Good with your money

Transferring out of your company pension - what are the pros and cons?

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ROYAL LONDON

Introduction - The world of pensions is changing

In the past, many people who worked for private firms built up a company pension based on how long they had worked for the firm and how much they earned. The amount of pension they would get was guaranteed by the rules of the pension scheme, and so they were known as defined benefit or DB pensions. These defined benefit pensions have a number of advantages.

- Your pension lasts as long as you do, so there's no danger of you running out of money.
- There is something for a surviving spouse after you die. The details vary from scheme to scheme but dependant's pensions of half of the scheme member's pension are common.
- There is some measure of protection against inflation, which helps to maintain the spending power of your pension. Again, the exact provision varies from scheme to scheme, but there is a legal minimum which all schemes have to deliver.
- Your pension is unaffected by the ups and downs of the stock market.

Despite all of these advantages, there are some downsides to having a pension of this sort, such as a lack of choice over when and how to take your pension. As a result, some people are considering whether to exchange their DB pension rights for a cash equivalent.

The purpose of this guide is to provide some basic factual information about the pros and cons of making a transfer of this sort, so that you are better informed prior to seeking impartial and expert financial advice about your individual circumstances.

However, it is important to stress that, because of the attractive features of DB pensions, the Financial Conduct Authority (FCA) tells financial advisers to start from the assumption that it is not in people's interests to exchange their DB pension rights for a cash alternative[1]. The Pension Regulator (TPR) also believes it is likely to be in the best interests of the majority of members to remain in their DB scheme[2].

If after speaking with a financial adviser, you wish to further investigate transferring out of your DB scheme, then provided you're no longer building up benefits in that scheme and are more than 1 year from your normal retirement, you'll have a statutory right to a Cash Equivalent Transfer Value from your DB scheme. This outlines the cash sum you will receive in exchange for giving up all your rights in your DB pension scheme.

1. A good place to start is the FCA page on pension transfer https://www.fca.org.uk/consumers/pension-transfer, which says: "In most cases you are likely to be worse off if you transfer out of a defined benefit scheme, even if your employer gives you an incentive to leave. The cash value may be less than the value of the defined benefit payments to you and your eventual pension payments will depend on the performance of the new scheme, with the risk that the scheme does not deliver the returns that you expect". The FCA website does however point out that "there are risks to staying too".
2. See point 30 of this link: https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/db-to-dc-transfers-and-conversions#408c2a27c95f4777a68fa0ae3ae2ebe2

Introduction

These cash sums can be used in two main ways:

- for those who are still saving for their retirement, the cash sum can be transferred into a personal pension where it will be invested, or
- for those who want to start living off the proceeds of their pension, it can be transferred into a drawdown account, where some of the money is invested and some is taken out either in lump sums or as a regular income.

In both cases, there is no guarantee as to the future level of income, and the only thing that is defined is the contribution going in to the scheme. For this reason, such arrangements are known as defined contribution or DC schemes.

Two particular factors led to an increased interest in converting DB pension rights into cash lump sums which can be invested in DC pension arrangements, between 2015 - 2022.

First, in 2015 new pension freedoms were introduced which give you more choice over what you can do with your DC pension pots. Now it's also possible to take a lump sum from your pension, as well as buy an annuity, or draw an income from your pension as and when you need it. As part of these reforms, the tax treatment of beneficiaries receiving proceeds from a DC pension on the member's death, was made much more attractive.

Second, the low interest rate environment during this period meant that the transfer values being offered in exchange for DB pension rights soared to record levels. This mainly reflects the fact that it was costing DB schemes a lot more to meet the pension promises that they have made.

For all of these reasons, interest in DB to DC transfers increased, with advisers and schemes reporting large numbers of scheme members asking for valuations and seeking advice.

There are a few things to be aware of at the outset.

- DB to DC transfers are irrevocable – you cannot change your mind a few months or years later even if you wish you hadn't made the transfer.
- In general, once you have started receiving benefits from your DB pension scheme you cannot then give them all up in return for cash. However, occasionally a scheme will offer you a deal where some of your pension benefit can be given up in return for a lump sum.
- There are some types of DB pension schemes where cash transfers are not possible. These are mainly public sector schemes such as those for nurses, teachers and civil servants. The reason for this is that there is no pension 'fund' – the pensions of today's retired workers are paid for out of the contributions by today's workers and their employers.

The law requires that if you wish to transfer a DB pension pot valued at £30,000 or more you must seek financial advice before doing so[3], and rightly so. These are valuable pension rights and they should not be given up lightly.

Any decision about what to do with them should be made on an informed basis and few individual savers would have the necessary expertise to make that judgment. So we strongly support the requirement to take advice before giving up significant DB pension rights. This advice can also look at the whole of an individual's pension rights which may lie in several schemes and be a mixture of DB and DC rights. This guide is not designed as a substitute for impartial, tailored financial advice.

3. The rules on which transfers must be made with advice are slightly more complex than this but a scheme would be expected to tell a member if advice is required before the transfer of their particular rights can take place The latest FCA rules are set out in Policy Statement PS18/20: https://www.fca.org.uk/publications/policy-statements/ps18-20-improving-quality-pension-transfer-advice

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What this guide does seek to do however is simply to help you in the early stages of considering a DB to DC transfer by familiarising you with some of the key issues that you will need to take into consideration. This will hopefully lead to a more informed conversation with your adviser if you decide to proceed to the next stage. The guide seeks neither to encourage nor to discourage such transfers, but rather to set out in a balanced way the pros and cons of retaining your DB pension rights as compared with taking a transfer.

Types of advice and paying for it

If you want to transfer a DB pension worth £30,000 or more, you must seek financial advice before doing so. You can opt for full advice or abridged advice. In addition there is something called 'triage' which we explain below.

Some advisers may operate a "triage" system. This is simply a stage before abridged or full advice where the customer is given generic information on the pros and cons of transferring a defined benefit pension.

The information you'll get at this point is much like the information in this guide – it's simply to help you understand the options and is not specific to your circumstances. Triage is not advice.

Abridged advice

A lower cost option than full advice which can only have two outcomes:

- A personal recommendation **not** to transfer; or
- That it's unclear from the information available whether a pension transfer will be in your best interests, and that full advice would be required to arrive at a decision.

You can then make the decision to go with full advice if you want to. You should be aware that if you proceed to full advice, there is a chance the adviser will conclude you shouldn't transfer your pension and you will still have to pay the full advice fee. (Advisers should deduct the fee already received for abridged advice from the full advice charge)

Full advice

Here the financial adviser carries out a review and recommends if a pension transfer is in your best interests or not. If you go with this option, you will have to pay for the advice even if the adviser concludes that you shouldn't transfer your pension.

Before October 2020, financial advisers often only charged for advice if the transfer went ahead. This was known as contingent charging and it has been banned by the regulator over fears it could create a conflict of interest. However, there is an exemption for specific groups of customers which mean advisers can still use contingent charging for people who are in serious ill-health or serious financial difficulty.

While abridged advice can result in a recommendation not to transfer, it is only possible to proceed with a transfer if full advice has been taken.

The current system

At present, if you are a member of a DB pension scheme you have the right to ask the scheme to offer you a cash lump sum in exchange for your entire DB rights[4]. This lump sum is known as a cash equivalent transfer value (CETV).

If the transfer value is more than £30,000 you are required to seek independent financial advice before deciding whether or not to proceed with the transfer. This advice must be provided by, or at least checked by, a specially-qualified pensions transfer specialist.

The Financial Conduct Authority has updated its rules about how advisers are to assess whether a transfer is a good idea. As part of this process, since Autumn 2018, advisers have been required to present you with a 'Transfer Value Comparator' (TVC). In simple terms this is a measure of how the money you have been offered by your pension scheme compares with the value of the pension you are giving up.

In brief, the adviser has to work out the sum of money that would be needed today, if it were to be invested up to your retirement on a 'risk-free' basis, that could buy you a pension (through purchase of an annuity) that matches the pension you are giving up. So, for example, you may be offered a transfer value of £400,000 to give up your pension, but the TVC calculation may say that you would need £500,000 invested in the way described to be able to replicate the pension you are giving up.

The closer the amount you are being offered is to the capital sum that emerges from this calculation, the better value you are being offered. But this calculation on its own will rarely lead to a definite 'yes' or 'no' as to whether you should transfer.

Advisers will often talk about assessing a potential transfer with reference to a critical yield. The critical yield is the investment return that would be needed on the transferred sum to build up a large enough pot at retirement to buy retirement benefits at least as good as the DB pension given up.

In many cases, to achieve a pension pot large enough to buy an income for life of equal value to the DB pension foregone will require a relatively high rate of return which in turn would imply taking a high degree of investment risk. Whilst this is not an absolute bar to an adviser recommending a transfer, many advisers would be nervous about recommending a transfer in such a situation. However, as we discuss later in this guide, this is not the only consideration – or even necessarily the most appropriate one – when deciding whether or not a transfer would be in your interests.

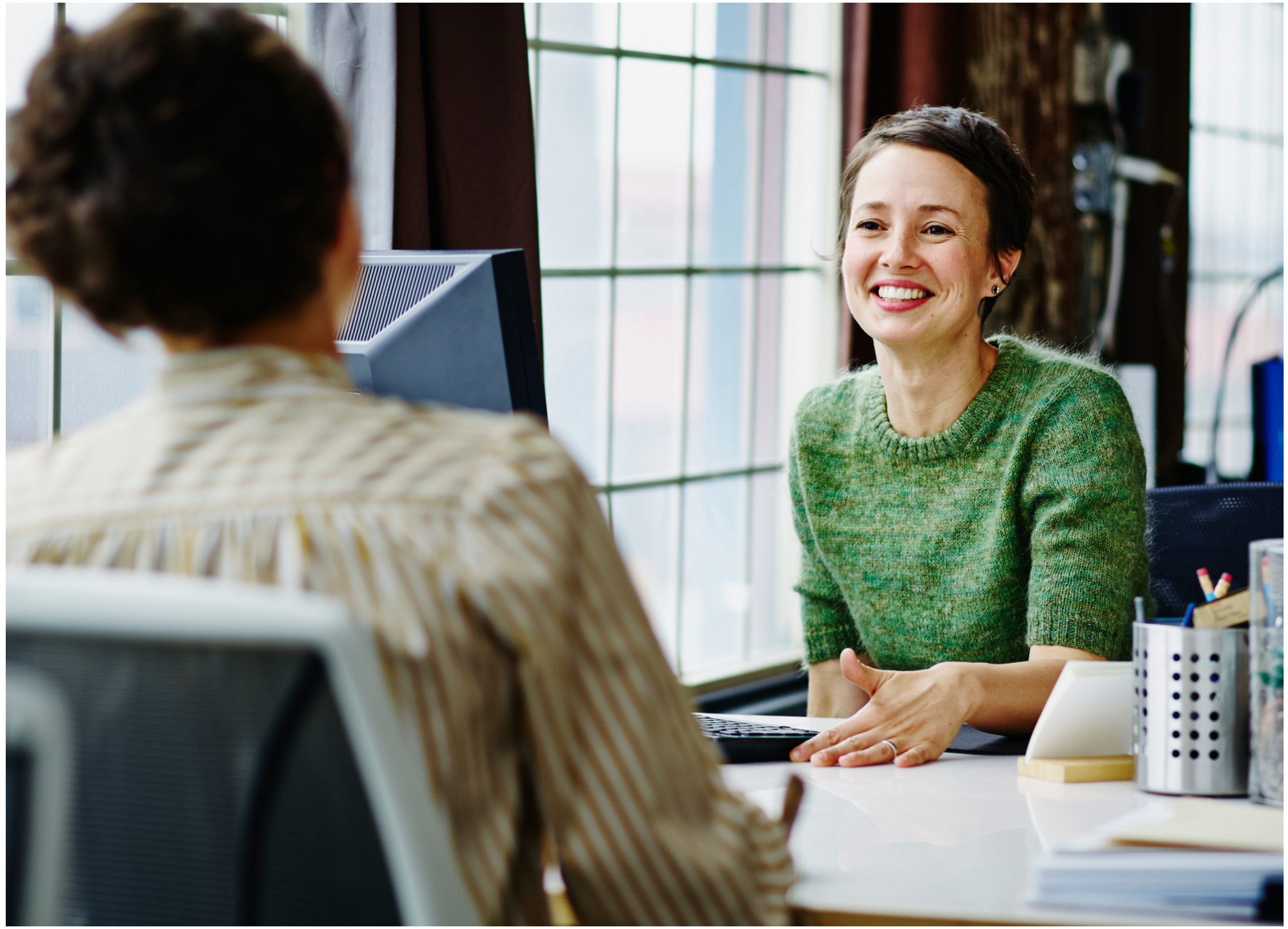
4. This right does not apply to members of 'unfunded' schemes such as those in the public sector for teachers, nurses, civil servants and others, as there is no 'fund' to transfer. There is also no right to transfer if you're in the 12 months leading up to your pension scheme's normal retirement age.

The current system

If an adviser concludes that a transfer is not in your interests, this is not necessarily a barrier to the transfer taking place. If you are insistent that you wish the transfer to go ahead, some advisers will implement the transfer in any case, stressing that this is not in line with their advice and that you need to accept responsibility for this decision. Others will simply decline to facilitate the transfer and you will need to go elsewhere. This is something worth exploring with your adviser before starting the process.

It's important to understand that anyone wishing to proceed to transfer on an insistent client basis must first have been through the full advice process. Abridged advice alone is not sufficient to proceed as an insistent client.

In the next two sections we consider some of the reasons why converting your DB pension rights and putting the money into a DC pension instead might not be suitable for some clients, and then we look at some circumstances where it may be.



Four reasons not to transfer

1. Certainty

One great advantage of having a DB pension is that it lasts as long as you do. If you happen to live longer than average then it is the scheme that has to find the money for this.

By contrast, if you transfer your DB pension rights into cash and manage it yourself, you are taking on the uncertainty about how long you are going to live. There is clear evidence that people tend to under-estimate how long they will live, so there is a risk that you will run out of money prematurely. On the other hand, you may be so worried about running out of money that you draw down the money too slowly and do not enjoy the full benefit of your retirement savings.

You could overcome this uncertainty by buying an income for life (an annuity) but for various reasons this is very unlikely to be as good as the pension you have just given up in your DB pension scheme. Indeed, if all you want is a guaranteed income for life then it is hard to see why you would have left your DB scheme in the first place.

It is more likely that you will go on investing your money and drawing an income from your fund, and the big unknown is how quickly it is safe to withdraw money.

There are, of course, things that you can do to manage this risk. For example, if you use the services of a financial adviser, they can help you to review your investments and your withdrawal rate and make adjustments if you are running down your pot too quickly[5].

Whether you are concerned about running out of money too quickly, or about having to be overly cautious about the rate of withdrawal, it is important to understand that these are not problems you would have if you left your money in your DB scheme.

2. Inflation

Some people will enjoy a long retirement, perhaps 25 years or more, and the value of having an income which has some protection against rising pricies could be considerable.

Within your DB scheme the extent of protection against inflation which you enjoy will depend on the rules of the scheme and on when you were a member of the scheme.

To give an example of the importance of inflation protection, let us assume that inflation runs at 2% a year, that your entire DB pension rights are guaranteed to rise by this much, and that you have a 20 year retirement. If your starting pension at retirement was £100 a week, it would be £148.59 by the end of your retirement. Without inflation protection you would still be getting £100 a week – a final pension nearly one third lower.

Clearly the cash transfer value that you are offered will reflect the value of the inflation protection built in to your pension scheme. But once you have taken the cash, all of the inflation risk falls to you. If, for example, inflation were to reach 4% then in the DB scheme your pension would rise by at least 2.5%, and possibly more. So the real year-on-year fall in the value of your pension would only be around 1.5%. But with a DC pension pot a 4% rise in the price of goods represents a 4% fall in your standard of living.

Whilst it is possible to insure against rising prices by, for example, turning your pension pot into an inflation-linked annuity, this is likely to be poor value compared with the pension that you have given up.

5. For Royal London customers a Drawdown Governance Service is available to advisers which models a range of scenarios about how your investments might do and provides an early warning system for advisers if your strategy needs to be reviewed.

Four reasons not to transfer

Generally speaking, a DB pension scheme is likely to be able to make much more cost-effective provision against the risks of inflation than an individual can do by buying an index-linked annuity from an insurance company. Of course, if you invest your DC pension successfully you may be able to achieve an above-inflation rate of return but the protection against inflation is not guaranteed in the way that it is in a DB scheme.

In short, if you are concerned about the potential impact of rising prices over the course of a long retirement, and/or about the uncertainty of whether future inflation will be high or low, then staying in a DB scheme is likely to give you both better inflation protection and greater certainty.

3. Investment risk

When you are a member of a DB pension scheme your money is generally invested in a range of assets. This could include shares, bonds, property, infrastructure assets, commodities and so forth. The value of these different assets can, of course, go up or down. But when you are in a DB pension scheme, the ups and downs of these investments make no difference to the amount of pension you receive – the scheme still has to pay your pension and the employer has to bear the investment risk. You are, in effect, insulated against the ups and downs of investment.

By contrast, if you take a cash transfer and invest the money yourself, the value of your fund can – and will – go up and down. This could have a considerable upside – your assets might appreciate considerably. But there is also a considerable downside risk – that your assets will perform badly and you will have to live on a much reduced income.

A key consideration therefore is your attitude to risk. If pretty much all of your non-state pension rights are in your DB scheme and you convert all of them to a cash lump sum to be invested, then you are taking a big risk. You need to consider how you would feel and how you would cope if your investments did badly.
Obviously there are ways in which you can reduce the risk associated with investing in a DC pension or in a drawdown product. For example, you could invest in lower-risk investments but the potential returns may be smaller as a result[6].

The key point here is that when you transfer out of a DB pension scheme you are transferring investment risk from your old employer's shoulders onto your own shoulders.

It is also worth bearing in mind the additional costs which you would face if you manage your own DC pot rather than leaving your rights in a DB scheme. These would include the costs of initial and any ongoing advice you may require as well as product fees and charges. These costs would not arise if you left your funds in a DB scheme.

4. Provision for dependants

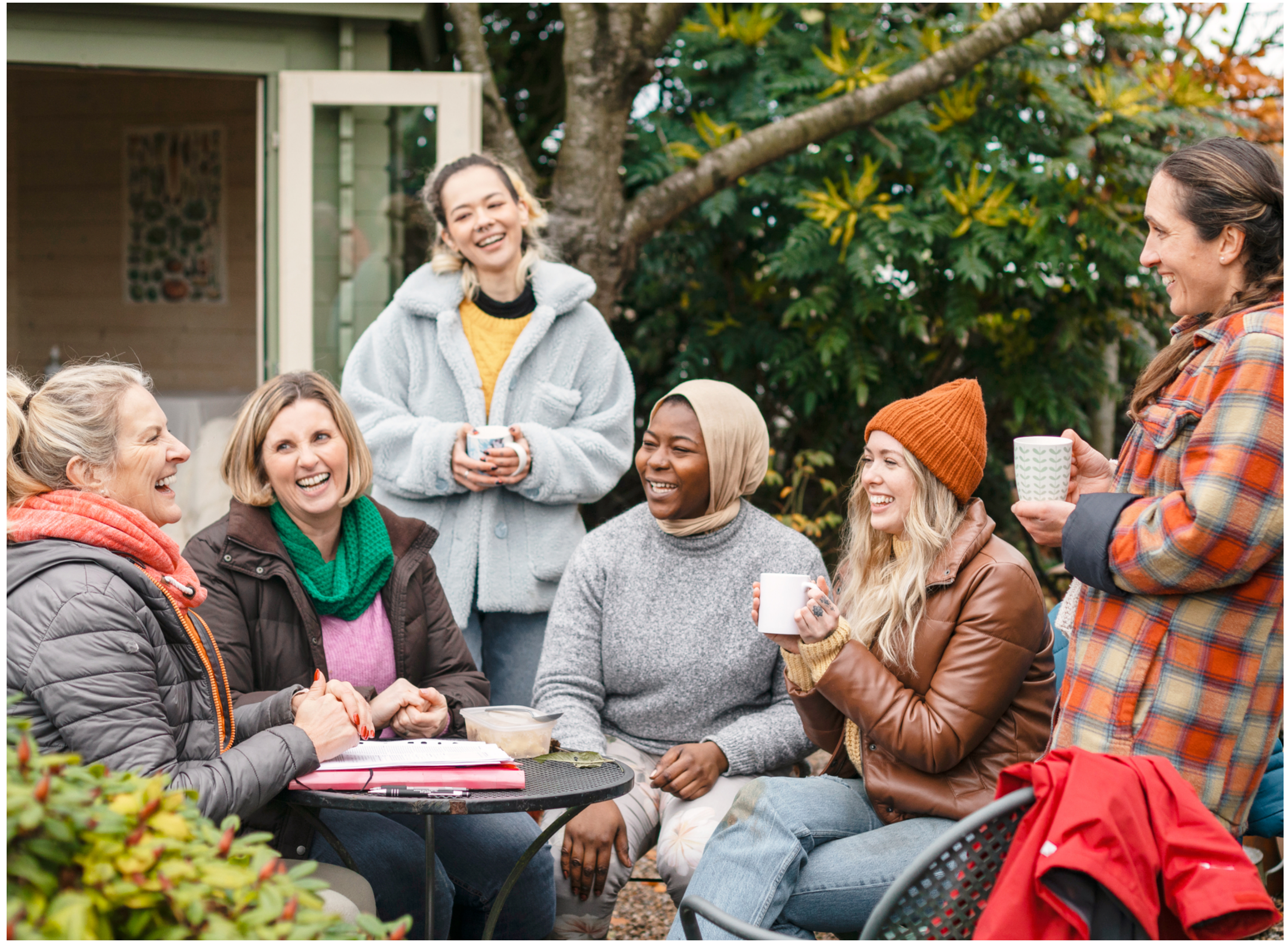
Since 1997, DB pension schemes have had a legal duty to provide a pension for widows or widowers if a scheme member dies after reaching scheme pension age[7] and many schemes will offer benefits for widows, dependent children etc. beyond the legal minimum. This is a valuable benefit and should not be disregarded lightly. There will also be some rights for widows (from 1978) and widowers (from 1988) under the rules around Guaranteed Minimum Pensions (GMPs) which many schemes had to provide.

6. There is a different sort of risk associated with having your money in a DC arrangement, namely that the provider may go bust. In this case there is a Financial Services Compensation Scheme which can provide assistance up to a cap. More details can be found at: www.fscs.org.uk.
7 . There are complex rules about survivor benefits for same-sex married couples, cohabiting partners etc. and some schemes will do more than the statutory minimum in such cases.

Four reasons not to transfer

Of course, any cash offer which is made to a scheme member will to some extent reflect the fact that the scheme offers benefits to dependants. But because not all scheme members will be married or have dependants, the cash value on offer will tend to reflect the average value of such benefits across all scheme members, including those who will get no dependants benefits. In simple terms therefore, the amount of money you might get to reflect the fact that the DB scheme offered dependants benefits would probably be well short of what you would need to buy equivalent benefits if you were to try to do so as an individual.

It is, of course, possible to turn your pot of money into an income for life with an income for your surviving partner if you were to die. But DB pension schemes are generally able to offer benefits of this sort in a more economical way than an individual annuity purchaser is able to. In addition, depending on your surviving spouse's circumstances, s/he may prefer the certainty of a pension from a DB scheme rather than having the responsibility of managing an inherited DC pension pot.



Four reasons to transfer

1. Flexibility

Whilst DB pension rights can be very valuable and attractive, they can also be rather rigid and inflexible. For example, a scheme may have a set pension age and although taking an early pension may be possible, it may not be on favourable terms. In this case, taking your pension earlier may mean it is much lower than if you had waited until you reached pension age. Similarly, a scheme may have generous arrangements for married members who leave behind a widow or widower but these may be of no value to unmarried members of the scheme.

If you convert your DB pension rights and put the money into a DC pension instead, then you benefit from the new pension freedoms which allow you much more choice about how you use your money. In addition, the cash amount that you are offered will generally reflect the average cost to the scheme of providing benefits to widows and widowers, so if you are a single person you will get some of the value of that provision which you would not have done if you had stayed in the scheme[8]. In terms of flexibility, those aged 55 and over can now generally access their DC pension pot as they wish. So if you wanted to retire at 60 and live off your savings you could do this with a DC pension whereas you might have had to wait until you were 65 if you had stayed in the DB scheme. Of course, transferring the money does not mean it will last any longer (and indeed if the valuation of the rights is done on a cautious basis you may be losing some value when you transfer). So although you can take your pension earlier under a DC arrangement, you will be spreading the value of your pot over more years than if you had waited until the scheme pension age under the DB arrangement.

Another important aspect of the increased flexibility following a transfer is that you can decide how you want to spread your income and spending through your retirement rather than having a rigid amount throughout. For example, you may take the view that you want to spend more in earlier retirement while you are more mobile and able to travel, and spend less later in retirement, and having a DC pot to draw on enables you to make choices of that sort.

2. Potential for access to more tax-free cash

Whilst income from a private pension is subject to income tax, most pensions allow you to take one quarter in the form of tax-free cash. In a DB pension this usually means you get a cash lump sum at retirement plus a lower regular pension than if you had not taken the cash[9]. In a DC pension you can generally take one quarter of your pension pot as a tax-free cash lump sum provided you are aged 55 or over.

One reason why a transfer to a DC arrangement may be attractive is the potential to draw a larger tax-free cash lump sum than if you remained in the DB scheme.

If you stay in a DB arrangement you can generally give up a quarter of your pension rights in exchange for a tax-free lump sum. However, this might be less than the maximum you could get if you transfer to a DC pension.

One way of thinking about these rates for converting pension foregone into a lump sum in DB schemes is to think about how long you are likely to live[10]. Suppose you expect to live for 20 years and are giving up a pension of £250 a month or £3,000 a year. Over the next 20 years you would receive £3,000 times 20 or £60,000 in pension (excluding the effects of inflation). So if the DB scheme offers you a tax-free lump sum of less than £60,000 you might feel that you are not getting a good deal.

8. Of course, if you are married, the opposite argument would apply.
9. Some DB schemes are designed by default to give you a lump sum plus a regular pension and may not have the option to take the benefits exclusively as a (larger) regular pension with no lump sum.
10. A good place to check is the Office for National Statistics website entitled 'How long will my pension need to last' – http://visual.ons.gov.uk/how-long-will-my-pension-need-to-last/

Four reasons to transfer

An alternative would be to withdraw your entire DB pension rights and transfer them into a DC arrangement. Once the money is in a DC arrangement (and assuming you are aged 55 or over) you can then take one quarter of the whole pot as a tax-free lump sum and this could be a larger figure than under the DB arrangement. If tax-free cash is particularly important to you, there may be some advantages to transferring out, especially if your scheme is one which offers relatively ungenerous tax-free lump sums within the scheme[11].

3. Inheritance

Whether or not it makes sense to stay in your DB scheme may depend in part on who will be left behind after your death and to what extent you want to support them financially. Recent changes in the tax rules on inheritance of certain sorts of pensions have made it more attractive to consider having your pension rights outside the existing DB scheme.

If you remain a member of your current pension scheme then when you die there may be a pension for your surviving widow or widower. If you die very early (perhaps a few years into receiving your pension) your widow or widower may benefit from a guarantee period where the full pension has to be paid for a minimum of (say) five years.

If you are part of a couple but not married, those rights may be more limited but this will vary from scheme to scheme and may be at the discretion of the scheme trustees. And there may also be some pension entitlement to any surviving dependants such as children of school age.

Whilst such provision is welcome and valuable, it does mean that in many cases when you (and perhaps your widow/widower) die, your pension dies with you. In particular there is nothing left to pass on to your beneficiaries.

An alternative is to convert your DB pension rights and transfer the money into a pension (if you are still saving) or a drawdown arrangement. In this case, if you were to die, the value of the assets in the pension or investment could pass on to your beneficiaries.

One particularly important consideration is the tax treatment of such money. The rules are that if you die before the age of 75, then the cash balance left behind can be received by your beneficiaries completely income tax free. Even if you die over the age of 75 then whoever inherits your pot only has to pay income tax in the usual way when they make withdrawals. Furthermore, if your beneficiaries do not draw on this inheritance (perhaps because they already have sufficient income) then it can be passed on to subsequent generations[12]. However, it is worth bearing in mind that present or future governments could change the rules on the tax treatment of inherited pensions at any time. It's also important to remember that if you move to a DC pension, and particularly if you live for many years after beginning to draw income from your pension, there may only be a very small, or possibly no remaining fund at all, to pass to beneficiaries upon your death.

11. Note that the amount of tax-free cash is potentially larger if you immediately take 25% following the transfer. If you simply put your transfer value into a DC pension some years before retirement then whether or not you get a larger tax-free lump sum depends on the investment performance of the funds between the transfer and when you take the lump sum.
12. It is worth noting that if you die within two years of a transfer, your adviser or representatives may be expected to prove that they did not know your death was imminent. If they cannot do so, the favourable inheritance tax treatment of the remaining pension pot may be called into question.

Four reasons to transfer

4. Health

One of the advantages of a DB pension is that it lasts as long as you do.

But what about people who think – or know – that their life expectancy is likely to be on the short side? For example, if you draw a pension at 65 and die at 71 then you will not have got much out of the pension scheme compared with someone who lives well into their nineties. DB pension schemes work by pooling risk, and in effect those who live for the longest time are subsidised by those who live for the shortest time.

If you think you might be one of those whose life expectancy is below average then you might consider taking a transfer out. The value you are offered should (broadly) reflect average life expectancy and this may be a bigger amount of money than the amount it would have cost the scheme to pay your pension if you had stayed in but died relatively young.

If you take your money out in this situation you could simply invest it with a view to your beneficiaries receiving the cash when you die. Alternatively, if you are not concerned about leaving anything behind after you are gone you could buy something called an enhanced annuity. This is basically an income for life, but one which takes some account of your likelihood of dying prematurely. So, for example, someone who has been a chain smoker all their life or who has a serious medical condition might be able to get a relatively generous annuity rate because the annuity provider does not expect to be paying the annuity for very long. One option would be to obtain a transfer value quotation from your current scheme and then find out what annuity you might be able to buy before actually making the transfer. You could then form a view as to which option would give you the better value.

To transfer or not to transfer

To reiterate the point made in the introduction to this guide, we are neither promoting DB to DC transfers nor seeking to discourage them. The FCA is clear that a sensible starting point is the assumption you are likely to be worse off if you transfer out of a defined benefit scheme. This presumption should help to ensure that you appreciate the value of what you already have by way of guaranteed pension rights in a DB arrangement.

In saying that, we hope that what this guide has done is make you aware of some of the many factors which have to be considered by each individual when deciding whether or not to trade in DB pension rights for a cash sum.

For some people, the arguments in favour of transferring may be particularly compelling. Those who want to maximise their tax-free cash, do not expect to live long in retirement, are thinking about how best to pass on unspent pension to their beneficiaries, and/or are willing and able to take on the investment risk associated with their pension, could all find the current terms on offer to be attractive.

On the other hand, those who value the certainty which a DB pension provides may well wish to stay put. If they do so, they will know that their pension will last as long as they do, that they have a measure of insulation against inflation, that they do not need to worry about the ups and downs of the financial markets and that there will be a pension there for a widow or widower when they are gone.

Ultimately, the decision about whether to transfer should be made after a conversation with a regulated adviser who is either a qualified pension transfer specialist or has their work checked by one. The adviser can take account of your personal circumstances and preferences. Whilst such advice is not binding on the individual, we hope that this guide has shown that the complexity of the choice involved means that such advice should be taken very seriously.

We also believe that ongoing advice through retirement is of value, particularly if a transfer is made. With the large sums that are offered to many people to transfer out of DB pension rights, skilled management of the resultant investment pot is of the utmost importance.
This will help to mitigate against some of the risks identified in this guide.

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