority of people below their scheme's normal pension age the PPF will generally pay a 90% level of compensation. This generally means 90% of the pension accrued (including revaluation) immediately before the assessment date. Those benefits are then revalued in line with the increase in the inflation rate between the assessment date and the start of the compensation payments. Revaluation is capped at 5% p.a. compound relating to pensionable service prior to 6 April 2009 and at 2.5% p.a. compound relating to pensionable service on or after 6 April 2009.

This compensation is subject to an overall annual cap, which, for the year commencing 1 April 2018, equates to £35,105.56 at age 65 after the 90% has been applied (the cap is adjusted according to the age at which compensation comes into payment). Once compensation is in payment, the part that relates to pensionable service on or after 6 April 1997 will be increased each year in line with inflation, capped at 2.5%. Again, this could result in a lower rate of increase than the scheme would have provided. In addition, there will also be compensation for certain survivors. The annual cap is increased if you had 21 or more years pensionable service.

After a ruling in the European Court, in the autumn of 2018, the PPF has to ensure that individuals do not receive compensation that is less than half of the benefits they would have had under their former DB pension scheme. This will be an issue for individuals who had pension benefits that are more than twice the compensation cap. The PPF is looking to correct this issue but will also require the Government to introduce legislation to address this issue.

7.2 The Financial Services Compensation Scheme

Once you transfer out of your final salary occupational pension scheme, your benefits will no longer be protected by the PPF. Instead you will typically be covered by the Financial Services Compensation Scheme (FSCS) should the relevant pension provider become insolvent.

If you are still building up your pension pot (that is, you haven't yet used your pension fund to purchase an annuity or placed the fund into flexi-access drawdown; it doesn't matter whether contributions are still being made) 100% of your pot will be protected if it's directly managed in a life insurance contract; this protection applies where the product provider fails and not in the instance of bad advice. Where external funds are held in addition to or instead of the insurance company's own directly managed funds, there is no cover under the FSCS should an external fund fail. This is because the insurance company purchases the external funds not the policyholder and insurance companies are classed as large companies and as such are not allowed to claim under the scheme. However, these external funds are held in what is known as "nominee accounts" and are therefore ring-fenced for the investor's use only and specifically not the creditors of any investment firm that may have failed.

Where pension funds are invested directly in other investments the £50,000 investment protection would apply in the event of an investment failing, providing the criteria described below applies. The FSCS can pay compensation if the firm concerned has failed and cannot return your investments or money owed, and you lose money because of:

- bad or misleading investment advice
- negligent investment management
- misrepresentation or
- fraud

They do not pay compensation if your investment has not performed as well as hoped.

8. Why Might I Consider Transferring my DB Pension?

If you as an individual value a regular known level of retirement income that will continue for the rest of your life and will increase each year to take account of inflation, you probably would not want to consider transferring.

Before looking at the possibility of transferring your pension you should consider carefully the level of income you will need/want in retirement and where this will come from. The best way to gauge your income needs in retirement is to look at what you spend now and which of those expenses you will no longer have once you stop work; that is probably what you will need in retirement. You might also split this income requirement down to your core needs (such as food and utility bills etc. and discretionary spending, such as holidays and entertainment). You need to consider what pension benefits you and your partner will have in retirement, including your State Pensions.

You can obtain a forecast via www.gov.uk The normal full State Pension entitlement from April 2019 is £8,767, although some people may have a higher or lower pension than this. So, for a couple this *could* be a total of over £17,400 a year.

Once you have an idea as to the level of income you will need in retirement, you should consider how much of that annual income you want to be secure. By that we mean, you know how much will be paid each year and it is not likely to reduce in the future. DB pension income is a secure income and so is your State Pension. If you are taking a drawdown income from your invested pension fund or income from your ISAs, you should be aware that this income is not guaranteed. You need to decide how much of your total income or perhaps your core income requirement you want to be covered by secure income and what proportion you are happy to be of a more flexible and less reliable nature. In simple terms, you may not want to be worried about how to pay your bills in retirement if you heard on the news the stock market has crashed by 10% or more. If you have more capital than is required to meet your basic needs, you may be able to be more relaxed about these market fluctuations.

Once you have decided how much income you need and how much of that income you want to be covered from secure sources, you may well decide you have one or more DB pension schemes you would like to consider transferring. You might want to transfer for one or more of the following reasons:

- The tax-free lump sum (PCLS) that is available to you once you have transferred is likely to be higher than the amount available under the DB pension scheme.
- You can take the PCLS from a DC scheme without having to take a pension income.
- If you are stopping work at age 60 but won't start to receive your State Pension until later (66, 67 or 68, depending upon your date of birth) having a DC fund may allow you to draw a higher level of income from age 60 until you start to receive your State Pension, i.e. bridging the income gap.
- You may want to take a higher level of income early on in your retirement and then after a few years, reduce your expenditure. However, remember that as you get older, your living costs *may* go up, if you go into a care home or need help at home.
- You may be in the fortunate position of having more pension income than you actually need. You may think you don't need to draw any pension income if you transfer your DB pension to a DC scheme and you would rather retain the money to pass on, when you die.
- You may believe that you are unlikely to live as long as average and you would like to be able to pass on any unused pensions funds on your death. However, if you live longer than expected, there may not be much to pass on, depending on investment returns.

These are just some of the reasons why people transfer. If you would like to explore this further, then please get in touch. However, the analysis we must undertake to give you advice is complex, and you will be incurring costs even if you decide, having had the advice, not to transfer, or if our advice is that we do not recommend you transfer your pension fund.

9. What is the Advice Process?

If you decide to go ahead with asking us to explore a pension transfer with you, we will ask you to sign an agreement to the standard fees that we charge for this type of advice. These are one-off fees and are charged regardless of whether we recommend or eventually carry out the transfer on your behalf. Once we have agreed the fee with you we will ask you more details about your personal circumstances and we will ask you to sign a letter to enable us to speak to the DB scheme administrators on your behalf.

We will contact the scheme administrator of your DB pension scheme to provide us with your CETV and Statement of Entitlement (if you have not already got these). Once this data has been received, we will let you know and then start work on preparing your suitability report.

The report will set out our understanding of your circumstances and your retirement objectives. We will compare the benefits payable from your DB pension scheme with suitable alternatives. We will explain the "pros and cons" of each option. We will then assess the suitability of transferring and will link this in with your own financial retirement objectives.

We will let you know if we think the transfer is wholly unsuitable for you. If we believe that transferring may be a suitable option for you we will also make it clear that the ultimate decision as to whether you transfer or not must be yours (as with any other financial investment).

If you ultimately decide that you wish to transfer *and* it accords with our assessment of suitability, we will also explain to you how your pension fund should be invested and why transferring your pension could meet your stated objectives.

If our recommendation is not to transfer, we will explain to you why this is the case. In this situation, you will still be required to pay our agreed fee. We will be under no obligation to provide any advice certification to enable you to take a transfer if we do not believe that it is in your interests to do so.

9.1 What happens once I have agreed to Transfer my DB Pension?

If, following our assessment of suitability, you still wish to transfer your pension we will ask you to sign a new replacement fee agreement to enable us to make you an ongoing client of the firm for whom we look after pension/investment funds. This will involve a higher initial fee to cover the implementation costs and an ongoing fee to cover our perceived necessary review costs. Once you have agreed to become an ongoing client of the firm, we will start the process of moving the pension fund.

We will then submit the transfer request and set up your new pension arrangement for you, including establishing the recommended investments.

If you prefer to self-manage your pension investments you should be aware that we will be far more cautious about providing you with transfer advice, as we would have no control over the ultimate investments chosen. If you are considering this option, please do make this clear to us at the outset.

9.2 What if your advice is not to transfer my Pension?

It is possible that once we have undertaken our analysis, we have to advise you that transferring your pension is not in your best interests. If this is the case, we will clearly explain why we have come to that conclusion. However, we appreciate that you may still wish to go ahead with the transfer. **You should be aware that we are highly unlikely to be prepared to facilitate a pension transfer where we have specifically advised against the transfer.**

10. Risk Considerations

Transferring from a DB pension scheme is an important decision, so you need to ensure that you fully understand the implications before doing so.

There are a number of risk considerations that you need to take into account when transferring from a DB pension scheme. It is important that you are aware of these.

- This type of transaction is irreversible – it is not possible to 'undo' a transfer and revert back to your original DB pension scheme should you change your mind.
- When benefits are transferred from a DB pension scheme, all the valuable benefits in the form of "promised" pensions that would have been provided, are lost. For example, you will be giving up a secure, inflation proofed income and a guaranteed spousal income.
- If the transfer is not completed within three months of the date of your Statement of Entitlement, a new transfer value will need to be requested and the revised figure may be lower than the original figure. Your DB pension scheme may also charge you for this new calculation.
- You may not be able to obtain the same level of life cover to replace your DB pension scheme's lump sum death benefits.
- If your DB pension scheme is protected by the PPF, you will lose this protection (please refer to the 'PPF' section above for more details).
- In view of the fact that transferring pensions can be a lengthy process, the transfer value and the pricing of the funds to which the transfer is to be made may fluctuate during the process and you may suffer a loss as a result.
- The level of benefits that may be obtained from the purchase of a future annuity is uncertain; which may result in your eventual income at retirement being less than if you had remained within your DB pension scheme, under this option.
- Once transferred, your pension funds will be exposed to investment risk.
- At the time you decide to take your pension, there may be a lack of available annuity types to replicate the benefits being given up.
- Any recommended solution with regards to the investment of your pension funds following a transfer, will often require you to become more actively involved in the ongoing investment choices of your funds and ongoing reviews will be important.
- Your eventual income in retirement may be less than the pension which would have been available under your DB pension scheme.
- If you are in poor health when you transfer, there could be inheritance tax issues associated with making the pension transfer.
- People do not typically know how long they will live, so there is a risk that you may run out of money prematurely.
- There is no guarantee that your eventual income in retirement will keep pace with future inflation.

If you have any questions or need an independent review of your financial planning or investment arrangements, please contact us to discuss your situation further. AW Financial Management LLP is an Independent Financial Adviser regulated by the Financial Conduct Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.

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