# AF7 Pension Transfers 2020/21
# Part 3 Early leavers and the right to transfer

The milestones for this part are to understand:

- When pension rights can be transferred.
- What happens to pension rights when the member changes jobs.
- The main options on leaving
- How a cash equivalent transfer is calculated

## The right to transfer

Funds in an **uncrystallised PP or SIPP** can be transferred at any time to another provider.

For an **DB or DC occupational scheme**, only deferred uncrystallised benefits can be transferred.

The most common way to get deferred benefits is to change jobs. The individual is then classed as a deferred member of that scheme.

If an active member wants to transfer but continue to work for the employer, they must leave the scheme before the transfer can be done.

Members of **unfunded** state sector schemes such as the Teachers' or National Health Service can only transfer to another scheme in the transfer club.

Transferring is not a crystallisation event and will not use up any of their Lifetime Allowance.

## Pension rights on moving jobs

With the completion of auto-enrolment many more individuals will be contributing to their employer's scheme. These are unlikely to be "jobs for life" so what happens to the pension on changing jobs?

This will depend on whether the pension was:

- A money purchase arrangement
- A Defined Benefit Scheme

**Money purchase arrangements**

The general rule is that there is no refund of member's contributions unless the member withdraws under the "cooling off" provisions of the auto-enrolment provisions.

The member cannot make further contributions to their fund but will continue to benefit from potential investment growth. The Government has proposed a “pensions dashboard” so that individuals can see all their pension arrangements in one place.

If both the old and new employer use NEST, the member’s fund can be transferred into the new employer’s arrangement.

Having “stranded” funds in different places can have several disadvantages.

- Having several funds makes it difficult for the member to keep track of these.
- When benefits are taken it is simpler to have one fund.
- There may be no planned investment strategy. The employer may use a default portfolio or use life styling that are unsuitable for the member’s needs.
- Combining funds into one fund may result in lower charges.
- An occupational scheme may prohibit the former member from accessing the benefits flexibly.

Transferring can either be done on leaving the job at a later stage but before a transfer is recommended a check should be made to see if:

- There is a Guaranteed Annuity Rate, and what are its terms.
- Flexible benefits are available under the existing arrangement.
- There is a protected PCLS arising from pre April 2006 benefits as this could be lost on transfer.
- The charges of the ceding and receiving arrangement.
- Whether there is an exit penalty.

## Early leavers: Defined Benefit Schemes

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

If the member leaves after two years they 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 1/60$^{th}$ 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

The scheme must revalue any GMP 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. 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.

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.

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|---|---|
| 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. If this is the situation the case study will give you the relevant rate.

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. Neither of these benefits **may** be paid to a deferred member.

Jack is 40 and has 10 years' service in his scheme. His salary is £42,000. If he were to die his widow would receive a pension of £21,000 plus a DIS benefit of £168,000.

If Jack had left service, he would get a deferred pension of £7,000. If he then died the scheme is under no obligation to pay this much to his widow.

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.

In practice the individual may not get the exact number of years they had in their former job. This is because the structure of the schemes may differ. For example, the scheme retirement ages may be different. The ceding scheme will calculate a Transfer Value and the receiving scheme will convert that to years of equivalent value in 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

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.

Before moving on let's look at how the factors interact and why the CETV will vary from time to time.

- In general, it will increase as the member gets closer to NRD because there is less time for the TV to grow to the amount required to produce the lump sum needed to pay the revalued benefits.
- If inflation has increased this will increase the revalued pension and if everything else remains the same the CETV will increase. If inflation reduces the CETV will also fall. A change in inflation will have an impact on the member's DB pension which could also affect the CETV. A higher inflation rate means that the rate of escalation will increase which in turn increases the price of an annuity
- If annuity rates are high, the lump sum required will be lower so the TV will also fall. If annuity rates are predicted to be lower, as would be the case if inflation was increasing, the capital sum will increase as will the TV
- If assumed discount rates are high a lower initial sum is required to produce the lump sum at NRD so the TV will be lower. A low assumed discount rate will result in a higher TV.
- Changes in legislation, mortality assumptions and actuarial practice would also affect the amount of the TV.

There is a CETV calculator on my website that allows you to put in different assumptions and see how this affects the CETV.

Finally, and this may be an obvious point, the CETV does not, on its own, give any indication as to whether it is worth transferring.

That concludes this part so you should now understand:

- When pension rights can be transferred.
- What happens to pension rights and funds built up in employment when the member changes jobs.
- The main options on leaving
- How a cash equivalent transfer is calculated