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Defined Benefit Pension Transfers:
Generic guidance for use in 'triage'

This document is in the form of **guidance** to give anyone, as a client or potential client of Fowler Drew, enough objective and general information about **safeguarded** benefits from a Defined Benefit pension scheme and **flexible** benefits from a Defined Contribution replacement scheme to enable them to make an informed decision on **whether to take advice** on a transfer of pension benefits from safeguarded to flexible. The purpose of the guide it is not to inform you on whether or not to transfer. Transfer advice is rightly a heavily regulated activity with prescribed procedures. It is expensive. Those who choose not to proceed to advice on the basis of this or any other generic guidance avoid paying advice charges unnecessarily.

Clients who have read this guidance can have better quality conversations with us if they decide to proceed to advice. Prospects wishing to retain us for any form of regulated transfer adviser will be expected to have read this guidance and to show an understanding of the content.

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In a nutshell

Defined Benefit pension schemes are 'occupational' pension arrangements, organised by employers, which provide a contractual level of annual income. The amount of income is normally defined by reference to length of service and unknown future salary (either at the date of leaving or averaged over a specified period of time) – hence 'Defined Benefit'.

The safest form of retirement income

The attraction of these schemes for members is that they are insulated from most of the risk associated with delivering the promised benefits. It is up to the employer to ensure the scheme is sufficiently funded to enable the trustees to pay pensions as they fall due, for as long as beneficiaries live. For this reason they are often referred to as 'gold-plated' or 'the Rolls Royce of pension schemes'.

In a scheme that is 'funded' (only some public-sector schemes are 'unfunded' and these do not allow transfers out), the contractual liability to meet the benefits is technically not guaranteed but enjoys several levels of underpinning that make for a very high level of security.

1. The sponsor

First, the employer (also known as the 'sponsor') makes 'contributions' to the 'fund' to cover the employees' rights to benefits. The employer's contributions will be set at a rate that assumes investment returns will be earned on the funds when invested. These rights accrue as long as scheme membership continues, regardless of whether the member remains employed by the sponsoring employer, and as long as the contractual terms remain unchanged. Contractual contributions are treated in European law as 'deferred pay' and are therefore subject to (for instance) gender equality. The employees' legal status in relation to a failed employer is as a creditor.

The quality of the sponsor-specific promise to pay certain benefits in the future is commonly referred to as the employer (or sponsor) 'covenant'. The concept of a covenant, embracing both the legal obligations and the ability to meet them, implicitly recognises that the enforceability of the contract in full varies in fact.

2. The trust fund

Second, in a funded scheme the investments are 'ring-fenced' from the assets of the employer by holding them in a trust arrangement, so the members are not just dependent on the good credit of the sponsor. The trustees, though appointed by the sponsor, are required in law to protect the interests of the members of the schemes, including taking into account their assessment of the quality of the sponsor covenant.

Current pension regulation stipulates, by way of a code of practice, that paying the promised benefits is the key objective for scheme trustees but trust law itself is not that explicit. However, regulation does provide a framework for continuous monitoring of the likely adequacy of the fund to meet the promised benefits based on prudent assumptions. This is separate from, and in addition to, the accounting regulations applying to the sponsor that also require regular valuation of scheme assets and liabilities. The Pensions Regulator can require employers to agree a programme of additional contributions to make good any shortfall in assets relative to the calculated present value of the liabilities. In practice these arrangements have to balance securing the past accrued rights against the risk of weakening the ability of the employer to support future accruals. This balance is typically achieved by stretching out the payments rather than compromising on the level of required additional contributions. The arrangements are opaque not transparent.

3. The protection fund

Third, all private schemes are required to contribute by levy to a mutual scheme, the Pension Protection Fund (PPF). The PPF manages these contributions with the purpose of meeting any liabilities that cannot be met by employers. The rate of levy for each scheme is continuously assessed based on i) the judged strength of the individual sponsor covenant and ii) estimates industry-wide of the size and chance of shortfalls, which typically vary with economic conditions. The Protection Fund operates under a Government charter but is not guaranteed by the Government.

Safe but not guaranteed

Whilst these three levels of underpinning minimise the risks that a member will not enjoy the full value of the benefits they have accrued, they may not accurately be described as 'guaranteed'. Terms such as 'guaranteed', 'safeguarded', 'risk free' and 'protected' are commonly loosely used, including by the Pensions Regulator and the Financial Conduct Authority, in order to contrast with arrangements that give no similar underpinning. The risks of a shortfall relative to any expectation of real (after-inflation) income are typically much smaller when pooled in large Defined Benefit Schemes compared with personal or individual provision that does not benefit from pooling of risks, economies of scale and continuous regulation of funding adequacy.

Active and deferred members

Defined Benefit schemes have two categories of members. 'Active' members are currently employed and accruing rights to benefits. 'Deferred' members are those that have ceased employment but are either unable, or have chosen not, to transfer their rights to a new employer. The date of leaving, as opposed to the date of retiring, determines their income level. Since 1986, deferred pension income is subject to statutory uplift to limit the erosion of the purchasing power of the income by inflation between leaving and retiring.

Final Salary Pension Scheme

'Final Salary Pension Scheme' is a term loosely inter-changeable with Defined Benefit Pension Scheme because most Defined Benefit schemes do base the contractual pension income on the salary being earned at the date of retirement (or leaving, if earlier). All Final Salary schemes are Defined Benefit schemes but not all Defined Benefit income rights are set by reference to final salary and may be set, for example, by reference to career-average salary.

Defined Contribution Pension

In a nutshell

A Defined Contribution pension is one where the employer contracts to provide contributions to a registered pension plan based on the terms of an employment contract, usually defined as a percentage of then current salary. The employer offers no promised level of income in retirement. The income the capital will purchase is uncertain and that risk is borne by the individual. Collective Defined Contribution schemes organised by employers are also often known as Money Purchase Schemes because the income depends on what the money will buy at the time. Historically it would have bought an annuity but there is now considerable freedom about how to turn the accumulated capital into a pension.

Less secure than a Defined Benefit pension

Though the principles of income provision are the same as in a Defined Benefit scheme (contributions plus returns earned on them are converted into an income stream at retirement), the employee alone has responsibility for: the returns earned in their personal pension plan; how the capital in their plan is converted to income; how that income is made to last for as long as needed. Where in a Defined Benefit scheme the sponsor covenant and the Protection Fund stand behind the value of the contractual benefits, in a Defined Contribution scheme the income provided and its purchasing power after inflation are dependent on what happens to the economy, financial-asset markets and interest rates, all of which are beyond the control of the investor. A Defined Contribution pension outcome is much less certain or secure than a Defined Benefit pension. This would remain true even if the underlying investments in each happened to be identical.

Types of Defined Contribution pension plan

A registered pension plan that can receive employer contributions (which may also receive contributions personally rather than by an employer) could be a pooled investment arrangement organised under the new auto-enrolment legislation; an investment-industry product from an insurance or other financial services business; or a self-invested personal pension (SIPP). The purpose of the registered plan is to hold the investments within a regulated vehicle that allows the government to control and restrict access to the funds, as a condition of tax treatment specific to personal pensions.

Choices about how to take benefits

Members of Defined Contribution pension plans have choices as to how the capital accumulated from contributions and investment returns is converted into a stream of payments comparable with the income paid under a Defined Benefit arrangement. Conversion of capital to income can take the form of an annuity (whereby an insurance company sets the terms for conversion based on prevailing interest rates) or a draw from capital (continued investment with the rate of withdrawal determined by the member). Whereas rates of draw were previously constrained by pension legislation, such that in all likelihood most drawdown plans would at some stage end with the purchase of an annuity, progressive legislative changes over the years have removed these constraints. The effect of choosing to draw down from capital is that exposure to investment risk continues for longer and the sustainability of the draw depends also on how long the member lives (referred to as 'longevity risk').

With the exception of an index linked annuity with widow/widower's benefits, none of the options for converting capital to income offers the same level of certainty or security as a Defined Benefit pension.

Efficiency compared with Defined Benefit schemes

Throughout the period in which their capital remains invested, both up to and after retirement, members of Defined Contribution plans are typically exposed to higher costs than in a pooled Defined Benefit scheme. Even conversion to an annuity is likely to be more expensive than the terms an employer can obtain for the same transaction. Scale efficiencies are much harder to achieve.

Defined Benefit Pension Transfer

Defined Benefit pension transfer describes the process by which a Defined Benefit scheme offers an individual member a cash sum, known as the Cash Equivalent Transfer Value (CETV), to buy out the member's rights to all benefits under the Scheme's rules. If accepted, the CETV amount has to be paid into a receiving scheme which is a registered pension scheme from which the member may then take benefits as pension legislation permits, including taking benefits at any stage after age 55. It is therefore in effect a transfer from a Defined Benefit pension to a Defined Contribution pension.

It is also a transfer of risk from employer to member as the member takes on full responsibility, without recourse to the employer or the Pension Protection Fund, for the performance of the capital when invested, the conversion of capital to income at retirement and the sustainability of drawdown income (if preferred to an annuity) for however long the member and any dependent spouse live.

On transfer, the rights to further contributions to meet new accrual of benefits for a current employee will cease. Since most employees will not want to lose employer contributions they are entitled to, it is normally only deferred pensions from previously terminated employment that are considered potentially worth transferring.

Defined Benefit schemes are required to offer a transfer option to all members. In the final year before the scheme's set retirement age the Trustees have discretion to allow a transfer. Once a pension is in payment, no transfer can be made.

Pension regulations provide a framework for ensuring the terms offered to buy members out are fair in relation to remaining members (see Cash Equivalent Transfer Value below). Most schemes only permit the transfer of all benefits: the pension rights are not divisible. Where a partial transfer is permissible, the chances of a transfer being suitable are improved compared with either not transferring or transferring all.

Transfers with a CETV in excess of £30,000 require a member to obtain advice from a FCA-regulated individual pension transfer specialist. FCA rules prescribe how they perform a transfer review and make a suitable recommendation. The rules call for detailed assessment of the Defined Benefit scheme benefits and transfer terms as well as: a recommendation of a suitable replacement pension vehicle; the intended investment strategy and its appropriateness; the planned means of converting of capital to income and the costs of managing the replacement capital compared with the cost-free nature of the scheme benefits. The ceding Defined Benefit scheme Trustees will want certification by an adviser that the member has been advised. The receiving Defined Contribution plan administrators may also only accept a transfer where the member's decision to transfer was in line with, rather than conflict with, the adviser's recommendation.

A transfer is normally initiated by a member requesting a CETV offer. It may be initiated by the scheme making offers to buy out members in bulk, usually on 'enhanced' terms.

Cash Equivalent Transfer Value

A number calculated with rules and judgement

A Cash Equivalent Transfer Value (CETV) is calculated (subject to regulatory guidance) as the expected cost of providing the member's benefits within the scheme. It is a value determined on actuarial principles, that is to say it requires assumptions to be made about the future course of events affecting the scheme and the member's benefits, taking into account the actual investments backing the liabilities. It is also subject to fairness principles binding on trustees, as payment of amount that did not apply the actuarial principles appropriately could favour one group of members (such as those leaving) over another (those remaining).

Fair value requires assumptions to be chosen with the aim of leading to a best estimate of the amount of money needed at the effective date of the calculation which, if invested by the scheme, would be just sufficient to provide the benefits. When deciding on the assumptions for this best estimate, trustees must seek advice from the scheme's actuary.

Fair value must place a value not just on the member's accrued benefits but also any options and discretionary benefits that the trustees decide should be included. An option is something which can be exercised by the member without needing anyone else's consent (trustees or employer). Common options are: to exchange some pension for a lump sum at retirement; to begin taking a pension earlier or later than normal pension age (which might be subject to a reduction or an increase, respectively, in the amount of pension); to give up some pension in exchange for a higher dependant's pension on death.

Fair value must also allow for the estimated ability of the scheme to meet its liabilities, which is measured by its regular actuarial valuation of assets and liabilities. A scheme that has a technical shortfall (ie it is not fully funded) should adjust the fair value downwards.

Can fairness be relied on?

Though fair value is necessarily in part a matter of judgement, the member is entitled to rely on this regulatory framework as neither the member nor the adviser has access to the same information as the trustees and actuary. An adviser can challenge and probe but cannot independently assess the fairness of the terms.

CETVs are much easier to calculate consistently between different schemes and actuaries when the investments backing the liabilities of the members as a whole or the class of member affected by a transfer (such as all deferred members) are largely or entirely 'hedged', that it to say the assets held are selected to match exactly the liability in nature, maturity and amount. There is then no judgement required in deciding on the appropriate discount rate used to calculate the cost of meeting the liability.

However, there is a degree of commonality amongst actuaries about the 'normal' real returns they are willing to assume for equities because all actuaries are drawing on essentially the same historical evidence. These 'normalised' return assumptions have proved to more stable than real interest rates. This has introduced unusual volatility into the 'generosity' of CETVs when expressed as a multiple of income.

Why CETVs have increased

The tendency for CETVs as a multiple of income to rise in recent years is a joint product of i) funds derisking (holding more fixed-income, liability-hedging assets) and ii) fixed-income yields falling (under Quantitative Easing). CETVs that used to lie in a range of 20-25 times annual income now lie in a range of 30-35 times and in some cases multiples in excess of 40 have been offered where schemes have more fully hedged liabilities and have no shortfall.

The derisking of Defined Benefit pension funds, involving the replacement of equities and property (with uncertain investment returns) by fixed-income investments (with certain returns), itself follows naturally from the impacts of pension accounting and pension regulation. Technical shortfalls (when liabilities measured by applying fixed-income discount rates are compared with market values for equities and property whose prices assume higher returns and higher discount rates) lead to increases in required contributions subject to control by the Pensions Regulator, may restrict dividend payments and reduce firm value to an acquirer. These negative impacts can be lessened, or capped, by joining the tendency to replace equities with fixed income investments.

Since the regulations require the best estimate of the amount of money just sufficient to provide the benefits to assume it were invested in the scheme, a higher allocation in the scheme's existing investments to fixed income will lead to a higher CETV as long as fixed income expected returns are below the expected returns of the risky assets held.

This would not arise, or not the same extent, if the best estimate had to assume a risk-adjusted expected return equivalent to the same confidence as the fixed income return. High CETVs therefore reflect a difference in the valuation approach as between transfers and accounting for ongoing solvency.

Comparison of risks

The table on the following page is designed to provide in schematic form an objective overview of all different sources of risk in the different forms of converting capital to income to fund spending. Its purpose is to allow a high-level comparison of the option of either retaining the Defined Benefit

	Sources of risk on basis you value sustainability of real retirement income: Capital Market Risk	Inflation Risk	Longevity Risk	Observations
Means of access to benefits:				
If you do not transfer:				
1 Existing scheme	**Guaranteed**	**Guaranteed**	**Guaranteed***	Subject to low-probability economic risks to sponsor
Alternatives requiring transfer:				
2 RPI Annuity	**Insured**	**Insured**	**Insured**	Subject to diversifiable risk of failure of insurer
3 Level Annuity	**Insured**	**Exposed**	**Insured**	As above but inflation risk exposed and unmanaged
4 Drawdown	**Managed**	**Managed**	**Managed**	
	Scale of risk vs time (xxx = greatest risk)			
Liabilities @ 1-5 yrs	**xxx**	**x**	**x**	Assumes dynamic horizon matching or 'lifestyling'
How managed		Cash		
Liabilities @ 5-15 yrs	**xxx**	**xx**	**x**	
How managed		Equities and Index Linked Gilts		
Liabilities >15 yrs	**xxx**	**xxx**	**xxx**	
How managed		Equities		

** Note: there is exposure to mortality risk for a couple if the pension payable to surviving spouse is a fraction of the deceased member's 'pension. This risk can be insured by the member paying premiums outside the scheme to cover the loss of income.*

pension or transferring into a personal pension arrangement and managing (or delegating the management of) the risks that are necessarily taken on when transferring.

Though designed to be both generic and objective, the table assumes a constraint that the aim of the retirement spending goal, common to all alternatives, is to sustain real spending over some plan life. In other words:

- it should be stable (not subject to cuts from year to year)
- it should maintain its purchasing power (on the basis that cuts to spending caused by inflation have the same impact as cuts caused by bad investment markets) and
- it must not run out before a date consistent with the chance of still being alive.

The table reflects a particular view of the relationship (or sensitivity) between the time horizon and the degree or impact of the risk source, where the sensitivity to the risk is also a function of the assets held.

This way of thinking about assets and liabilities, based on matching their horizon as well as their form and amount, is a common feature of the way sponsors, trustees and actuaries together determine how to invest the assets in a Defined Benefit pension scheme. It corresponds to a vertical division of the assets on a notional time line, which contrasts with the conventional approach to diversification of assets which is a horizontal organisation, in layers of asset classes and markets that are largely blind to time horizons and are usually described in terms of a level of resulting volatility of short-term returns. Asset/liability matching is also commonly referred to as Liability Driven Investment (LDI). The standard diversification approach is commonly referred to as Balanced Management. Horizon-dependence is also designed into many of the workplace pension options that could form a cost-effective replacement option in the event of a transfer, where it is often described as 'lifestyling'.

Across the top of the table are displayed the three different sources of risk that threaten sustainability: future capital market returns; future inflation; how long you might live.

Down the side we show the four alternatives: the existing Defined Benefit scheme, an annuity with inflation indexation, an annuity with no inflation protection and drawdown from capital.

The form of risk management from the point of the view of the member is described in each case as 'guaranteed' (which applies only to the Defined Benefit scheme), 'insured' (laid off with an insurance company), 'exposed' (and unmanaged) or 'managed' (in the sense that the risks are recognised and taken into account in the way in which the assets are managed). These are colour-coded as green (guaranteed or insured), amber for managed and red for exposed.

In the lower panel of the table, we have further broken down in a drawdown plan the sensitivity of the risk to the time horizon. A single x denotes that the risk over the horizon shown is in practical terms quite small whereas xxx denotes the risk is highly significant if not dominant. The relationship with time (divided for the purposes of illustration into three horizons) assumes that for equities the chance of loss (or shortfall relative to a known or required outcome) reduces over time whereas inflation risk increases with time. The relative risk of each of cash, fixed income investments and equities is therefore not fixed but varies with the time horizon. In a drawdown plan time is not abstract but a known period to consumption. The horizons shown correspond to income that has to fund spending in the next 1-5 years, 5-15 years and over 15 years.

In the lower panel, the non-equity or risk free holdings, because they fund the early years of consumption, are equivalent to a temporary annuity but without the benefit of life assurance. Since life assurance is only needed to deal with the chance of outliving your capital, it is not as important and may not be cost-effective for the early part of the plan when investment risks dominate. In the later stages of the plan, when longevity may be the dominant source of risk to sustainability, the optimal decision may be to apply the balance of the drawdown pension to an annuity purchase.

The key differences in risk perception that may not be obvious to everybody and so need emphasising are:

- the significance of uncertainty about future inflation
- the stage at which longevity risk becomes important and
- the concept that equities deal with inflation risk because companies' pricing can adapt to changes in the general rate of change in prices and costs in the economy.

The final observation on the table is that the longevity risk is assumed to relate to the life of the member. In most Defined Benefit schemes the death of the member will cause a drop in the level of pension paid to a surviving spouse and so the income level dependent on joint probability of death is not the same between Defined Benefit and Defined Contribution. For a married couple, there is longevity risk in a Defined Benefit pension. This is not a reason for transferring as the difference can also be covered by retaining the scheme pension and insuring the member's life in favour of the surviving spouse.

FAQs

How safe is my Defined Benefit pension?

A Defined Benefit pension is much more secure than the pension income provided by a Defined Contribution pension where risks are borne by the individual rather than the scheme.

Though the benefits are a liability of the scheme sponsor (the employer), they are not guaranteed. But they are protected at three different levels:

1. The employers as scheme sponsor, providing contributions to fund accrued benefits and to meet any future shortfall in accumulated contributions
2. A scheme-specific trust fund that receives and invests the contributions is ring-fenced from the sponsor's balance sheet; is governed by regulations general to trustees and actuaries and specific to pension trustees
3. A mutual fund, The Pension Protection Fund, funded by contributions from all schemes to provides a safety net if a sponsor fails to meet its liabilities.

These three forms of security are explained on page 2.

The risk of a Defined Benefit scheme is limited by this protection as to both the *chance* of a shortfall and the *size* of the possible shortfall.

The chance of a shortfall

The chance is a joint function (ie reflecting how both interact) of i) the strength of the employer relative to testing business or economic conditions and ii) the adequacy of the fund's assets to meet all liabilities. But if the fund looks like it may not be able to meet its liabilities in full, such as because bad economic conditions have reduced the value of the fund's investments relative to an objective valuation of its liabilities, the fund has to look to the sponsor for more money. If the same conditions are testing the sponsor, it may not be able to do much to improve the funding position quickly.

Though specific to the firm, the chance of the liabilities not being met by the sponsor is subject to change over the potentially long period before benefits are paid. Strong firms can become weak firms through bad management or events beyond their control like new technologies. The longer the period before the pension starts being paid, the less reliance can be placed on an assessment of the current strength of the employer.

The strength of the fund, in terms of holding sufficient investments at every stage to meet an actuarial assessment of the amount needed to meet all liabilities, is also subject to change with investment market conditions. This change can be limited, however, if the fund holds more (or only) low-risk assets whose expected return is always the same as or close to the return required to meet the liabilities. Such assets are known as risk free or hedging assets, because changes in the value of the liabilities will be matched by a change in the value of the assets. Most funds have increased significantly the level of hedging assets relative to property and equity investments whose market prices do not move closely with the interest rates used to measure the liabilities.

They have also increased their contributions. Over the past decade, roughly half the contributions paid by private-sector Defined Benefit schemes are to make good technical shortfalls. Additional contributions are as large as the regular cost of accruing benefits for employees. This reflects the unreversed reduction in interest rates after the banking crisis rather than the effects of the crisis on equities and property, which did reverse.

The size of the possible shortfall

The size of the risk is a function of the rules of the Pension Protection Fund. These determine how much the full pension benefits due can be reduced in the event of the scheme entering the Fund. The impact is predictable as long as you can see how the rules would apply in your own position.

Though a safe working assumption, you cannot be entirely certain that the rules that apply today will not change in the future. As long as the mutual fund does not enjoy a Government guarantee and depends on sponsors for its capital, it may itself become stressed in periods in which sponsors generally are stressed. It cannot therefore make calls on sponsors collectively when it needs to. In that extremely low-probability event, it is possible that rule changes will dilute the protection currently provided. No good adviser will make that an argument for transferring.

The most important of the current rules are as follows.

1. Pre-retirement

If you retired early and had not reached your scheme's normal pension age when the scheme entered the PPF, then you will generally receive 90% level of compensation based on what your pension was worth at the time. The annual compensation you will receive is capped at a certain level. The cap at age 65 is, from 1 April 2020, £41,461.07 (this equates to £37,314.96 when the 90% level is applied) per year. From 6 April 2017, the Long Service Cap came into effect for members who have 21 or more years' service in their scheme. For these members the cap is increased by three per cent for each full year of pensionable service above 20 years. The earlier you retired, the lower the annual cap is set, to compensate for the longer time you will be receiving payments.

In June 2020 the High Court ruled that a cap on compensation for those with larger pensions, and which only applies to those under pension age, is illegal on age discrimination grounds. The PPF (and the Government) have yet to respond. If they do not successfully appeal the ruling, PPF levies will be required to be increased above what they would otherwise be. Without appeal, the ruling removes one of the most important (if not typical) reasons for transferring a Defined Benefit pension so for those affected by the cap the uncertainty is critical.

2. Post retirement

If you were beyond the scheme's normal retirement age when the scheme entered the PPF, the PPF will generally pay 100% of the compensation level.

3. Inflation adjustment

For both sets of compensation above, in respect of active members: payments relating to pensionable service from 5 April 1997 will rise in line with inflation each year, subject to a maximum of 2.5% a year. Payments relating to service before that date will not increase. This is potentially less inflation protection than the failed scheme was expected to provide.

In respect of deferred members pre-retirement: compensation will increase annually in line with inflation between the time your former employer failed and the date your compensation comes into payment. This annual increase will be subject to a cap of 5% for compensation linked to pensionable service prior to 6 April 2009, and a cap of 2.5% in respect of compensation linked to pensionable service on or after 6 April 2009. The first is likely to be comparable with the original terms but the second may be weaker inflation protection.

4. Spouse benefit

This is in line with the terms of the failed scheme if in payment but may otherwise be lower.

Assessing the risk

This can be done by any member but clearly benefits from professional expertise and judgement. Since advice is required for any transfer over £30,000 (see here) it makes sense to look to the adviser to assess the chance and size of any shortfall in the promised benefits.

The content of the adviser's report that is prescribed by the FCA includes the level of the reduced projected pension, assuming the scheme did enter the PPF and that there was enough of a shortfall in scheme assets to require the full reduction. It does not require any assessment of the chance of that event.

It also requires a calculation of the return that the invested CETV amount would need to achieve, up to retirement, assuming that, at retirement, the capital was used to buy an annuity with the same inflation protection (known as the 'critical yield'), so providing the same 'real' income as the Defined Benefit pension. This may be academic if the intention is to draw down rather than replicate the form and level of the promised benefits. (Prior the instigation of the PPF, it was more likely that a member of a Defined Benefit scheme would want to transfer out to avoid the more serious consequences of the failure of the sponsor to pay benefits in full, even if they intended to use the money to buy an annuity.)

The prescribed calculations do not include the possible erosion of the real value of the Defined Benefit pension once it is being paid by the PPF even though this may be more significant than the cut in the initial pension amount. In a good transfer report this should form part of the comparison of possible real income as between remaining and transferring.

In all cases, the assessment of the risk should form part of the reasoning about the merit of transferring but in most cases it will not dominate the calculation of relative advantage.

You should be aware that unscrupulous advisers and pension scammers are likely to play up the risk to encourage a transfer they anyway want you to undertake.

Should I transfer/cash in my Defined Benefit/Final Salary pension?

FCA regulations require transfer advisers to start from the assumption that a transfer is unlikely to be in the best interests of most scheme members. This is a reasonable assumption in practice

- if most members do not have the experience or risk tolerance to take on the risks that a transfer necessarily exposes them to; and
- if most schemes have not 'derisked' to the extent that the CETVs are likely to offer better outcomes (the dependence of the CETV on the individual scheme's investment strategy and funding position is explained on pages 5-6).

The theoretical case for a transfer, specific to individual circumstances rather than to most members, is that transfer is likely to be in your best interests if the CETV can provide more personal benefit than the pension income itself.

This highlights the two different aspects of good advice and a good decision:

1. Accurately identifying how you personally value all the different forms of benefit each can provide
2. Making good projections of the possible outcomes by comparison with the known outcome of the Defined Benefit pension income

The two dimensions of the problem are not independent of each other. Good projections of the possible outcomes contain information that you can use to define what provides most benefit, what best describes 'a job well done' or minimises regret. Only you can define this but it may need help.

Since any transfer in excess of £30,000 requires a qualified specialist adviser, you are likely to want to derive value from that exercise in terms of both dimensions. The skill set required to qualify as a pension transfer specialist is based on knowledge and application of a set of rules. The skill set required to identify what benefits individuals seek from their resources and how they make value judgement is general to financial planners rather than specific to pension specialists. The skill set to quantify probabilities for the outcomes of a transfer into a drawdown plan combines actuarial and investment knowledge and should have more in common with the work performed in the Defined Benefit world than in retail investment services. After all, the Nobel-Prize winning American economist Bill Sharpe described drawdown as the most complex problem he has ever encountered in finance!

The quantification aspect of the problem is not limited to comparisons of gross income, even if this is in most cases the most important factor for the decision. A transfer also changes the number and nature of options when you have control and flexibility. Some of these options can be readily quantified, such as the likely income for a surviving spouse (because it can be costed from a life assurance quotation) and comparisons of tax free cash. But potential taxation effects are harder to assign a value to.

Here is a list of the aspects of a transfer than may or may not apply to you.

1. You value the chance of higher lifetime spending
2. You want to 'profile' your spending at different ages
3. You value the chance of passing unspent capital to heirs
4. You would value getting out more tax free cash
5. You don't want your spouse's pension income to be cut
6. You are unmarried and therefore place no value on a widow’s pension
7. You want to avoid cuts to income caused by failure of sponsor
8. You want to access your pension earlier than the scheme allows
9. You may need to manage taxable income to avoid higher rate tax
10. You are in poor health

If none of these applies to you, there is little or no prima facie reason for taking transfer advice.

Most people would assume the first, valuing better outcomes, applies to them, but not necessarily at an acceptable level of risk. If in fact the risk was too high or uncomfortable to live with the better outcomes would never be enjoyed as the strategy will be changed and possibly (usually) at a point when the portfolio is under stress, possibly locking in worse outcomes than even the worst projected case at outset.

This is a specific case of a general investment problem where a set of uncertain outcomes (in this case, sustainable real income or draw from capital), uncertain in the sense of having an estimated probability distribution (or possible range), can be compared with a known required or target outcome with little or no uncertainty as to its amount. This too may be addressed without transfer advice.

As a general problem, it is addressed by a generic calculator using a stochastic (or probabilistic) model of future uncertain investment returns, such as our online interactive Drawdown Planner (on our website). The distribution of probable outcomes in this general problem is highly dependent on the investment risk and on the interaction between market volatility and a fixed real rate of draw. The greater the risk, the wider the probable distribution. This means risk attitudes can be derived as an output of planning with a model rather than just as an input.

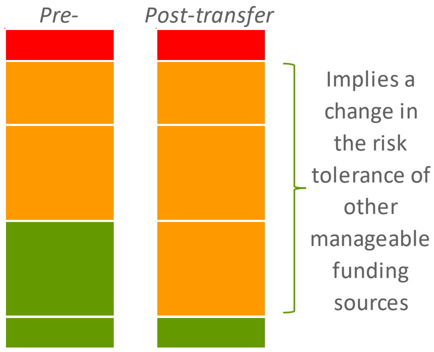
Treating a transfer as a specific case of this general investment problem, most of the numbers needed for a generic calculator are likely to be available if you already have a CETV. The required outcome, or target to beat, is effectively the present value of the projected pension at retirement. This is a number not usually provided by scheme administrators who quote either the pension income at the point of leaving or the projected pension at retirement. The closer to retirement age you are the smaller the difference between the projected value and its present value. The further from leaving, the greater the cumulative effect of around 3% pa past inflation in understating the present value. The resources available are the CETV, which we know is a present value. A calculator solving for sustainable draw given known capital, or solving for resources required to meet a known target outcome at any confidence level, will also require an assumed plan duration. In the specific case of a pension transfer, where the scheme pension is payable for as long as you live, a fair comparison requires a prudent assumption such as age 95 or 100.

Though the outputs of a generic drawdown tool cannot replicate a detailed analysis, it is a means of approximating whether, on investment grounds alone, there is a prima facie case for transfer. As in the general drawdown problem, it requires you to think about the differences in outputs about the level of draw in terms of visualised consequences and hence what you personally might value and why. And it must include an approximation of the likely volatility or changes in portfolio level over shorter periods, as this is the experience of risk you need to be confident you will be able to live with if you are to avoid the problem of locking in worse outcomes by changing strategy when the portfolio is under stress.

Establishing a prima facie case for transfer on investment or any other grounds is not allowed within the scope of the FCA's rules for 'triage': ascertaining whether a transfer is likely to warrant a full advice process with its attendant costs. However, the FCA can hardly prevent the remote use of generic calculators to provide threshold tests of standard investment trade offs.

It can only be a prima facie case because the test of whether a transfer is in your best interests must take into account any other savings and investments, in or outside a pension account, that could contribute to your retirement income. This is only possible with financial planning for the retirement goal as a whole. This is because the maximum benefit could be derived from a combination of safeguarded and flexible benefits and because, to the extent that existing resources already sit on top of the underpinning of safeguarded benefits, the optimal investment strategy for the flexible capital should (but may not) take into account the underpinning. This general principle is illustrated in an example below.

Spending source	Risk pre-transfer	Spending contribution (for illustration)
Property (if needed)	Risky (may be leveraged)	
Non-pension financial capital	Manageable risk	
Defined Contribution pensions	Manageable risk	
Defined Benefit pensions	Risk free	
State Pension	Risk free	



How can a pension be worth more than it costs the employer to provide it?

This strikes at the heart of the improvement in CETVs as a multiple of pension income. Following the explanation on page 5 about how schemes are obliged to calculate CETVs, multiples have generally improved most where funds have derisked from equities to fixed income assets. If they still held as much in equities as they used to, expected returns on the fund would be higher and so the calculated cost of providing the promised benefits would be lower and the CETV multiple would be correspondingly lower.

The higher multiples are only worth more to the member than the Defined Benefit pension if the member would choose to hold more in equities than the scheme chooses. The member would choose to hold more in equities if that meant that the real income the capital could eventually buy was higher than the real income if the capital was instead invested in the same way as the scheme. Though the member might value these higher expected outcomes, how they value them is probably also subject to some constraints, such as not falling short of the income they were due to get from the Defined Benefit pension by more than a certain (possibly quite small) amount. They are visualising the consequences of different outcomes when these are necessarily uncertain.

The difference in investment preferences between the scheme and the member can be explained in economic terms by something called 'utility' or 'welfare'. You can think of this as what matters most, or what best describes success and minimises regret. It can be captured in preferences such as between securing minimum benefits and enjoying higher benefits; between short-term progress and long-term outcomes.

It is also often about consequences. CETVs were much lower when there was little difference between how schemes and individuals thought about their own utility. Collective individual views about utility have not noticeably changed. But new accounting rules and regulatory changes have definitely altered the way private Defined Benefit pension schemes think about their utility, against their natural inclinations, because they introduced a new set of consequences. Stability in the funding adequacy and hence of contributions now dominates factors such as maximising long-term outcomes or minimising the long-term costs of pension provision. It is the difference in the typical scheme and the typical individual's utility that makes the resulting CETV worth more to many members than the cost of providing the benefits.

If an individual's own utility is defined in ways that result in the same sort of choices and trade offs that the sponsor has already made, such as because they want to avoid ever having to adjust their spending down, even if they give up any chance of improving it, then even these higher CETVs are likely to be no more attractive to them. The FCA's starting point that most people's best interest are served by not transferring makes the assumption most members do share this description of their utility. But it may also assume many if not most will lack the comprehension to make the tradeoffs required, whether or not that comprehension requires experience of the same or similar trade offs.

How do I know whether my income will be higher or lower if I transfer?

You cannot know: you can only make an assumption or an estimate. It is too important for it to be guesswork alone which is why all transfers with a CETV of £30,000 or more require advice from a qualified specialist (below that the cost of the advice might make it counter-productive).

Because a transfer involves the member taking on risks otherwise borne by the employer or sponsor of the Defined Benefit scheme, the outcomes are either *known* (in real terms), in the case of the Defined Benefit pension, or some *range* of possible real outcomes, in the case of the Defined Contribution pension. Where a range is involved, it is prudent to focus on quantifying the range and its associated chances, rather than estimating the most likely outcome. It is prudent because it is skeptical about people's ability to pick a particular outcome from a range and because individuals can then think about the different consequences of better or worse outcomes to guide them to a choice between the two options that most closely matches the features they value.

In economic terms this is described as maximising utility. Since utility can be hard to express in abstract, thinking about the consequences of the range of outcomes (the levels of income at different confidence levels equivalent after tax to real spending) will help you exhibit your utility directly. This is the reverse of the conventional approach to risk preferences in which they are expressed first in abstract and that then leads to a product or solution an adviser thinks matches the expressed risk preferences.

The adviser's transfer report is required to make some comparison between the Defined Benefit income (projected in today's money) and the possible benefits if you transfer. But the form of the comparison is not prescribed and there is no requirement to quantify the full distribution of possible outcomes or assign any chance to whatever point forecast or assumption is used.

In most adviser transfer reports the comparison is limited to two outputs:

1. The required investment return that would match the level of income assuming either an annuity is purchased or a managed drawdown is preferred
2. Assuming a particular return, how long the capital would last if the same real income as the Defined Benefit pension was drawn.

The report is unlikely to include the information the individual most wants which is i) the appropriate level of actual draw that meets constraints they themselves set and ii) the potential for increasing that draw or for creating additional wealth.

The limited toolkit of the adviser community contrasts with the much more sophisticated toolkits that pension scheme actuaries use to advise their clients. These rely on modelling (or simulating) the full range of possibilities so that both an eventuality and its likelihood can be used to inform decisions.

Actuarial models are themselves not perfect. They tend to rely on normalised assumptions about investment risk and return. The possible outcomes of a drawdown portfolio should not be static or normalised. The portfolio should be managed dynamically so that the levels of risk vary both with age and the recomputed funding position (the risk level changes even if the risk approach, like utility, remains constant); and the expected returns vary with changes in the achieved returns up to every point (the funding position changes less than market levels change). A probabilistic drawdown model needs to allow for the impact on the sustainability of the draw of the sequence of market conditions during the draw.

A probabilistic model of a drawdown portfolio should have mathematical solutions for all of the following.

1. The return dynamics in the presence of a draw, capturing both financial-market risk and uncertainty about inflation
2. Constraints in terms of minimum tolerable draw
3. Constraints in terms of the tolerances of temporary cuts in draw
4. Constraints in terms of how long the capital has to last with or without cuts in draw
5. A direct link between risk aversion and the outputs above

The investment of the CETV amount should not be planned in isolation but should be part of a holistic plan for meeting your retirement objectives and other goals. Ideally, the expected Defined Benefit income is already a risk-free part of the expected retirement spending and so, for any unchanged attitude to risk, the replacement of that risk free asset should logically alter your current risk approach. A good adviser will therefore make a holistic planning of the retirement goal a condition of advising on a transfer.

How should I invest the Cash Equivalent Transfer Value?

You might assume this will depend on whether the capital is assigned to replacing the Defined Benefit income or to some other goal such as bequest at death in a tax-efficient manner. However, as long as your existing plan for retirement income assumes the underpinning of the Defined Benefit income, it will need to be replaced by some other source of income if not the CETV. You cannot avoid the comparison of outcomes.

As explained above, because a risk free asset is being replaced by a risky asset, any unchanged risk attitude should logically lead to a change in the overall risk level compared with the capital pre-transfer. This highlights the importance of planning holistically. You should not treat the CETV as either an independent increment or as a resource equivalent to existing resources. It is likely, however, that new goal planning triggered by exploring a transfer option will lead to changes in your existing approaches to risk.

If your CETV is over £30,000 and requires transfer advice, the adviser will be responsible for ensuring his or her recommendation takes into account the investment strategy for the replacement assets. However, that will not necessarily extend to the holistic analysis we believe is critical, which is why we only provide transfer advice if it is in the context of full initial planning for a new investment management client (other than in exceptional circumstances when investment reasons do not dominate).

What also follows from this is that an adviser should be reluctant to advise if the transfer value will be the main source of future employment income as this may well imply that the scheme member lacks the experience and composure to manage and live with both investment risk and decisions about how much to draw.

How can I turn my transferred pension into a retirement income stream?

The Cash Equivalent Transfer Value (CETV) obtained from transferring rights from a Defined Benefit pension scheme can only be paid into a registered personal pension plan. How you take benefits from it is then governed by whatever legislation applies at the time.

With the introduction of the new 'pension freedoms' legislation in 2014, all previous restrictions on the amount that can be withdrawn from a Defined Contribution pension have been lifted, except that access is still prevented until age 55. This is good news since it allows people to better tailor their pension withdrawals to suit their personal circumstances and tax situation and prevents people from sleepwalking into the purchase of a poor-value annuity product.

However, the wider range of pension withdrawal options (Flexi Access Drawdown, Uncrystallised Funds Pension Lump Sum, Flexible Annuity), and the associated tax consequences of each, make the retirement landscape far more demanding. With professional guidance, the optimal choice from amongst these alternatives may in fact be clear, following naturally from the degree of freedom to vary income sought by the member or from the member's tax position.

In most cases the fundamental challenge is independent of the particular arrangement chosen: how to maximise retirement spending without running out of money before death.

It is still possible after the pension freedoms to buy an annuity to turn the pension capital into an income stream. The annuity will deal with the risk of running out of money before death as well as the risk of investment returns falling short of required returns. An annuity can also be chosen that matches closely the inflation protection provided by the scheme pension. But since these are all features of the Defined Benefit plan you started with, to achieve a higher real income requires the CETV when invested during the period up to the point you wish to take benefits to earn a significantly higher return, after expenses (which are likely to be higher without the economies of scale of the Defined Benefit scheme), than was assumed by the scheme when calculating the CETV it should offer.

That required return should have a very high chance of being exceeded to justify a transfer on the basis of size of income alone, to compensate for giving up the security of the income provided by the Defined Benefit scheme. The required return merely to equal the scheme income is a calculation (known as the 'critical yield') required by the rules governing advising on a transfer. It will rarely justify a transfer. Most advisers would advise against transferring where the member's intention was to replicate the level of security of the Defined Benefit scheme by buying an inflation-indexed annuity with equivalent spouse benefit.

An exception to that general rule is where the security of the ceding scheme was itself in question, for instance, if the promised income was well above the maximum level that would be paid by the Protection Fund if the scheme had to be rescued by the PPF and there was a significant period before retirement when the employer's solvency was at risk. The size and personal consequences of the potential cut might then be far more important than any assessment of the chance of that happening. As noted on page 10, this reason for transferring may disappear if the High Court's recent ruling that the cap is illegal on grounds of age discrimination is not successfully appealed.

Exceptionally, there may also be particular individual circumstances that are important enough to dominate the decision. But these will be harder to find support for from an adviser, unless exceptionally compelling, and may in any event be covered by the scheme's freedom to offer, at a price, alternatives to the contractual pension.

What if I transfer out and then find I should not have done so?

You have no recourse to third parties if, with the benefit of hindsight, you have made errors of judgement about risk and uncertainties inherent in the transfer that you understood and accepted at the time. That contact with reality is a reminder of how risk is transferred from a scheme to a member when opting for a transfer.

You may have recourse, however, if you were misled on matters of fact by a third party or given unsuitable advice, provided that the advice was not itself an error of judgement that any informed person might have made.

If the Cash Equivalent Transfer Value was over £30,000 and therefore you were required to take advice, you will have a documented advice process you can examine for possible misinformation or for errors of judgement that were not consistent with the standard required of a professional. These could be grounds for complaint. You may take any unresolved complaint to the Financial Ombudsman Service (FOS). As a general principle, the advice given is tested in terms of what should have been expected could happen, rather than what actually did happen; and the likely impacts are considered in light of your personal situation at the time of the advice, even though the actual consequences on which damages are assessed will reflect what actually happened. FOS's assessment of the compensation due is generally calculated to put the individual back into the position they would have been in without the advice. Since it is not possible to return to the Defined Benefit scheme, an equivalent financial award is necessary. The Ombudsman's decision is final and binding.

Advisers are required to carry Professional Indemnity insurance and so any award is likely to be met in practice by the insurance industry rather than the adviser's own financial resources. In the event your adviser is no longer trading and a successor firm has not inherited its liabilities, a successful award of compensation by the Ombudsman would be met by the Financial Services Compensation Scheme (FSCS). Since insurers are becoming reluctant to underwrite past transfer business, because of a significant level of unsuitable transfers in recent years, more of the burden of FOS awards is likely to fall on the FSCS as advisers do not typically have the capital to meet the claims instead of their insurers.

If the reason for your complaint was that you were subject to a scam, it is more likely that you will receive an award but also that it is unlikely to be recoverable other than from the FSCS.

In the event the amount of damages exceeds the maximum FOS can award, an individual has recourse to the courts but whereas FOS is free legal action may prove very expensive and requires any damages and costs to have a reasonable chance of being recoverable.

These protection mechanisms are not subject to any time limit.