AF7 Pension Transfers 2023/24
Part 1 Introduction and DB schemes

Introduction

Anyone who wants to give advice on transferring "safeguarded benefits" must pass a recognised qualification of which AF7 is one.

The exam will test your technical knowledge of transfers and how these are applied to a given situation. In other words, what's possible and what's advisable?

The majority of questions will be concerned with members of final salary schemes who are considering transferring into a PP or SIPP in order to take benefits flexibly. It is complicated, but at its root it's about deciding which is more valuable, a guaranteed lifetime income or a lump sum now. This decision is irrevocable, once the pension is transferred, the member cannot be taken back into the scheme.

The notes are split into six parts:

- The first part covers the main benefits offered to DB members.
- The second summarises the main options when benefits are taken flexibly
- The third part will look at the rights of deferred members including the right to transfer
- The fourth part considers the factors that must be considered in deciding whether or not to recommend a transfer from a DB scheme.
- The fifth part considers how the 2023 Budget affects the LTA and maximum PCLS
- The fifth will focus on how a sustainable income can be taken from a transferred fund
- The sixth will look at the compliance requirements.

The milestones for this part are to understand:

- The main benefits offered to a member of a defined benefit scheme.
- The main risks to members and protection offered by the PPF

A brief history of pension transfers

Whilst you will not be asked historical questions in AF7 it is useful to get an overview of how we got to the current situation.

Up until the mid to late 1970's there was a tacit understanding that if you joined a bank, an insurance company or a large commercial organisation, you would have a secure job and get a pension when you retired some 40 years later. It would have been a final salary scheme and all employees had to join as a condition of employment.

This wasn't quite the golden age that some commentators would have us believe. Many schemes would not allow women to join. If you left employment you could lose all your pension rights and there was no requirement to increase a pension in payment.

From the late 70's schemes had to give "early leavers" a right to preserved benefits but these needn't be revalued. The pension was "frozen" which meant inflation eroded its value. Limited revaluation was only introduced in 1986.

The most significant change came in 1988 when employers were prohibited from making membership of the pension scheme a condition of employment. It also gave deferred members the right to exchange their pension rights in return for a lump sum.

This led to the "pensions misselling scandal" of the late 80's and early 90's when members were told that they could get a larger pension by leaving the scheme and investing the transfer value into a Personal Pension. This was theoretically possible but was predicated on achieving high investment returns and high annuity rates at retirement. This did not happen and most persons who transferred would have been better off remaining in the scheme.

As a result, pension transfers were seen as being high risk and many firms and advisers decided to avoid them.

The situation changed with the introduction of "pensions freedoms" in 2015. This allowed members with money purchase arrangements to withdraw anything they wanted directly from the fund. Moreover, when the member died any remaining funds could be passed to a beneficiary and would not form part of the deceased's estate for IHT purposes. This was not available to members of final salary schemes but if they transferred the benefits to a SIPP or PP they could have the same flexibility. At the same time low gilt yields resulted in transfer values of over 20 times the member's pension being offered. This started a renewal in considering transferring out of the scheme close to the point of retirement.

DB scheme benefits: Do you know what you're giving up?

DB schemes are sometimes described as "gold plated pensions" and it is easy to see why this is the case at least from the member's point of view.

It promises a pension based on a percentage of the member's salary at date of retirement. This is based on an **accrual rate** which typically in the private sector is 1/60th. If they were a member for 30 years they will get 30/60th or ½ their final salary.

A money purchase arrangement provides no such promise and members rely on the fund value at crystallisation being sufficient to meet their needs.

An active DB member also receives additional benefits that are payable prior to retirement.

A lump sum death in service benefit.

This is based on a multiple of salary at time of death. If the multiple is 4 and the member's salary was £40,000 then the amount paid would be £160,000. This is almost always paid under a discretionary trust. The member cannot usually demand the benefit is paid to a specific person but can complete an expression of wish. This can be overruled by the trustees and whilst rare they may do this in the case of marital breakdown.

Peter died and left an expression of wish asking the trustees to pay the benefit to his partner Sandra. The scheme contacted Peter's manager and found out that he had left his wife Carol and children two years earlier. Based on that information the trustees may decide to pay all or part of the benefit to Carol

The benefit of having the payment under a discretionary trust is that the money will not be part of the deceased's estate and can be made very quickly. Most schemes will usually try and get the money paid out within a matter of days of being notified of the member's death.

Spouse's pension, pre-retirement

Most schemes will pay a spouse or dependant a pension if the member dies before retirement. The best will base this on the member's prospective service.

Jim's scheme pays a spouse's pension of 50% of salary at date of death based on potential service. The accrual rate is 1/60th.

Jim died aged 45 having been a member for 10 years. The scheme retirement age is 65. His salary was £40,000.

His potential service was 30 years, so his pension is calculated as 30/60 of £40,000 which is £20,000. His widow gets 50% of this and would receive a pension of £10,000 a year. (This is an example and schemes may pay more than this)

Ill health pension

Subject to HMRC requirements being met the scheme will usually pay an ill health pension.

In order to qualify for an ill health pension, the following conditions must be met:

- the member must have ceased work because of illness or accident
- the trustees must have medical evidence that the member will be unable to return to work.

This last point is a high threshold particularly for a younger member. The prognosis for a 30 year old who was involved in a car accident may be that he is unlikely to return to work for seven or eight years but a full recovery will be made. In those circumstances the member

would not qualify for an ill health pension and if one were made it would be an unauthorised payment.

As the member gets closer to 55 it becomes easier to meet the requirements and once over 55 the ill health pension is no longer applicable as they would be able to crystallise the benefits under the normal rules.

In a DB scheme the pension may be based on potential service to retirement.

Let's say in the previous example that Jim did not die but qualified for an ill health pension. This would be calculated as follows:

Salary £40,000 x 30/60 = £20,000

DB benefits at retirement

Early and normal retirement

The basic offer is that the member is paid a guaranteed income for life from the scheme retirement date, usually between 60 and 65.

The member can request to take the benefits before then (provided they are over 55) and this is normally a formality. However, the scheme will usually apply an actuarial reduction which reduces the size of the pension to take account that it will be paid for a longer period.

David is 58 and has 30 years' service. Based on 1/60th accrual and a salary of £40,000 his pension would be £20,000. However, the scheme retirement age is 60 so by taking it earlier he gets two years more income than if he had waited until reaching 60. The scheme will therefore reduce his pension.

They may also offer an increase in the pension if the member works on after scheme retirement date.

Whilst there must be a scheme retirement date, there is no legal bar to the scheme paying the pension and letting the employee carry on working.

PCLS calculation

At retirement a final salary member has only one decision to make; how much cash to take? In the private sector the practice is for the member to give up part of the pension for cash. In principle the amount of PCLS is still 25% but as there is one fund for all members we need a method to calculate this.

The scheme will have a commutation factor (CF) stating how cash can be taken for a reduction of £1 in the pension. A commutation factor of 14 means that for every £14 cash taken the pension would be reduced by £1.

The scheme will inform the member of the annual pension if they take no cash. They will also give the member the maximum cash that can be taken together with the commutation factor and await the member's instructions. Any cash must be paid before the first pension payment. Once a payment has been made it is not possible to take any cash.

In calculating the maximum PCLS, the scheme must use this formula.

$$\frac{\text{Pension before commutation x Commutation factor}}{1 + (0.15 \text{ x Commutation Factor})}$$

Tom has a pension of £15,000 and the CF is 14.

14 x £15,000 = £210,000
1 + (0.15 x 14) = 3.1
£210,000/3.1 = £67,741.94

The reduction in pension would be £67,741.94/14 = £4,838.71
Tom could therefore get a pension of £10,161.29 plus a cash sum of £67,741.94.

Tom could choose any sum between £0 and £67,741.94.

Schemes probably prefer members to take the maximum cash since this reduces their long term liabilities.

There is an alternative formula for calculating cash which is

$$\frac{\text{Pension before commutation x Commutation factor x20}}{20 + (3 \text{ x CF})}$$

You get the same figure and either is acceptable.

Final salary pension increases

One of the great benefits of a final salary pension is that it is legally required to increase in payment each year giving retired members a certain degree of protection against inflation. The technical term for this is **escalation**.

The simplest situation is where **all** the pension rights were accrued after April 1997. The pension must increase in payment as follows:

- For benefits accrued from April 1997 but **before** April 6 2005, the scheme must increase the pension by CPI to a maximum of 5%
- For benefits accrued **after** April 6 2005, the scheme must increase the pension by CPI to a maximum of 2.5%

The position for rights accrued before April 1997 is more complicated because of the presence of a Guaranteed Minimum Pension (GMP).

If the scheme wasn't contracted out of SERPS/S2P there would be no GMP and the scheme does not need to increase pensions in payment for any benefits accrued before April 1997.

Faisal was a member of a **contracted in scheme** from April 1987 until March 2016 when he retired.

The legal minimum that the scheme must increase his pension by is:

April 87 to April 1997	Nil
April 1997 to April 2005	CPI capped at 5%
April 2005 to April 2016	CPI capped at 2.5%

A Guaranteed Minimum Pension always had an element of inflation protection. For GMP accrued between April 1978 and April 1988 the State takes full responsibility for increasing the GMP which it does by increasing part of the member's State pension.

From April 1988 the State required the scheme to increase any GMP built up after that date by CPI capped at 3%. If CPI was higher the State would pay the excess as part of the state pension.

This means that someone who has benefits that started before April 1997 in a contracted out will have a pension split into 3 elements

- Guaranteed Minimum Pension (GMP)
- Pre 97 Excess Benefits (that is benefits built up in excess of the GMP)
- Post 97 Benefits

Therefore, if asked to state how such a member's pension would increase in payment **for someone who reached state pension age before 6 April 2016**, this should be your answer.

GMP	• For benefits accrued **before** April 6 1988 the scheme does not have to increase the pension since the State provides full CPI protection • Benefits accrued **after** April 6 1988 the scheme pays the first 3%. If CPI is higher the DWP will pay the excess
Pre 97 Excess benefits	The scheme does not have to provide escalation
Post 97 Benefits	• For benefits accrued **before** April 6 2005, the scheme must increase the pension by CPI to a maximum of 5% • For benefits accrued **after** April 6 2005, the scheme must increase the pension by CPI to a maximum of 2.5%

This split is important for another reason. Some schemes may allow the member to make a partial transfer which in practice means pre 1997 benefits could be transferred leaving the GMP and post 97 elements in the scheme.

The original rules linked increases to Retail Price Index (RPI) but the 2011 budget changed this to Consumer Price Index (CPI). However, if the scheme's own rules say that benefits must be increased in line with RPI then this overrides the legislation.

These are the legal minimum a final salary scheme must provide. Schemes can and often do pay increases at a higher rate than this. In particular, they will often provide escalation on pre 97 excess benefits.

Whilst escalation is very attractive if increases are capped at 5% or 2.5%, in periods of high inflation the real value of the pension will reduce.

Escalation for members who reach State Pension Age after April 5 2016

The abolition of contracting out from the start of the 16/17 tax year had implications for the rules on the escalation of any GMP.

There will be no change for anyone who reached **State Pension Age on or before April 5 2016.**

Everyone who reaches State Pension Age on or after April 6 2016 with a GMP will be affected. Increases in the GMP element will no longer be provided by the State as part of the member's State pension. This means no increase in the pre April 1988 benefits. The scheme will still be responsible for increasing the post 1988 benefits by CPI capped at 3%.

In practice most schemes already offer escalation on pre 1997 non GMP benefits at CPI/5% and they may extend this to the old GMP benefits.

Spouse's/dependant's pension post retirement

All final salary schemes must pay a pension to the member's spouse of at least 50% of the member's pension on all benefits accrued since April 6 1997. For same sex marriages and civil partnerships, the scheme is only obliged to pay benefits accrued since December 2005. Contracted out schemes must also provide a 50% spouse's pension from any GMP element.

Legally schemes can pay a "dependant's pension" to anyone but the scheme's rules may restrict this to a legal spouse or civil partner. In practice, many schemes pay to an unmarried partner on a discretionary basis. Some schemes will cease payment to a spouse if they remarry.

Whilst these are the minimum requirements many schemes will pay a spouse's pension on all benefits. They may also pay a higher amount than 50%.

There is no restriction on the size of a dependant's benefits provided the member dies under age 75. (The scheme may of course impose its own restrictions). If the member dies after 75 the aggregate of dependant's pensions cannot exceed the member's scheme pension.

A spouse's pension from a defined benefit scheme is always taxable regardless of the age of the age of the member on death.

Pension Guarantee

A scheme can guarantee that the pension will be paid for at least 10 years so that it can continue after the member's death.

The scheme can also offer a guarantee similar to Lifetime Annuity Capital Protection. The formula is:

Pension at the start x 20 less gross payments made

Stan died 6 years after receiving his company pension. The initial pension was £15,000 and at the time of his death had received £100,000 in gross payments. The scheme offered pension protection, so the amount paid would be:

£15,000 x 20 = £300,000 less £100,000 = £200,000

The payment is tax free if the member died under 75 and taxable as the recipient's non-savings income if death occurs after 75.

Bridging pension

Some schemes include the state pension as part of the calculation. If the member retires before state pension age the pension is calculated in the normal way but reduced when they start to receive the state pension

Faith was a member for 30 years and retired at 60 with a pension of £12,000 a year. She reaches SPA at 66 and her pension is now £13,000. Her state pension is £8,000 so he company pension is reduced to £5,000

Triviality

If final scheme benefits have a capital value of less than £30,000 they may be commuted for a cash sum under triviality. A PCLS of 25% of the fund can be taken and the rest is taxable.

Risks for DB members

Whilst a DB scheme offers the members many benefits, it is not without risk. The major risk is that the sponsoring employer goes into liquidation. This would not matter if the scheme

had sufficient assets to cover all the promised benefits accrued at the date of liquidation. If the scheme is in deficit the members' pensions will be at risk.

The 1995 Pension Act made the first attempt at securing member's benefits but this proved inadequate. The Pensions Act 2004 introduced the **Pension Protection Fund** (PPF) to give protection to all members of final salary schemes that where the sponsoring employer failed **after 6 April 2005**

Schemes do not automatically enter the PPF once the employer becomes insolvent. It will only be accepted **if the fund has insufficient assets to pay benefits at PPF level.** The Pensions Regulator (TPR) will also work with the trustees to try and seek an alternative.

Once an insolvency event occurs the trustees must notify TPR and the scheme will enter a minimum 12 month assessment period. During this time:

- No new members can be admitted.
- No further benefits accrue and no transfer values can be paid. The only exception is if the member, before the assessment period started, requested a CETV, gave instructions in writing to transfer and designated a scheme to accept the transfer value
- Benefits can be paid out but only to the level of PPF compensation
- The PPF can intervene in the management of the scheme and give directions to trustees
- The PPF will review any moral hazard issues
- It will review any recent rule changes
- The PPF will instruct the scheme actuary to carry out an actuarial valuation at the date the assessment period started

The trustees and TPR will investigate possible rescues (by a take-over for example). They will also assess whether the assets of the scheme are sufficient **to pay the benefits at PPF levels** which will be lower than what the scheme was originally offering. If neither is possible the scheme can be admitted to the PPF which takes over the scheme's assets.

Pensions will be paid on the following basis

- Members who have retired and are now over the scheme normal retirement age, or in receipt of an ill health pension or a dependent's pension will get 100% of benefits. In other words if they were being paid £15,000 a year pension, they will continue to receive that.
- Members who haven't reached the scheme's NRD including those who took early retirement, when the insolvency event occurred, will only get 90% of benefits.
- A further actuarial adjustment may be applied to those who take early retirement.
- Spouse's pension of 50% of the member's PPF compensation
- Revaluation of deferred pensions will be CPI to a maximum of 5% for benefits accrued up to April 2009 and 2.5% for post April 2009 benefits. Escalation only applies to post April 1997 benefits and only at CPI subject to a maximum of 2.5%.

Jim and his daughter Kate both worked for the same employer and were members of its DB scheme. The scheme has been admitted into the PPF.

Jim had retired in 2014 having joined in 1974. Prior to the collapse of the business his pension was £28,000 a year. The scheme increased his pension by 4% a year and paid a spouse's pension of 2/3rd of the member's pension.

Kate had been a member for 15 years when the employer collapsed. Her pension rights at that point were £8,000 a year.

In the PPF Jim will still receive £28,000 a year but only benefits accrued since April 1997 will be increased and these will be limited to CPI capped at 2.5%. If he dies before his wife, she will receive only 50% of his pension rather than 2/3rd

Kate will not accrue any further benefits. Benefits accrued prior to April 2009 will be revalued by CPI capped at 5%. Post 2009 accruals will be revalued at CPI capped at 2.5%. At retirement she will receive 90% of the revalued pension.

Even if the sponsoring employer is still in business, members may be concerned if they are informed that the scheme is in deficit. When there is a deficit the scheme trustees must agree a recovery plan with the employer that aims to eliminate the deficit over a period of time.

The other risk members face is dying shortly after retirement. This is particularly severe if the member wasn't married or had no dependants since the pension would cease on death

That concludes this part so you should now understand:

- The main benefits offered to a member of a defined benefit scheme.
- The main risks to members and protection offered by the PPF