Standard Life

Pension Post

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For financial advisers only

DB schemes - Do I stay or do I go?

A client with a deferred pension in a defined benefit (DB) scheme may have the option of taking a transfer value. They ask you 'Do I stay or do I go?'

Below is a commentary from Technical Guidance Ltd which we hope you find useful when advising clients.

Option 1

Leaving the preserved pension in the DB scheme

In this case, the deferred pension will likely be adjusted each year between now and the client's NRA by the lesser of 4% pa and CPI (which could be negative or positive).

The main risk of leaving the benefit in the scheme is that the client may not get the full pension promised because one or more of the following happen:

- The trustees could reduce the deferred pension by a Section 50 reduction before the client reaches NRA; a Section 50 order arises where the trustees apply to the Pensions Authority to reduce benefits for active and deferred members, as an alternative to winding up the scheme with a deficit
- The trustees could reduce the pension in payment after NRA (where it is not secured by an annuity) though a Section 50 order. The maximum reduction allowed currently is related to the level of pension:

Pension	Maximum section 50 reduction
Less than €12,000 pa	Nil
€12,001 - €59,999 pa	10%, but the reduced pension can't be less than €12,000 pa
€60,000+ pa	20%, but the reduced pension can't be less than €54,000 pa

- Inflation could be negative and the deferred pension could be revalued downwards in line with the decrease in the CPI. For example, CPI fell by -0.3% in 2015 which would lead to a reduction in the deferred pension. However some scheme rules may provide only for positive or no increases and so in those schemes for 2015 the deferred pension may have been maintained.

The statutory revaluation changes over the last five years have been:

Year	Statutory revaluation increase/decrease in deferred pension
2019	0.90%
2018	0.50%
2017	0.40%
2018	0.00%
2019	-0.30%

- The scheme could wind up with a deficit either before or after the client reaches their NRA. Where the employer is solvent at the time of scheme wind up but cannot or will not make up the deficit, the assets of the scheme (after allowing for winding up expenses) are used as follows:

1st **AVCs and Transfer values applied in the scheme on a DC basis**

2nd **Pensioners** – varying by the level of their pensions (excluding any post retirement increases provided by the scheme rules):

Up to €12,000 pa	100%
Between €12,001 and €59,999 pa	90%, to a minimum of €12,000 pa
€60,000+ pa	80%, to a minimum of €54,000 pa

3rd **Active and deferred clients** – 50% of their transfer value

4th **Pensioners** – Balance of their entitlement, not provided at 2 above (but excluding post retirement increases)

5th **Active and deferred clients** – Balance of their transfer values, to the extent assets allow

6th **All** – Post retirement increases, to the extent assets allow

- Deferred and active members are particularly exposed in a wind up. If there are not enough assets to go all the way down the line, for example, all assets are used for 1st to 4th above, then their transfer value could be 50% of the standard transfer value. In certain circumstances it could be lower

- The trustees could provide the client at NRA with a Sovereign Annuity for their pension, and the Government(s) backing the annuity could subsequently default on their obligations to the life company causing a reduction or cessation of the annuity

The risk factors above are largely related to:

- The risk that the employer will not have the financial commitment and/or capability to fully fund the scheme on a long term basis; and
- How far away from NRA the client is and how many other scheme members will become pensioners before him or her. The further down the queue, the higher the risk of not getting the full deferred pension promised as more pensioners will take precedence on a scheme wind up

The deferred pension is therefore a form of IOU, a piece of paper backed by current scheme assets with anticipated future employer contributions and investment growth, promising a future benefit subject to many risks.

Option 2

Take a transfer value

The standard transfer value offered will usually be calculated on assumptions specified by Pensions Authority Guidance; this is usually referred to as 100% of the Minimum Funding Standard (MFS) transfer value, as the TV in this case is the minimum the scheme needs to hold in respect of the deferred pension to meet the funding standard set by legislation.

However, the TV offered at any time could be more or less than 100% MFS:

- If the scheme does not meet the funding standard currently, the actuary will reduce the TV to reflect the level of underfunding, so that maybe an 80% of 90% MFS TV may be offered
- In some cases, the employer may offer (for a limited period) an 'enhanced' transfer value (ETV), i.e. greater than 100% MFS, for example, 125% MFS TV

The TV offered can, in some cases, look low as a multiple of the alternative deferred pension, particularly where the client has more than 10 years to go to NRA.

Take for **example**, a client aged 50 who has a current deferred single life pension entitlement of €30,000 pa payable from NRA 65. Currently a 100% MFS transfer value for this deferred pension might be circa €260,000 or about 9 x annual pension. This can look low to the client. The main problem is that the assumptions used to calculate the TV are way out of line with current financial circumstances.

For example, the TV in this case would have assumed:

- A pre-retirement discount rate, net of charges, of about 5.1% pa
- A post retirement return assumption of 4.5% pa, when in fact current annuity rates are based on bond yields of circa zero return

And if the TV looks low to the client relative to the deferred pension, **the transfer value broadly represents what the client would actually get from the scheme if it wound up today**; in effect the transfer value figure is the only asset currently backing the deferred pension promise. The rest will have to come from future contributions and investment growth, which may or may not happen.

The transfer value is therefore often the canary in the coalmine. A very low transfer value compared to the alternative deferred pension tells you there's probably a hole in the scheme funding.

Given the assumptions used to calculate the TV, t**he TV is almost certainly never going to reproduce the deferred pension alternative using any reasonable set of future assumptions. But the point is, the deferred pension is not guaranteed either and is subject to many risks** outlined above.

If the employer's future financial commitment to the scheme is in serious doubt, the question may then become when to take the transfer value rather than if, as the scheme may wind up at some stage anyway with a deficit leading to a possible loss of part or all of the promised pension.

Reasons to take the transfer value now

There are many reasons why a client may decide to take a transfer value now, accepting that the invested TV is highly unlikely to produce retirement benefits equal in value to the deferred pension given up. These reasons may include:

- The client has other fixed sources of income in retirement, for example, other pensions, rental income, etc., sufficient to cover their anticipated living expenses in retirement
- A belief or fear that if he or she stays in the scheme, they may not in fact get the full pension promised for any of the reasons outlined earlier
- A belief or fear that the solvency position of the scheme might deteriorate further leading to a lower TV offer later on; if things are bad now, they could be worse later on
- A belief or fear that bond yields will increase in the future, which would have the impact of reducing the TV offered, all other things being equal
- Taking up an enhanced transfer value (ETV) offer, for example, 125%, which may be time limited
- Getting access to the ARF option; for those with larger transfer values, the 25% lump sum under the ARF option may be greater than their lump sum entitlement under the DB scheme
- Getting earlier access to retirement benefits, for example, in a Buy Out Bond from age 50 onwards. Where a DB scheme does not meet the funding standard, early retirement is not allowed. You have to wait to NRA to get your benefits
- preserving the capital on death where the DB scheme only provides a reduced Spouse's pension on death either before or after retirement

Reasons to not take the transfer value offer now

There are many reasons why a client may decide to not take a transfer value now, possibly with a view to reviewing the decision later on:

- A belief that the scheme is sound and will pay out the deferred pension in full, and that the invested TV would not reproduce retirement benefits of equivalent value to the deferred pension
- The client needs fixed income in retirement and can not accept the risks involved in an ARF providing fluctuating and unguaranteed retirement income
- The scheme might wind up on a double insolvency, i.e. scheme and employer insolvent, and in such a case the Government may top up the transfer value to a minimum level, for example, 50% MFS, if the standard transfer value available from the scheme is below that minimum at that time
- A belief or hope that a higher TV will be on offer in the future; all things being equal and assuming the scheme remains solvent, the TV should increase by about 5% pa, due to the unwinding of the TV discount rate; (however, an increase in bond yields might eliminate this increase or even decrease the TV on offer from its current level)
- If a TV of less than 100% MFS is being offered currently, the full 100% transfer value is payable to their estate on death before NRA; if the client is in bad health currently, taking a TV of less than 100% MFS would reduce cover for his or her dependants

Declaration of conflict of interest

If you will be remunerated for your services to the client by commission, which will be paid only if the client opts to take the transfer value to a Buy Out Bond or PRSA, for example, you should declare this conflict of interest in writing to the client before the client makes a decision to take the transfer value.

Are you giving advice?

If you set out to the client the pros and cons of taking a transfer value from the DB scheme, you may be taking the view that you are not providing advice to the client but simply information and that the resulting taking by the client of the transfer value and investment in a BOB or PRSA is an execution only transaction for which you would not be liable.

However this position is unlikely to stand up at the Ombudsman or in Court if the client later sues for bad advice, for a number of reasons:

- The client will feel they received 'advice' from an expert in financial affairs even if your service doesn't contain a positive recommendation to take the transfer value. Setting out pros and cons could be said to be itself a financial service when provided by someone holding themselves out to be an expert in this area
- If you did not declare to the client the conflict of interest you had, i.e. that you would be paid only if the client opts for the transfer value, this could be relied later at the Ombudsman or Court to suggest that you had a strong financial incentive to 'nudge' the client towards taking the transfer value, i.e. that you weren't neutral in the matter
- If you provided a Statement of Suitability to the client for the investment in the BOB or PRSA, this could be taken as confirmation that you had in fact provided advice to the client in relation to the whole transaction
- A client could potentially take a case that the information provided by you (i.e. the pros and cons) was inaccurate or incomplete or misleading and was a 'financial service ' provided in conjunction with the regulated service of recommending a particular BOB or PRB, i.e. it was all one continuous financial advisory service
- It is a common requirement for deferred members of DB schemes opting to take a transfer value to be required to sign a Declaration to the scheme trustees saying they obtained 'independent' financial advice before making a decision to take the transfer value. Therefore the client may have relied on you or indeed nominated you in writing to the scheme trustees as the person who provided 'financial advice' to them before making a decision to take a transfer value
- A pure 'execution only' service would involve NO assistance with the client decision making process. For example, the definition of execution only in the Central Bank's Consumer Protection Code

  Clause 5.24 defines it as: 'the consumer has specified both the product and the product producer by name and has not received any assistance from the regulated entity in the choice of that product and/or product producer'.

[1] The term is not defined in the Financial Services and Pensions Ombudsman Act 2017, other than to say it included financial products, which term is also not defined in the Act.

Information

There are a number of items of information that should be sought before advising a client on whether to retain their deferred pension in the DB scheme or take a transfer value:

- The client's current deferred pension entitlement and the current alternative transfer value offered. Is the TV less than 100% MFS? Is there an enhanced TV on offer, and if so, is there a time limit on acceptance?
- **Client's other potential sources of regular fixed income in retirement;**
- A copy of the scheme's latest actuarial valuation report. This will help to identify if the scheme is failing to meet the funding standard, and if so by how much
- If the scheme does not currently meet the funding standard, is there a funding proposal to make up the deficit? If so, what is the proposal, is the employer sticking to its commitments; is the scheme on track to make up the deficit or has it veered off course?
- Are the trustees contemplating or is there any proposal to impose a Section 50 reduction in benefits? If so, by how much? If there is a concrete proposal the TV on offer will probably already reflect the proposed reduction
- Are there any plans to wind up the scheme?