Should I stay or should I go?

There are around 11.8 million people who have built up benefits in private sector defined benefit pensions and its seems that higher transfer values are increasingly tempting people to leave these so called "gold-plated" schemes.

There has been a huge increase in interest in defined benefit (aka Final Salary) pension scheme transfer values since new pension freedoms legislation was introduced by Chancellor George Osbourne in 2015. According to the FCA, 34,053 people were provided with a recommendation to transfer or convert their defined benefit pension between April 2020 and September 2021 alone[1].

The Financial Times previously reported "cash lump sums offered to individuals looking to give up generous final salary pensions have jumped to records highs." According to the insurance company Royal London, six million people with defined benefit pensions have seen their transfer values increase significantly. The insurer suggests some members are being offered "eye-watering" sums, often tens of thousands of pounds more than several years ago. For an individual with a pension income worth £20,000, it is not uncommon to be offered 30 times that amount, in other words, £600,000 in cash.

A Royal London survey of more than 800 financial advisers found growth of more than 50% in the volume of transfers out of defined benefit pensions taking place in 2017, with the most common transfer value lying in the £250,000 - £500,000 range[2]. The vast majority of clients transferring were in their 50s, and the typical cash sum offered is between 25 and 30 times the value of the annual pension given up.

So why are so many people transferring out of these schemes that offer a guaranteed payment for life? The answer is twofold: Transfer values for defined benefit schemes have been at inflated levels recently and secondly, the recently introduced pension freedoms that provide for vastly improved flexibility in how a pension can be taken applies to Defined Contribution (DC schemes) only.

[1] The figures are according to https://www.fca.org.uk/freedom-information/data-defined-benefits-pension-transfer-activities-february-2022

[2] https://www.actuarialpost.co.uk/article/people-choosing-cash-lump-sum-over-regular-pension-income-12233.htm

Inflated transfer values

Transfer values are the sums paid from a pension scheme when a member chooses to withdraw their entitlement. In the past, lack of knowledge and lethargy meant many people kept pensions in previous employers' schemes until they came to retirement.

The level of a transfer value from a defined benefit scheme is not specified in the scheme's rules, unlike other benefits. The terms used are set by the trustees, on the advice of the scheme actuary, at the time of the transaction. Transfer values paid from defined benefit schemes are the only ones that require assumptions about the future. Also, due to the pooling of risk between members, the level of transfer payment can also affect other people's entitlements. The scheme actuary's aim is to calculate the "best estimate" of the amount needed to buy the equivalent to the scheme entitlement. The actuary has to tread a careful line to be fair to both sides, ensuring any transferring member and those remaining in the scheme are not left worse off. The actuary also has to be mindful that schemes have to guarantee their transfer value quotations for a period of at least three months to give members time to make arrangements with an insurer.

So let's briefly look at the reasons for the increased transfer values in the last couple of years which has sparked increased interest from members.

Transfer value calculations require assumptions about discount rates, inflation rates and demographic assumptions, all of which apply many years into the future and so there is considerable uncertainty over how these factors will play out. Discount rates are often based on long-dated bonds adjusted for the scheme's actual asset mix. Currently gilt yields are at low levels, which results in lower discount rates and higher transfer values. At the same time, the long-term inflation rate outlook has risen, which also tends to increase transfer values in many defined benefit schemes.

Experience suggests that those who have requested and received inflated transfer values may also have told their friends and families about the relative size of their transfer values, encouraging more people to consider transferring.

Cash lump sums offered to individuals looking to give up generous final salary pensions have jumped to records highs.

The Financial Times

Pension freedom

Members transfer for different reasons. They might feel more secure with a policy in their own name, in case anything happened to the scheme; the BHS pension debacle in 2018 is an example of this. Or perhaps they want to have all their pensions in one place. It also allows defined benefit members to tailor their pension to suit their own needs, where these differ from those in the scheme's rules, for example by:

- Taking their pension earlier or later than the scheme rules offer
- Allowing for different levels of inflation protection
- Altering the level of dependants' pensions to provide more or less for a spouse, or to remove them completely if they have no dependants

Pension freedoms introduced in 2015 changed this in a big way, encouraging more members to transfer. Since 2015 holders of defined contribution plans:

- Do not have to buy an annuity
- Can draw their pension flexibly
- Can even take the whole pot as cash, although this would be subject to tax

The important point is that these freedoms only apply to members of defined contribution schemes, so if defined benefit scheme members wish to take advantage of the flexibilities, they must transfer. Publicity over the new legislation also seems to have spurred people into considering their own pension and taking action.

It must be noted however, that if a scheme is underfunded, paying out a full transfer value could mean remaining members are left worse off. Underfunded schemes, those with a poor outlook for returning to full funding, may reduce transfer values (an "actuarial reduction") so as not to disadvantage those left behind even further.

For an individual with a pension income worth £20,000, it is not uncommon to be offered 30 times that amount, in other words, £600,000 in cash.