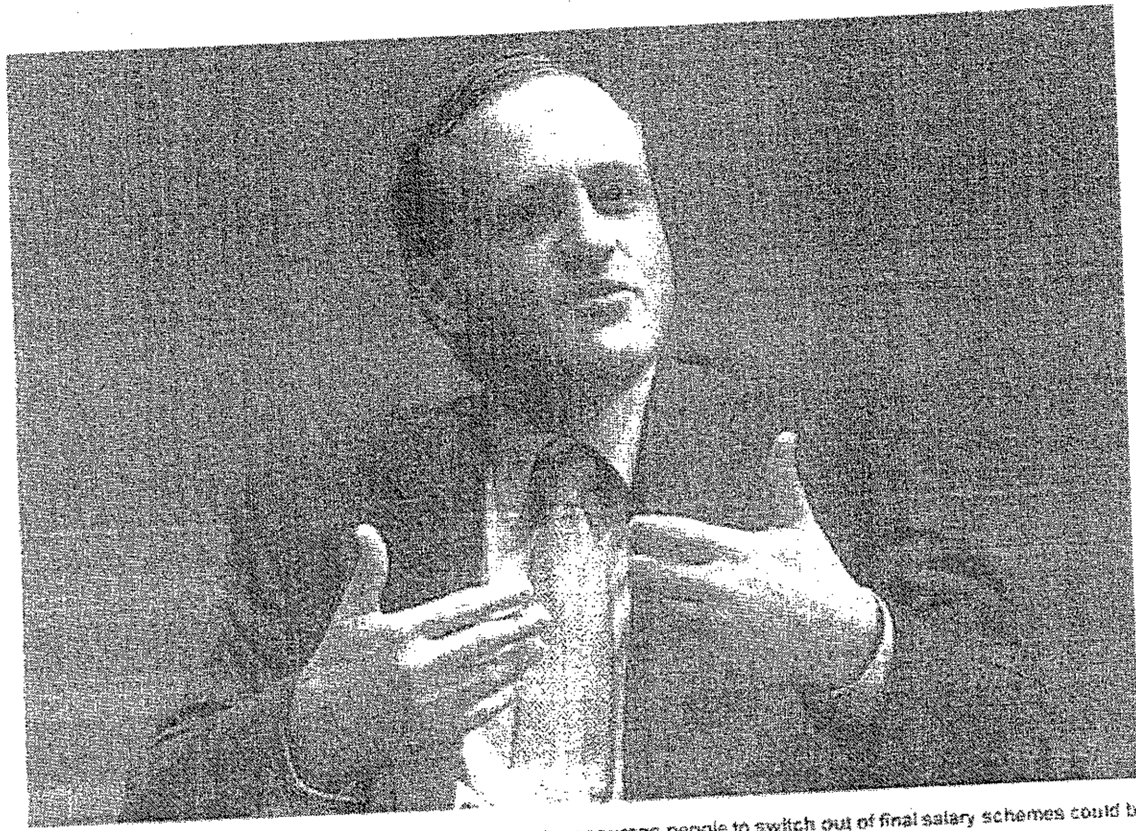
THE TIMES

Should you transfer out of a final salary?



Pensions Minister Steve Webb is worried that incentives to encourage people to switch out of final salary schemes could be a mis-selling scandal.
Dave Thompson/PA

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Be wary of cash sweeteners

Pension savers are being warned to think twice before giving up valuable pension benefits in exchange for cash up front or a one-off boost to their retirement savings.

The number of employers offering a guaranteed level of retirement income to staff, known as a defined-benefit pension or final-salary scheme, has dwindled in recent years. And now some of the companies who still have staff enrolled in these pensions are trying to get out of their obligations by offering sweeteners to employees who are prepared to sign away their rights.

KPMG, the accountant, expects the number of schemes offering these incentives to increase, predicting that 70,000 members will receive this type of offer this year

alone. It believes that half of all defined benefit schemes are considering such a move, meaning that about 2.5 million people could soon be made an offer. Based on average take-up rates, which are about a quarter, this means that about 750,000 people may move their pension savings out of a fund that guarantees them a set income in retirement and into one where their future wealth will depend on the performance of investment markets.

Anyone lucky enough to still belong to a final-salary or career-average pension scheme should be wary of such offers, but many people are blinded by the chance to receive a cash payment and unable to appreciate the value of the benefits they are giving up.

The Pensions Minister, Steve Webb, below, recently warned that these offers have the potential to become the next big mis-selling scandal. The Government is consulting with the industry on a new code of practice for schemes offering these incentives to ensure that communications to members do not oversell the benefits and underplay the risks of signing up to deals like this.

But it is not beneath the Government to use similar tactics itself. Despite lambasting these practices in the private sector, it offers a similar cash bribe to pensioners to receive a lower annual state pension income. Each year about 66,000 retired people choose to defer receiving their state pension and are offered two options: a higher pension each year when they eventually retire or a lump-sum payment. They are sent a letter with a summary of the options and a more detailed 64-page document.

A freedom of information request revealed that about two thirds — or 42,000 a year — choose the lump sum, even though it may be worth as little as a quarter of the value of the pension income forgone.

Why are schemes doing this?

Many occupational schemes have liabilities greater than the assets they own. The equity and gilt markets can cause huge fluctuations in the scale of deficits. Quantitative easing — the process by which the Bank injects money into the economy by buying assets such as government bonds — has also been blamed, because it lowers gilt yields, making it more expensive for employers to provide pensions and resulting in increased deficits.

The schemes undertake what are known as "de-risking" exercises to reduce the level of their future liabilities, by encouraging members to sign up to a pension that will be less costly for the business to provide. However, the term "de-risking" is one-sided. The exercises may reduce risks for the employer, but in general they involve any employee who accepts the incentive taking on more personal risk over their future retirement income, as they will be giving up guaranteed benefits.

What are the deals offered?

There are two main types of offer that a pension scheme might make — an enhanced transfer value (ETV) or a pensions increase exchange (PIE).

Under an ETV the money is moved out of the existing scheme and into a defined contribution scheme that does not provide a guaranteed level of income in retirement, but where the income will depend on how well investments perform. To incentivise members to do this they will receive a cash payment upfront or an increase in the transfer value of their pension savings. Under a PIE, the member is offered a one-off increase in the value of their pension savings, which remain in the original scheme, if they give up the right to inflation-linked increases in the future.

Martin Bamford, of Informed Choice, the independent financial adviser, says: "Transferring out of a defined benefit pension scheme is rarely the right thing to do. It can be tempting to accept cash today in return for lower pension benefits in the future, but these are valuable and will be what pays for your lifestyle in later life."

Mr Bamford says the PIE-type offer is not as financially dangerous to the employee as an ETV, as they will lose the right to a guaranteed income; however, they will face the risk that this could be eroded in real terms because of the impact of inflation.

Sometimes scheme members are offered financial advice as part of the deal. But they should ask whether the adviser will receive commission for recommending take-up. Members can ensure that they get advice that is completely impartial by searching for an adviser on unbiased.co.uk, but they are likely to have to pay a fee.

Kevin Edwards, of Midland Financial Solutions, another financial adviser, recently dealt with a case for a client who worked for Northern Foods and had built up benefits worth £5,100 a year in retirement through the company's final-salary pension scheme before it closed to further contributions.

The client's pension savings had a transfer value of £53,835, but the scheme offered an ETV that could either be taken as a cash lump sum or, with an increase of 10 per cent to the transfer value, move the money elsewhere. The lump sum was £4,180, taxed as income; the enhanced transfer value was £59,219. Mr Edwards says: "Given the difficult economic climate, it is easy to understand why the prospect of £4,000 in cash would be attractive." But he adds that, by transferring out of the scheme, the client would have taken on three key risks: that his investments would not perform well, that he would live longer than his fund could support and that annuity rates would be offering poor value by the time he retired. By transferring the money out, the enhanced transfer value of just over £59,000 would have to achieve an average investment return of 10.6 per cent before charges for the next 27 years to equal the value of benefits he would be sacrificing in the final-salary scheme.

Leaving money in a final-salary scheme does carry the risk that the scheme will become insolvent; however, the Pension Protection Fund protects 90 per cent of benefits for those who are not yet retired and 100 per cent for those already drawing a pension.

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