

Introduction

Dealing with the benefits of an 'early leaver' from a final salary occupational pension scheme is a highly complex matter.

Over the years, it has also proved to be controversial.

During the late 1980s and early 1990s, many transfers took place from final salary schemes to personal pensions, which were launched in mid-1988. In the mid-1990s, for a variety of reasons, the financial services regulators judged that many of these transfers were inappropriate and forced insurance companies and financial advisers to review all their occupational scheme transfer business.

This review officially ended in 2002 and resulted in compensation payments of nearly £11bn.

Off the record, many insurers would agree that there was an element of hindsight in the regulator's actions.

A combination of falling long-term interest rates and increased life expectancy has substantially added to the cost of pension provision in a way that was unanticipated when the transfers took place. The same ingredients are at largely responsible for the closure of many final salary schemes.

The massive cost of righting the transfer wrongs serves to underline the potential risks involved in pension transfers.

There can be rewards from transfers too, although they are generally harder to come by.

Whether the overall value of benefits will be higher as a result of a transfer depends upon the adequacy of the transfer value, the investment performance of the transfer plan and prevailing annuity rates when a pension is eventually purchased. To complicate matters further, the basis of transfer values from final salary scheme was recently revised by the Department for Work and Pensions (DWP), with new rules that came into effect from October 2008.

Investment performance and annuity rates are two elements which cannot be predicted with any certainty, as the first few years' experience with personal pension transfers demonstrated.

There are currently four principal options open to 'early leavers' from a final salary scheme, which are considered in more detail in the following sections:

- Stay put, i.e. leave their 'preserved benefits' in their former employer's pension scheme.

- Transfer to the new employer's scheme, if one exists.
- Transfer to a personal pension (including stakeholder pension).
- Transfer to an individual deferred annuity, previously called a buy out bond or section 32 plan.

Leaving benefits in the former employer's scheme

This is the starting point against which any alternative should be judged.

Unless there are solid reasons for making a transfer, the sensible option will be to stay put.

A range of factors must be reviewed to understand what the current scheme provides:

Escalation of benefits before retirement

A transfer from a final salary scheme will normally consist of two elements:

- The guaranteed minimum pension (GMP), which effectively replaces SERPS benefits in a contracted out scheme.

As a result of changes introduced by the Pensions Act 1995, no new GMP has accrued since 6 April 1997.

- The non-GMP portion, which is the remainder of the benefit. This includes all benefits earned since 6 April 1997.

The GMP will normally be increased each year (revalued) in one of two ways:

- By a fixed rate. For leavers on or after 6 April 2007, this is 4.00% per year compound. For leavers between 6 April 2002 and 5 April 2007 the rate was 4.50%. For leavers from 6 April 1997 to 5 April 2002, the rate was 6.25%. Earlier rates were higher.
- In line with section 148 orders (i.e. broadly in line with national average earnings).

For an early leaver who left service after 31 December 1990, the whole non-GMP element accrued up to 5 April 2009 must be revalued at the lesser of the growth in the RPI or 5% per year compound between the date of leaving and retirement. For benefits accrued from 6 April 2009, the cap for the revaluation rate is 2.5%, not 5%.

For an early leaver who left service after 31 December 1985 but before 1 January 1991, this revaluation process need only apply to non-GMP pension benefits accrued after 31 December 1984.

Some schemes, notably government and other statutory schemes, go beyond these minimum requirements and provide full or partial additional inflation proofing before retirement.

One effect of the likely drop in the RPI over the year to September 2009 will be that across the year the amount of a preserved pension will fall.

Escalation of pensions in payment

The majority of final salary schemes provide increases to pensions in payment.

For service before 6 April 1997, these may take the form of guaranteed and/or discretionary increases.

Discretionary increases do not have to be allowed for in transfer values, but should be taken into account when making any comparisons.

A guarantee of full inflation proofing is common in statutory schemes, but rare in the private sector.

All pension benefits secured in respect of service between 6 April 1997 and 5 April 2005 must be increased each year by the lesser of the rise in the RPI and 5%. The upper limit was reduced to 2.5%, for benefits accruing from 6 April 2005. Pensions cannot fall if the RPI is negative.

Spouse's and dependants' death benefits

Early leaver's benefits usually include a spouse's pension payable on the death of the member before or after retirement.

In addition, there may also be pension benefits for children and, possibly, other dependants, e.g. common-law spouses (and even same sex partners in some cases).

Practice is changing rapidly in this area, driven by the Civil Partnership Act 2004 (which came into force on 5 December 2005), and it is unwise to rely on old scheme booklets.

Early retirement benefits

Some schemes give favourable treatment to early leaver's benefits taken before the scheme's normal retirement age.

For example, this may apply where the member has to retire early on grounds of ill-health.

In the past, most schemes have tended to be reasonably generous in their normal early retirement terms,

although early retirement factors are tending to become more cost-neutral because of financial pressures.

Any comparison of options should allow for early retirement options, whether or not early retirement is currently planned.

The Finance Act 2004 contains provisions that raise the minimum retirement age from 50 to 55 from 6 April 2010. There are limited transitional exemptions for occupational scheme members, which would be lost on an individual transfer.

Tax regimes

Under the simplified pension tax regime, in theory the differences in tax regimes between different types of pension have disappeared. In practice, not all schemes offer all the flexibility which has been created by the simplified regime. It is therefore important to study what benefits the old and new schemes permit, rather than what HM Revenue and Customs (HMRC) allow.

Care also needs to be taken to ensure that transitional protection is not lost when a transfer is made. The most likely danger is that protected tax-free cash will be lost on an individual transfer, unless it is made to a deferred annuity contract on scheme wind up.

Scheme financial security

The scandal involving the pension schemes of the late Robert Maxwell's empire brought the issue of financial security to the fore and eventually led to the Pensions Act 1995.

While the risk of fraud has been reduced as a result, the issue of financial security has not gone away.

Poor investment conditions in the first three years of the new millennium and rising pensioner life expectancy mean that almost all final salary schemes are now in deficit.

The Pensions Act 2004 introduced the Pension Protection Fund (PPF) from 6 April 2005, which is designed to provide a financial safety net for final salary scheme members if their scheme has a shortfall and their employer goes bust. However, the PPF only provides protection for pensions of up to £31,936 a year. Any excess is not covered unless the individual has already reached their scheme's normal retirement age or retired due to ill-health. The £31,936 cap applies at age 65, with a lower figure for younger ages, e.g. £28,925 at 60. The PPF is financed by a levy on all private sector final salary schemes and is not guaranteed by the government.

The Pensions Act 2004 also introduced a new scheme-specific funding basis, which is now being phased in as a replacement of the largely discredited minimum

funding requirement (MFR). The basic aim of the Pensions Regulator (TPR) has been to get schemes fully funded within ten years. Many schemes have already increased employer and employee contributions as a result.

An indication of the ability of a scheme to meet liabilities on a guaranteed basis is given by the FRS17 accounting standard, which many companies are struggling to meet. The PPF has estimated that the total deficit for private sector final salary occupational schemes based on the amount needed to cover PPF benefit levels was £253.1bn at the end of March 2009 against £81.5bn 12 months previously.

Scheme financial security is a highly complex area, which is best left to the assessment of professionals if there are any doubts.

Guarantees

Outside the area of escalation of pensions in payment, benefits under final salary schemes are largely guaranteed by the scheme or, if that fails, the PPF. Any transfer to another pension arrangement – other than another final salary scheme – will mean that such guarantees are lost, in whole or part.

As a general rule, the older the individual, the greater the significance of guarantees.

However, before 11 June 2003, some solvent employers were winding up their final salary schemes, an act which often crystallised a significant loss of benefits under the normal funding rules. This loophole was closed by regulations requiring solvent employers to make good any shortfall, unless to do so would itself render them insolvent.

The private sector final salary 'guarantee' is not and has never been 100% and the PPF, as explained above, has its limitations.

Other factors

There is a range of other factors that needs to be borne in mind, when looking at the benefits of an existing scheme.

For example, some schemes offer a 'bridging pension'.

This means that if the scheme's retirement age is before state pension age, the member's pension is increased until state pension benefits start to be received.

Other schemes, mainly in the public sector, operate a 'transfer club' which allows members to transfer between public sector jobs with full credit for past pensionable service.

This will normally be more favourable than an outside transfer.

A former public sector employee now in a private sector job, but possibly returning to the public sector later (e.g. teacher, nurse) would lose future 'transfer club' benefits if they were to transfer their benefits elsewhere.

Transferring to a new employer's pension scheme

If an employee transfers pension benefits to a new employer's final salary occupational pension scheme, they may be credited with 'added years' of membership of the new scheme.

These will usually be fewer than the years of service in the old scheme because of the different calculation basis between the two schemes.

Alternatively, the scheme may offer a fixed pension benefit or invest the transfer on a money purchase basis, i.e. with no guarantees.

When comparing a transfer to a new employer's scheme with the benefits of staying put, the following points need to be considered:

Expected salary growth

If the transferring employee is a high-flyer who expects a faster than normal rate of salary growth, then 'added years' can still be a highly attractive option.

This is because benefits will be based on salary at the date of retirement or leaving service, not the current salary on which the 'added years' are based.

On the other hand, if the employee expects below average earnings growth, 'added years' has little appeal.

Retirement date

The new scheme may not offer benefits at the same retirement age as the old scheme. If this is the case, it will be difficult to make a valid comparison of pension benefits without resort to early/late retirement factors, which can and do change over time.

Even where the retirement date is the same, it is unlikely that treatment on early or late retirement will be the same.

Escalation of pensions in payment

The practice of the new scheme may be more or less favourable than that of the old scheme. The comparison may not be straightforward.

For example, if both schemes offer discretionary pension increases, past treatment may be no guide to the future.

Spouse's and dependants' benefits

The level of benefits under the new scheme is unlikely to be the same as under the old scheme.

This is another area where comparison can be difficult, e.g. in the treatment of unmarried partners where trustees' discretion can play a major role.

Death and disability benefits

A similar consideration as that applying to spouse's and dependants' benefits applies to these benefits.

Scheme financial security

Just as financial security is an important factor in reviewing whether to stay with an existing scheme, so it is in the context of any scheme to which a transfer is to be made.

A transfer to a scheme with a much weaker financial position would not normally be advisable.

Transfer to an individual pension arrangement

There are two types of individual pension arrangement to which transfers may be made from occupational schemes:

1. Personal pension plans (including stakeholder pension plans)

A transfer to these plans is divided into two parts: protected rights and non-protected rights.

The protected rights element represents the value of the GMP and, for transfers from contracted out final salary schemes, the value of all pension benefits accrued since 6 April 1997.

It has to provide a pension in a particular format, but can now provide a tax-free cash sum.

The non-protected rights element is simply the residue and is subject to fewer restrictions.

2. Deferred annuities (also known as Section 32 plans or buy out bonds)

These are also split into two elements: the GMP element and the non-GMP element.

In this instance it is the non-GMP element that includes the value of all benefits accrued since 6 April 1997.

Both personal pensions and deferred annuity plans allow the individual to control the investment of their transfer monies, outside the original scheme.

The benefits of the two types of plan are similar, the main differences stemming from the treatment of GMP.

Tax-free cash sum

The maximum cash payable under a personal pension is 25% of the total fund (including protected rights).

The same limit applies to individual deferred annuity contracts, but the cash can only be drawn from the non-GMP element. This will mean that the deferred annuity offers less cash than the personal pension if the value of the GMP exceeds 75% of total benefit value. However, a transfer to a deferred annuity qualifies for transitional protection of tax-free cash on scheme wind up (see 'Tax Regimes' above), but a transfer to a personal pension does not.

Flexibility

Normally, the personal pension and deferred annuity can offer the same flexibility of benefits. However, because the GMP must be guaranteed, poor investment performance could mean that the drawing of benefits has to be delayed, at worst until as late as state pension age.

Early retirement

Provided the revalued GMP is adequately covered, all deferred annuity benefits can be drawn before state pension age (65 for men, currently 60 for women but due to be phased up to 65 between 2010 and 2020).

Under a personal pension, there is no restriction on the timing of benefits, other than the HMRC normal minimum pension age rules (i.e. age 50 up to 5 April 2010 and 55 thereafter).

Death benefits

Under most final salary occupational pension schemes, the pre-retirement death benefits for the 'early leaver' are limited to a widow(er)'s and dependants' pensions.

It is rare that any lump sum death benefit is payable.

For an unmarried member with no dependants, this effectively means their preserved pension becomes worthless on death before retirement.

In contrast, both a deferred annuity and a personal pension can offer lump sum benefits. The lump sum death benefit is 100% of the non-protected rights/non-GMP fund. The protected rights/GMP element must be used to provide pension if there is a surviving spouse or civil partner. Otherwise it may also be paid as a lump sum.

Any pension benefits will generally depend upon using the accumulated fund to buy an annuity, which can result in widow(er)'s pensions being smaller than the occupational scheme offers at the date of transfer, but higher as retirement nears.

Guarantees and risk

Under the deferred annuity plan, the GMP element remains guaranteed (but can be offset against the non-

GMP element), but there are no guarantees under personal pensions.

The importance of the guarantees is ultimately for the individual to decide, based on their attitude to risk.

For someone close to retirement with little or no other pension provisions, guarantees can be crucial.

A high flyer, with many years' future employment and a broad investment portfolio may be much less concerned about security of benefits and more willing to accept, or even seek out, investment risk.

Over-funding

Tax simplification means that deferred annuity plans and personal pensions are no longer subject to over-funding rules. However, tax penalties apply if the value of all retirement benefits exceeds the lifetime allowance (£1.75m in 2009/10), again subject to transitional reliefs that had to be claimed by 6 April 2009.

Transfer value analysis system

From the above list, it should be obvious that the comparison between a deferred annuity plan, a personal pension and staying with the original pension scheme is extremely complex. In theory the tax simplification rules have made matters easier, but not every pension arrangement takes full advantage of the flexibility created by the reforms.

The insurance industry has addressed the difficulty of transfer assessment by developing detailed transfer value analysis systems (TVAS), the output of which must be given to anyone considering a transfer from a final salary occupational scheme.

A TVAS will typically detail:

- The required rate of investment return for the transfer plan to match the benefits under the transferring scheme, assuming the individual retires at the scheme's normal retirement date, or takes early retirement (if the scheme has advantageous early retirement provisions).

The higher the rate of return required, the less attractive the transfer option.

- An analysis of the immediate lump sum and pension death benefits.

If this indicates a shortfall in comparison with the previous scheme, an illustration of the cost of providing the sum assured to make up the shortfall will also be given.

There may also be an analysis of future death benefits, e.g. just before retirement, to show how the two sets of benefits change over time. To ensure a

fair comparison the adviser should check whether there are any plans to change the structure of the old scheme in the light of pension simplification.

- A comparison of the amount of tax-free cash sum available.

The TVAS does not attempt to allow for tax. The TVAS must take account of charges in the transfer plan and make realistic assumptions where the previous scheme had a history of discretionary increases of pensions in payment and/or deferment.

Anyone considering a transfer should ask their financial adviser to guide them through the output of the TVAS and make certain that they understand the relevance of the numbers.

While the TVAS can provide the necessary numerical analysis, there are other aspects that must be considered.

For example, the individual's state of health may be a major determinant if the death benefits under the existing scheme are limited.

Psychology can also play its part, but often it is an unhelpful factor.

Redundant employees may want to transfer their pensions simply to remove any link with their former employers. While such a desire is understandable, it could involve considerable loss of benefits if the transfer is undertaken without consideration of the TVAS results.

Similarly, there is no case to be made for a transfer merely to achieve 'consolidation' or 'personal control' of benefits.

Transfers from other types of occupational pension scheme

Transfers are possible from money purchase pension schemes, i.e. schemes that build up a fund that has to be used to provide pension and tax-free cash at retirement.

In practice it may be hard to justify a transfer from this type of scheme into a deferred annuity or personal pension plan.

The money purchase scheme and the transfer plans work on broadly similar investment principles, so a switch between the two may incur costs without necessarily producing any compensatory superior investment performance.

On the other hand, a move from a high charging arrangement to a low charging scheme may be justifiable on overall financial grounds, even if a penalty is incurred on transfer.

There may also be circumstances where a switch to a personal pension or deferred annuity can make sense because of poor investment performance, limited fund choice within the occupational scheme and/or greater flexibility within the individual arrangement (e.g. an income drawdown facility).

This is an area of transfer planning which needs professional advice.

Conclusion

Dealing with a pension from a former employer is a highly complex area.

The risks in taking the wrong decision are all too clear from the huge compensation bills many insurance companies have faced in connection with personal pension transfers.

It is virtually impossible for the layman to make an assessment of the options available without the assistance of a professional adviser.

Even then, the final decision may be finely balanced, as much will depend upon assumptions about future investment returns and the level of inflation.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at May 2009, which are subject to change.