R04 2020/2021
The rights of early leavers

The milestones for this part are to understand:

- What options are open to an early leaver from both an DC and DB arrangement
- How a DB preserved pension is calculated and revalued
- The basics of transferring from a DB scheme

The days when someone joined a company on leaving school or college and expected to work there for the rest of their lives are long gone. This part will look at what happens to leavers from both money purchase and final salary schemes.

Early leavers Defined Contribution/Money Purchase

Once the employee has joined the scheme there is no refund of contributions other than under the cooling off limits.

The funds that have been built up will still have the potential to grow but no further contributions can be made. This means individuals may find themselves with many different arrangements. It makes sense to consolidate these to get investment control and possibly to benefit from lower charges.

Care should be taken as to whether the fund has additional benefits such as a higher lump sum than the normal 25% but there is no need to have a special pension transfer qualification to do this.

Early leavers: Defined Benefit Schemes

Members who leave a defined benefit scheme with less than two year's membership can get a refund of **their** contributions less 20% tax for the first £20,000 and 50% on the excess.

If a DB member leaves after two years, they cannot get a refund but get a **deferred pension**. This is their pension calculated as if they were taking benefits on the last day of employment.

Rob leaves his job aged 40 having been a member of the scheme for 10 years. His salary at leaving was £42,000. The scheme had a 1/60th accrual.

His deferred (or preserved) pension is 10/60 x £42,000 = £7,000

If the scheme only had to pay Rob £7,000 in 20 years' time its purchasing power would have fallen significantly. Good news for the scheme but bad news for Rob. Fortunately, at least for Rob, the scheme is legally obliged to revalue the pension between the date he left and when he takes the benefits.

The rules on revaluation split the pension into two elements:

- Guaranteed Minimum Pension (GMP)
- Non GMP benefits

GMP is only found in a contracted-out scheme where the member accrued benefits before April 1997. Full details of previous rates will be in the exam tax tables.

The scheme must revalue these benefits by a fixed rate. The rate is set by the Government and determined by the member's leaving date. The current rate is **3.5%** per complete tax year and applies to members who left after 6 April 2017.

Provided the member left the scheme on or after January 1 1986 non GMP benefits must be revalued. In practice schemes that revalue by the legal minimum will use the Government's **Section 52A table**.

This is produced annually and shows the percentage increase that must be applied to the pension at date of leaving. For example, someone who left a job sometime in 2000 and takes their pension at any time in 2020 will have their pension revalued by 61.6%

Non GMP revaluation works on a complete calendar year basis. The latest table shows revaluation up to 31/12/19 so will be used for anyone who takes their pension in 2020.

Similarly, it is the year in which you left the scheme rather than the specific date that determines the revaluation rate.

Tom and Jerry were members of the same DB scheme and are taking their benefits in April 2020. Tom left in December 2003 and Jerry left in January 2004.

Tom's revaluation rate will be 51.2% whereas Jerry's will be 47.1%

Behind these figures are the specific annual figures that have been amended at different times since revaluation became compulsory in 1986.

Between January 1986 and April 2009	RPI capped at 5%
Between April 2009 to April 2011	RPI capped at 2.5%
After April 2011	CPI capped at 2.5%

All the rates covered so far are the legal minimum and a scheme can offer higher ones.

From the member's point of view unless there are very high periods of inflation between now and scheme pension age the preserved pension should retain its purchasing power. Whilst inflation has been relatively benign for the last 10 years, the current cap is just above the Government's inflation target so there is a risk that inflation could reduce its real value.

Are all preserved pensions revalued?

Any GMP element has always had to be revalued but revaluation for non GMP was only introduced for members who left employment after January 1 1986 and this only covered benefits accrued since January 1 1985.

Full revaluation only came in for leavers after January 1 1991. As this last date is 29 years ago, it is likely that most deferred members will get revaluation on all their benefits but consider this situation.

George is retiring in October 2019 and his first job was from 1979 to 1983. Outside any GMP his pension rights would be the same as the day he left with no revaluation.

His second job was from 1983 to 1989. Only the benefits accrued since January 1 1985 will be revalued.

He worked at his third job from 1989 to 2001 and all these benefits would be revalued.

Potential problems with deferred DB rights

The scheme must offer a deferred pension but there is no requirement to provide death benefits. If an active member were to die, a lump sum payment based on a multiple of final salary would usually be paid and the surviving spouse would receive a pension. These benefits **may** be paid to a deferred member.

Preserving dependant's benefits is not compulsory but some schemes may offer some protection so it is essential that this is checked when giving advice.

Options open to the DB member

Taking a preserved pension is the default option. The member does not need to do anything.

In state sector schemes, such as the NHS and Civil Service, the pension rights can be transferred from one scheme to another. This is known as the **transfer club**.

Jane was in the civil service pension scheme for 10 years before she took up a new job in Local Government. Under the transfer club rules, she will be credited with 10 years' service when she joins the new scheme.

There is no such arrangement in the private sector and as most final salary schemes are shut to new members transferring to the new employer's scheme is not an option.

Anyone with a deferred pension from the private sector can give up all their rights to benefits in the scheme in exchange for a cash lump sum called **Cash Equivalent Transfer Value (CETV or sometimes just TV)** This can be invested in another money purchase arrangement such as a Personal Pension or a SIPP.

Members of unfunded state sector pensions, such as the NHS and Civil Service are not allowed to do this. Members of funded state sector schemes such as the different local authority schemes can transfer but the relevant minister has the power to reduce the CETV if the amount being offered is seen to put the fund and the remaining members at risk.

Members have a statutory right to request a CETV every year free of charge. There is no right to a CETV in the 12 months before scheme retirement age but many schemes may allow this.

An early leaver with between three months and two years membership is not entitled to a deferred pension but can request a CETV as an alternative to a refund of their contributions.

Calculating the CETV

This is going into the realm of AF7 so any questions will only cover the basic principles.

A DB scheme has one fund for all its members. The CETV represents the amount of money the scheme estimates is needed today to give the member the revalued pension at the scheme's normal retirement age.

There are four steps in calculating a CETV:

1. The deferred pension at **date of leaving** is calculated.
2. This is **revalued to the scheme retirement age** by estimating the level of inflation between now and then. The higher the assumption, the higher the estimated revalued pension will be.
3. **The revalued pension is converted into a lump sum**. This is done by estimating the cost of an annuity to provide the revalued benefits at scheme retirement age. The annuity must provide the same benefits as the scheme pension, that is escalation and spouse's pension. The lower the assumed rate, the higher the lump sum that will be required to provide this pension.
4. The capital sum needed to pay the revalued pension is then discounted back to **the date of calculation.** For periods of more than 10 years to NRD, equity yields may be used, if the term is less than 10 years, bond yields must be used.

The TV may be reduced if the scheme is in deficit and the trustees want to discourage members from transferring benefits. It may also be increased if the trustees are trying to encourage members to leave. The regulator sees this as a potentially dangerous activity and sets strict procedures if schemes offer an enhanced CETV as a means of encouraging members to leave and give up their rights.

CETV have increased over the past few years primarily because Gilt yields have fallen which affects both the capitalisation in stage 3 and the discounting in stage 4. There is anecdotal evidence that some have offered as high as 25 times the pension at retirement.

If the former member wishes to consider transferring his pension rights to a PP or SIPP advice must be given by a Pension Transfer Specialist if the CETV is more than £30,000.

The FCA considers keeping deferred rights with the scheme is the best option and the PTS must show why transferring is a better option. By staying in the scheme the pension will be revalued, when it comes into payment it will be increased each year and will automatically include a spouse's pension. The sponsoring employer takes all the risk. Moreover ,the member is not involved with making any investment decisions or having to pay advice charges.

On the other hand if the member transfers years before retirement they are exposed to investment risk as they rely on the fund achieving sufficient growth to match the revalued pension. If at retirement they take the income by means of drawdown they are agin exposed to investment risk, there is a danger that they may exhaust the fund and will have to be involved with a lot of admin and pay charges. They also take on all the risk.

The PTS must do a complete analysis of the individual's circumstances and demonstrate whether staying or transferring will best meet the client's requirements for sustainable income, capital, together with death and survivor benefits.

They must produce an Appropriate Pension Transfer Analysis (APTA). This will include a Transfer Value Comparator (TVC) that illustrates in graphic form the difference between the additional costs of buying the same benefits as could have been received by staying in the scheme.

If the client is advised to transfer they must give up all the rights to the benefits they would have received by staying in it.

That is the end of the tutorial so you should now understand:

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- How a DB preserved pension is calculated and revalued
- The basics of transferring from a DB scheme