

## Smart ideas about wealth

### Here we go with the pension transfer status quo!

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After two years of consultation on the issue of how defined benefit pension schemes should calculate transfer values, on 18 January 2007 the Department for Work and Pensions (DWP) announced its proposals, on which legislation is expected to be introduced with effect from April 2008.

#### *What does this mean for pension scheme members?*

This announcement relates to members who have deferred defined pension benefits and the way that the trustees of such schemes calculate the present day cash value of those defined benefits.

The DWP has announced that, following two years of consultation, they intend to legislate to continue with broadly the same rules, relating to how trustees calculate cash equivalent transfer values for members with deferred pension benefits, as we have at present (see figure 1). Trustees will continue to have discretion, advised by the scheme actuary, as to the assumptions that they use. The two most important assumptions are longevity (which, along with the gilt yield, affects the capital cost of the pension) and the discount factor (which affects the present day value of the capital cost of the pension).

If the scheme assumes low life expectancy (longevity) then the cost will be lower than one assuming high life expectancy, resulting in a lower transfer value. Even a few years' difference can have a massive effect, as highlighted in the difference in liabilities resulting from the differing longevity assumptions used by BT and the Post Office pension schemes. Interestingly, the DWP proposes to allow the scheme trustees to use different longevity assumptions for continuing members and for transferring members.

The discount factor must broadly reflect the investment strategy adopted by the scheme trustees, such that a scheme with, say, 70% equity type exposure will have a higher discount rate and thus a lower transfer value than a scheme with 70% cash and fixed interest type investments. It is therefore vital to look at the investment strategy being employed by the scheme.

More often than not this leads to members, particularly men and those members with above average life expectancy, being offered poor transfer values. What is in the best interests of the scheme is not likely to be in the best interests of the deferred member who wants to transfer his or her benefits out of the scheme.

The DWP commented that if it had introduced a prescribed set of assumptions which was more favourable to members, this might have put an additional financial burden on many schemes which are already under funded and increase the incidence of financial insolvency of pension schemes. Whilst Bloomsbury accepts this rationale, we do feel that members could have been given a better deal on transfers, which would have been fairer to both members and schemes.

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*What should members do now?*

Unfortunately the decision on whether to leave defined benefits with a former employer's pension scheme or to transfer the cash equivalent to another scheme, whether money purchase or defined benefit, is a complicated one. Transferring out is not necessarily more (or less) risky than leaving benefits with the former scheme, but rather the risks are different. Individuals should seek professional advice on the issue. The activity of advising on pension transfers requires advisory firms to hold a special class of authorisation and professional qualification and as such the cost of such advice will usually be at least £1,000 and in many cases the fees will be much higher.

As a general rule of thumb benefits should be left with the old scheme if any or all of the following factors apply:

- The deferred member has less than 15 years before benefits become available,
- The deferred pension scheme is fully funded (i.e., assets fully match liabilities),
- The member is comfortable that the sponsoring employer will continue to support the pension scheme,
- The member does not have the risk capacity to accept exposure to the investment strategy which would be necessary to meet or exceed the critical yield required to replace the old pension benefits,
- The ill health or dependants' benefits provided by the scheme are particularly generous (and valued by the deferred member) and cannot be easily replaced cost-effectively by other means,
- There is no transitional protection of either/both overall benefits and/or tax-free cash, both of which might be lost if the transfer were not done as part of a bulk wind up or buyout policy,
- The scheme has a predominantly low risk investment strategy and consequently the trustees have used a low discount rate to calculate the present day cash equivalent transfer value.

Remember, the decision on whether to transfer or not will depend on the individual circumstances of the member and the scheme and a careful evaluation of the facts.

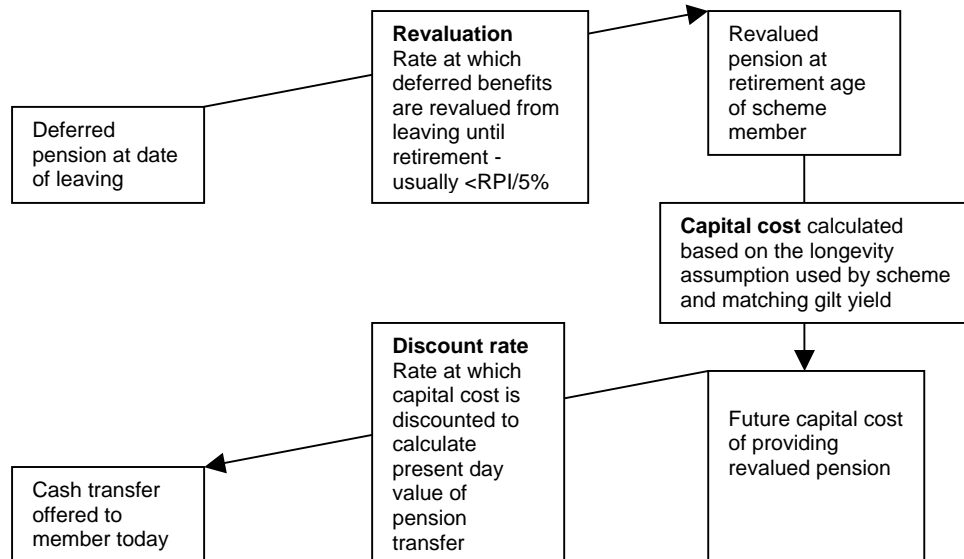
*How do members work out if they are getting a good deal?*

It is difficult for members to work out whether they are getting a good deal on their own. The starting point is to obtain a transfer value quotation from the trustees of the old scheme and then approach an adviser who offers pension transfer advice for an initial assessment. Usually the initial assessment will cost a few hundred pounds to ascertain whether a more detailed assessment is likely to be worthwhile.

One should, however, remember that the DWP has merely announced its conclusions following the consultation period, and that legislation will be required. Legislation was originally expected to be in place by April 2007, but the DWP now states that this is expected to be in place by April 2008. Whether we get the legislation by then and exactly what will be in the detail is anyone's guess. Recent experience suggests that subsequent amendments to the legislation are not inconceivable either.

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**Figure 1 – how defined benefit transfer values are calculated**



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