CREDENCE INTERNATIONAL

CREDENCE'S GUIDE TO

DEFINED BENEFIT PENSION TRANSFERS

Guide to Defined Benefit Pension Transfers

Presented to you by Credence International

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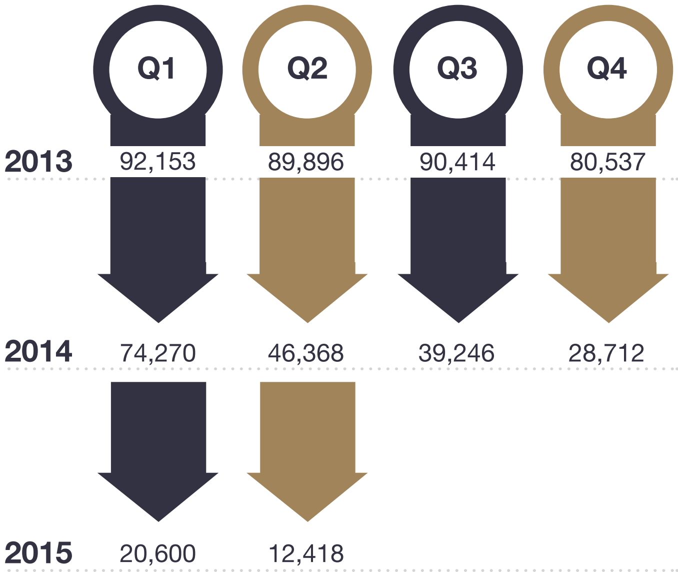
INTRODUCTION

In this guide we will explain exactly what a defined benefit transfer is, what has changed recently to make them a sensible option for an increasing number of people and why it's a great time to look at this option.

The Chancellor, George Osborne, started a pension revolution in 2014 when he announced the introduction of new pension freedoms in 2015. The rule changes shone a spotlight on annuities as the traditional way to generate income in retirement leading to a dramatic impact on annuity sales.



Annuity costs have soared in the last twenty years as risk free investment returns have fallen and life expectancy has risen.

Annuities are effectively a very expensive and inflexible insurance policy against living beyond normal life expectancy and to receive guaranteed income payments.

They lock in current interest rates and lock out further investment opportunity, or control over your capital. They look increasingly outmoded for modern retirement that can extend over 30 years with periods of very different income and capital requirements.

If you have a defined benefit pension due to be payable, you effectively own a deferred annuity. If you don't need insurance against a long life, or to get guaranteed income payments then a defined benefit transfer gives you the option to cash out of these expensive insurances and take advantage of the new flexible pension freedom rules.

As the cost of annuities have soared so has the cash value of transfer offers. So for the very same reasons individuals have all but stopped buying annuities, more and more deferred members of defined benefit schemes will find the transfer route attractive.

'ANNUITY COSTS HAVE SOARED IN THE LAST TWENTY YEARS AS RISK FREE INVESTMENT RETURNS HAVE FALLEN'

SIX GOOD REASONS TO TAKE A LOOK AT YOUR TRANSFER OPTION

The historic view is that 'it's always wrong to come out of a defined benefit pension scheme'. For some individuals this may no longer be the case and to redress the balance here are six good reasons to consider the transfer option.

1. A defined benefit pension can be a significant family financial asset, a transfer capitalises and gives you control of this asset, which can now be passed down through the generations without inheritance tax.
2. Transfer values are so high at present that a good deal of the investment risk associated with transfers can be removed. On most transfer values a 2% real investment return, after fees and inflation, will provide the same level of pension plus potential for residual value to be passed on.
3. Transfers offer you complete flexibility over when and how much you draw on your pension account and are in complete contrast to a fixed monthly pension income. It's inconceivable that 60 year olds retiring now with the prospect of potentially 30 years or more of retirement will have the same cash needs year in year out until they die.
4. This flexibility extends to taking the cash as early as age 55 and deferring the taxed pension until it's needed. The potential uses of this early cash sum are extensive, from paying down mortgages early, to investing in ISAs to generate tax free income, or helping the next generation on to the property ladder.
5. A defined benefit transfer takes away the life expectancy gamble implicit in a lifetime income. It capitalises the benefit once and for all based on normal life expectancy, irrespective of your personal health now and in the future.
6. With flexibility comes the ability to be tax efficient. In virtually all the cases where we have recommended a transfer there has been the ability to save tax as compared to the rigid defined benefit pension benefits. These can include:
   - A higher tax free cash sum following the transfer
   - The ability to limit pension income to specific income tax bands
   - The opportunity to defer and minimise the impact of lifetime allowance (LTA) penalty tax

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- *Those drawing a defined benefit above the LTA, without any protection, will pay at least 55% tax on any pension income above £50,000 p.a. This will be collected at source by the pension scheme from day one of the pension payments.*
- *Those with personal pension accounts valued at more than £1m (or higher with protection) can defer the impact of the lifetime allowance to age 75.*
- *This can be achieved by keeping drawings within the LTA limits up to age 75 and gaining benefit of a largely tax exempt investment account until that date when the 25% surcharge tax will become due on the excess value of the fund.*

DEFINED BENEFIT TRANSFERS EXPLAINED

A defined benefit transfer allows you to swap a future pension entitlement in a final salary, or defined pension scheme for a cash sum that must in the first instance be put into a registered, or HMRC recognised pension scheme.

The cash sum value is the 'cash equivalent ' of the pension income you leave behind, or put another way the amount of money today that would be notionally set aside in the scheme to meet your specific pension liabilities as they fall due. In practice the process of calculating a transfer value is done by the scheme actuary based on laid down guidelines. The calculation is a function of:

- How far away from retirement you are
- The level of pension you were entitled to when you left the employer
- The scheme rules dictating how pensions increase between leaving the scheme and when you retire and in retirement and such things as widow's benefits and guaranteed periods
- How long you might live
- Future investment returns that can be expected on funds set aside to meet your pension liabilities

Importantly the calculation uses standard assumptions about how long you will live and whether you are married rather than reflecting your own personal situation and state of health. Both the life expectancy factor and the investment return factors are changed from time to time to keep them up to date.

Under the defined benefit scheme your tax free cash lump sum and taxed pension income in retirement are fixed and guaranteed by the scheme and old employer assuming they both still exist. In some cases scheme liabilities have been sold on to an insurance company who then take on the responsibility for the guarantees. The guarantees extend to increases each year to protect your pension against inflation (usually up to certain limits) and paying your pension for life, no matter how long you live.

Once you accept the transfer value and have an invested fund in a personal pension the lump sums and income withdrawals you will be able to make will entirely depend on how you invest your fund and what investment returns are actually achieved. **If the fund does well you may end up with more net cash from the transfer value, if the fund does badly you could have significantly less and of course if you end up living a long time you may have to cut your pension income to keep the fund from running out.**

If you accept a transfer value you will be 'discharged' from the pension scheme. This means the sum has been paid in lieu of benefits and you have no further claim on the scheme. The transaction is irreversible. You can't buy your way back into the defined benefit scheme. Not surprisingly then it's a transaction which needs very careful consideration before acting on.

WHO THEY APPLY TO

Defined benefit transfers are available to what are known as 'deferred scheme members' i.e. those who have left the employer who sponsored the scheme but have yet to draw their pension or cash sum.

They can also be offered to employees at retirement or as part of an early retirement or redundancy package.

The option of a transfer is a legal right to deferred members except in the following cases:

1. Where you are within 1 year of your normal scheme retirement age, in which case the transfer option will be at the discretion of the scheme trustees. In the wake of the new pension freedoms most schemes are now allowing transfers right up To and beyond normal retirement age as long as no scheme benefits have been taken.

2. You are a deferred member of one of the public sector unfunded schemes, where transfers have been banned. These schemes include the NHS scheme, teachers' superannuation, police and military service schemes.

Those still working for an employer providing a defined benefit scheme will, in the vast majority of cases, want to stay in it and keep accruing more benefits. If your plan is to keep working for this company right up to retirement it will be worth finding out when would be the last point where a transfer value would be available.

Most employers and schemes are indifferent to members transferring out and will allow the option at and even after the normal retirement date as long as the scheme benefits have yet to start.

As soon as you take your cash sum and pension income from a defined benefit scheme the option to transfer disappears.

A defined benefit pension in payment is currently irreversible, although the Government has announced rules that will allow pensioners in payment to cash in their annuity income for a lump sum. We have yet to see what this will entail in practice.

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From April 2016 income tax relief on pension contributions has being tapered from £40,000 per year for anyone with total earnings of less than £150,000 down to £10,000 per year for those with earnings over £210,000.

If you are over your LTA this could mean you will pay 45% tax on your deemed contribution to a scheme which will generate no further tax free cash and only pension income taxed at 55% or more.

Some employers are now offering salary enhancements to members who opt out of defined benefits schemes who will be caught by these changes.

WHY IT'S A GOOD TIME TO CONSIDER YOUR TRANSFER OPTION

Defined benefit transfers are not new, they have been a legal right to deferred pensioners since the eighties. So why are they now a more attractive option?

Considered opinion has been that for the vast majority 'best advice' is to stay in schemes and so the option of a transfer has often only been brought to the attention of those with very big pension entitlements and by specialist advisers. In most cases they simply have not been discussed with members.

Employers are not able to provide advice on transfers and many financial advisers are not qualified to advise on them, or have been prohibited from advising on them by compliance departments viewing them as too complex and too risky (for the adviser that is). So for many the transfer option will never have been discussed.

SO WHY CONSIDER THEM NOW, WHAT'S CHANGED?

There are two contributing factors:

1. Transfer values relative to future pension entitlements are currently very high due to exceptionally low gilt yields.

2. The 2015 pension changes provide huge choice as to how pensions savings can be used in retirement, these choices are not available to those who go on to retire on a defined benefit pension but can be accessed via a transfer and will be attractive to many.

HIGH TRANSFER VALUES

As defined benefit pension schemes (just like annuities) have to provide fixed pension incomes in retirement, the most important investment return factor in the calculation used by actuaries to work out a cash equivalent transfer value is the risk free investment return based on UK gilt yields.

Gilts or Government backed securities provide a guaranteed return to a future date and are used by the scheme actuary to discount the cost of future pension payments when calculating their current cash equivalent value and hence the transfer value.

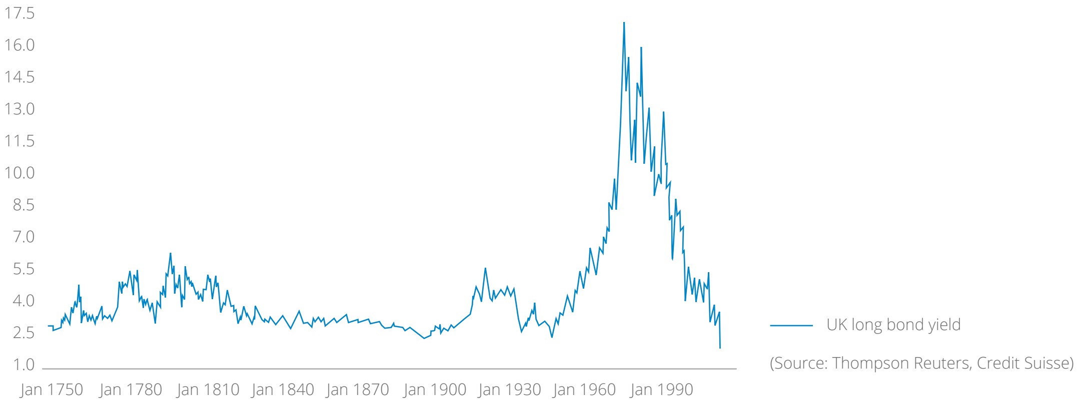
As gilt yields fall the cost of annuities and the value of cash equivalent defined benefit transfers rise. The exact opposite would of course be true if interest rates and gilt yields started to rise again. Transfer values will start to fall.

'AS GILT YIELDS FALL THE COST OF ANNUITIES AND THE VALUE OF CASH EQUIVALENT DEFINED BENEFIT TRANSFERS RISE.'

HIGH TRANSFERS VALUES

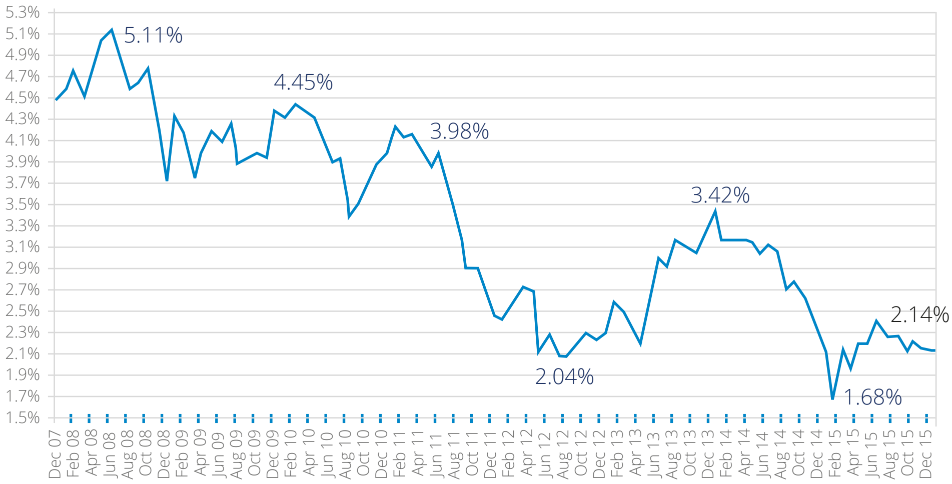
The table below shows how UK gilt yields have varied over the very long term, with a steep rise in the 1960's and 70's as inflation rocketed followed by a steady decline as inflation has reduced over the last 25 years.

UK LONG BOND YIELD, 1750 TO 2014



Shorter term and post the financial crisis and subsequent recession, rates have continued to reduce as the UK Government has lowered base interest rates and sought to stimulate the economy through quantitative easing (QE). Fifteen year gilt yields bounced back at the end of 2013 but have again retrenched to below 2.5%. As can be seen in the chart above sub 2.5% is a very low level by historical standards.

15 YEAR GILT YIELDS OVER THE LAST 8 YEARS TO NOVEMBER 2015



Credence Tips

Low gilt yields are why we currently have a great window of opportunity to consider a transfer values. These conditions may prevail for a few more years, but are unlikely to last forever. Increases in Gilt yields from current levels would result in lower transfer values.

JUST HOW BIG IS MY TRANSFER LIKELY TO BE?

As previously described your transfer value will be unique to you and will depend on your specific age, the scheme benefits and the scheme actuary's set of factors, which do vary slightly from scheme to scheme. However we can give you some general guidance based on the transfer values we are currently seeing.

If you are in your 50's and the scheme retirement date is age 65 you are likely to be offered a transfer value of around 20 times the current value of your deferred pension. If you are in your 50's and the pension scheme retirement date is age 60 you will likely offered a transfer value of 25 times the pension you might expect in today's values.

As a general principle the closer you are to normal retirement the higher your value will be as there is less time for the transfer value to grow before benefits would normally be paid.

A couple of key words used in the examples on the previous page:

Might be - Firstly transfer values do vary quite considerably depending on a range of factors so age 65 schemes might be in the range of 18 to 23 times the current deferred pension and age 60 schemes 23 to 30. A lot depends on how generous the annual increases are to the deferred pension and will be on the pension in payment. Secondly if schemes are badly underfunded and it's clear the employer does not have the means to make up the deficit, then the trustees have a right to scale back any transfer values they get asked for in line with the scheme deficit, so as to be fair to all members.

Today's values – it's important to get the right pension number before you multiply it up. Different schemes send out differing notices to members up dating them on their benefits. Some only give the pension on leaving, some revalue this to the date of the statement. Some show the projected pension at normal retirement date. The factors quoted above hold true for the pension expressed in today's money i.e. revalued up from the date of leaving, but not projected forwards to the normal retirement date. Some actually show the transfer value on the statement, then it's easy and you don't have to speculate.

In our recent experience most people are shocked to see how much their pensions are worth. In some cases they might be benefits which are quite small and may have been almost forgotten but still produce a few hundred thousand pounds of value. In larger cases where people had their benefits valued for A –Day in 2006, it can come as a surprise that the value has roughly doubled in the last 8 years and this through a period of financial crisis and when stock markets have largely gone sideways.

Examples

A 55 year old is entitled to a pension in today's values of £30,000 per year starting from age 65, the transfer value might be around £600,000.

A 55 year old is entitled to a pension of £30,000 per year in today's values starting at age 60, the transfer value offered might be around £750,000

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2015 saw one of the UK's largest banks reduce transfer values by around 10% and another FTSE 100 company announce planned reductions to transfer values in 2016, irrespective of market conditions and purely down to the increased outflow of funds through transfers.

According to the Pension Protection Fund as of January 2015 private sector schemes had a combined deficit of £370bn against total liabilities of £1.64trn. 5,175 were in deficit and 882 ran a surplus. Six FTSE 100 companies had deficits bigger than their market capital values, two of these are the two dropping transfer values above. As more people seek to transfer out of schemes Credence International expects more schemes in deficit to reduce transfer offers irrespective of market rates.

HIGH TRANSFERS VALUES - IMPLICATIONS

A big transfer value has a number of implications.

1. It focuses the mind on what you might want to do with the money. You may have other assets and income, which means you don't really need the pension, or the pension transfer value might be large enough to be one of the family's biggest financial assets. These are all good reasons to take a good look at the transfer option even if you ultimately decide to stay in the scheme.

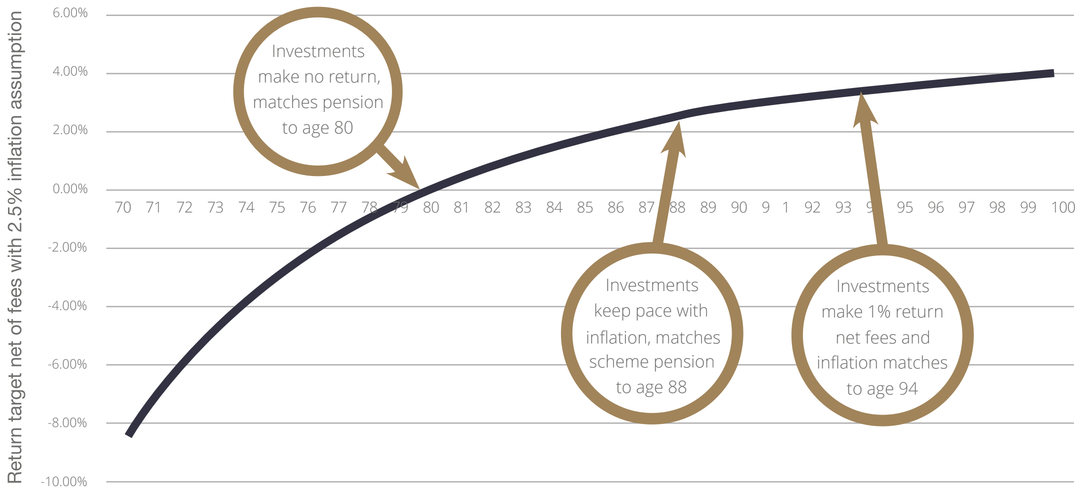
2. A generous transfer value means you can be relatively cautious about how you invest the created pension fund and still end up with both more cash and all the flexibility that comes with the transfer route.

3. A high transfer value can mean a much higher tax free cash sum can be taken post transfer as compared to what the scheme will offer. This is particularly the case when looking at early retirement options. Its not unusual to see twice the level of tax free cash available at age 55 and this can have significant planning advantages.

The chart below shows the investment return (net of fees) needed on a typical reasonably generous transfer value at current levels to match the defined benefit pension given up. The only assumption made is that of the pension increases paid by the scheme up to and in retirement which have been set here at 2.5% per year.

If you are targeting a return of 4-5% per year, or just 1-2% above inflation, you don't have to take a large amount of investment risk if you don't want to. Note these targets are based on creating pension income matched to the scheme benefit. In many cases it will be possible to reduce the tax paid on your flexible pension withdrawals as compared to that paid on a defined benefit pension income enhancing the net of tax pay out from the transfer value.

TYPICAL TARGET RETURN CURVE FOR A 55 YEAR OLD TRANSFER FROM A WELL FUNDED SCHEME



CHANGES TO PERSONAL PENSIONS AT RETIREMENT

THE REMOVAL OF WITHDRAWAL RESTRICTIONS IN PENSION DRAWDOWN

Historically, if you did not buy an annuity and used the alternative pension drawdown, the permitted pension withdrawals were linked to annuity rates. So as annuity rates fell permitted withdrawal levels fell. Now you can take as much or as little income from your drawdown account as you want as and when you need it.

THE REMOVAL OF THE DEATH TAX

Until 2015, if you were over age 75 on death the value of any unused pension account was taxed at 55% before funds could go on to the next generation. This so called 'death tax' has been removed completely and pension accounts can now be passed on to the next generation, intact and free from inheritance tax.

Whilst transfer values have always given more options to take cash early, or to vary income year to year, pension drawdown account withdrawals were limited and residual pension accounts looked pretty unattractive on death. So the extra flexibility of the transfer route only went so far.

Now with these two changes personal pension account holders have complete flexibility as to how they use their accumulated pension savings ranging from:

- Accelerated withdrawals to provide extra cash from as early as age 55, including full encashment of the account, through to
- Deferred withdrawals and passing on pension account value to future generations.

These choices simply don't exist to those who take a defined benefit pension, whose only choices are whether to take a tax free lump sum at retirement, or whether to retire earlier or later. Once these choices are made defined benefit scheme pensioners are locked into a level of income that can't be changed and will be worthless to the next generation. Tax savings can come from a range of opportunities;

1. A larger tax free cash sum available in many cases
2. Flexing income withdrawals to minimise tax
3. Deferring withdrawals to pass value to the next generation

The most common way to use the extra flexibility of a transfer is to access the tax free cash early but to defer drawing taxed income withdrawals until they are needed. This can't be done with a defined benefit

'PERSONAL PENSION ACCOUNT HOLDERS HAVE COMPLETE FLEXIBILITY AS TO HOW THEY USE THEIR ACCUMULATED PENSION SAVINGS'

WHY YOU MIGHT TAKE A TRANSFER OFFER

You need a number of good reasons to give up guaranteed lifetime income and take on investment risks, costs and the extra responsibility of looking after your own fund.

Here are four points you will want to be sure of before proceeding with the transfer:

1. The transfer value represents at least fair value and ideally is generous versus the pension benefits left behind.

2. You are comfortable with the extra responsibility of looking after an invested fund.

3. You can cope with a lower level of income later in life if the fund gets run down, this is usually a function of having other sources of income and capital.

4. You can make better use of the alternative withdrawal options offered by the transfer route as compared to the scheme cash and income options.

For the second of these points it helps if you have had some experience of invested savings in things like ISAs, or perhaps an invested personal pension account from a different period of employment.

Having other savings and sources of income in retirement is a good way of mitigating the investment and longevity risks of going the transfer route. The ability to control pension income from one year to the next can often help those with other savings and income to be more tax efficient.

On the last point there are lots of ways in which individuals might want differing benefits to those offered by the scheme for example:

- It suits you and saves you tax to be able to take the cash sum early and defer the income withdrawal
- The transfer is big enough that you can preserve its capital value for the next generation whilst still having enough income in retirement

Larger transfer offers can be compelling because they often belong to people with other assets and income such that they don't need a guaranteed income in retirement and would prefer to use the transfer value in a completely different way, for example to preserve its value as part of the family assets. But smaller transfers can also make sense where there is a clear way to use the money which makes more sense to the individual than to take the life time pension. Ill health can be a compelling reason, if it's clear your life expectancy has been shortened compared to the average then the chances are you and your family will get more cash from a transfer than staying in the scheme.

Credence Tips

The likely suitability of taking a transfer will come down to very personal circumstances and objectives. Credence International's experience is that whilst members looking to transfer generally share the same motive to control their own destiny no two individual's situation are the same and how transfers get used can vary enormously.

WHY YOU MIGHT STAY IN A DEFINED BENEFIT SCHEME

Whilst the case for transfers has become more compelling and attractive to a wider group of people a defined benefit pension remains a great benefit to hold.

So if you are in any doubt as to the attractions of the transfer route for your particular situation then default position should always be to stay in the scheme.

Staying in a defined benefit pension will also be the best option for you if:

1. You are attracted to a secure lifetime income, delivered with very limited risks and without effort on your part.

2. If you have little or no experience of looking after invested savings and don't want this responsibility. Note that this can become a burden as you get older and unless other members of the family will help, or you have good professional advisers and fund managers.

3. If the defined benefit scheme will be your main source of income in retirement and you have little or no tolerance to this income fluctuating or even running out.

4. If the defined pension benefits offered by the scheme actually match the year by year income requirements you think you will need. There is little point doing a transfer to simply try to replicate guaranteed benefits already provided by the scheme.

THREE STEPS TO MAKING A SUCCESSFUL TRANSFER

STEP 1 – GET YOUR TRANSFER VALUE

The first step is to get a transfer offer in writing from your scheme by submitting a request for a transfer offer to the scheme administrator. You can do this yourself or your adviser can do it for you and get copied in with the correspondence. If you know who you are going to use for advice it makes sense to involve the adviser as early as possible as they will then be able to go to the scheme administrator directly for any information they need not included on the transfer value offer.

Transfer offers generally come with a three month guaranteed window during which the scheme will not recalculate the transfer value. This gives you three months to get the advice you need, to plan what you might do with the transfer and then make a final decision to accept it.

Members are generally entitled to one free transfer offer calculation every year. If you want more than this you will likely be charged for the actuary's time, typically a few hundred pounds.

STEP 2 – GET THE ADVICE YOU WILL NEED

For those with transfer offers of more than £30,000 it's now a legal requirement to get properly qualified advice on a transfer before it's executed. Pension providers and schemes are effectively policing this by refusing to accept and pay transfers unless there is proof the advice has been received.

ADVICE CHECKLIST

Here below is a checklist of what should be covered in the advice you receive:

- A full explanation of the pension and cash sum benefits you would leave behind, including options for early and late retirement.
- A full explanation of the options open to you along with the governing rules and tax treatment of the personal pension fund that will be created by the transfer.
- A full explanation of the key risks associated with the transfer option as well of those of remaining in the scheme.
- A personalised critical investment return assessment which will look at what investment return is required on the transfer value to match the defined benefit pension you would leave behind.
- If you have a larger transfer value or have opted for protection against the lifetime allowance, then an explanation as to how the lifetime allowance impacts your fund and any changes to your protection caused by the transfer.
- Importantly the adviser should offer their opinion as to whether the pension transfer is a sensible transaction for you to undertake given your specific circumstances and financial objectives.

To do this they will need to:

- Understand you and your family's financial position.
- Make sure you are both comfortable and have the financial resources to tolerate the risks implicit in the transfer option.

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You won't be able to proceed with the transfer unless you have decided on the pension plan that is going to receive the transfer value. Apart from getting your agreement to the transfer the defined benefit scheme paying out the transfer is obliged to check that the receiving scheme is properly registered and recognised by HMRC as a pension scheme.

Establishing a plan of action as to what to do with the transfer value is the most important part of assessing the transfer value and is a key thing to work out with your adviser. If a clear plan of action does not emerge during the advice process you should probably stay in the scheme. If you are married it's essential to involve your spouse in the advice process as their financial future is at stake as much as yours and should anything happen to you they will need to be able to work with the adviser in your absence.

STEP 3 – ESTABLISH A PLAN FOR AFTER THE TRANSFER

The key elements to this will be the answers to:

- When will you likely make withdrawals from your pension and what will these be? This does not have to be set in stone but having a most likely scenario will help you with the next two elements.
- How will the transfer money be invested, who will manage it and what kind of investments will make up the fund?
- Once these first two points have been worked out then you, or your adviser on your behalf, will need to find a secure, low cost yet properly serviced pension solution that will facilitate your plan.

Whilst thinking about how to invest the transfer money you should also take the opportunity to review all your existing investments and use of tax wrappers such as ISAs and offshore bonds. The 2016 budget changes create enormous planning opportunity to enable those generating income in retirement to lower their tax payments.

With the flexibility of pension drawdown and with the extra cash from the tax free sum you should be looking to see how you can optimise:

- The new £5,000 dividend allowance
- Lower Capital Gains tax rates
- A £5,000 per year saving income allowance
- Tax free ISA income

From April 2016 couples who organise their investments tax efficiently can enjoy over £60,000 per year of tax free pension income, savings income, dividends and capital gains, plus their tax free ISA income before paying a penny of tax.

TAKE YOUR TIME

Once you have a guaranteed transfer offer you will no doubt be keen to make sure you secure it within the three month deadline. However this does not mean you have to make all your withdrawal and investment decisions within this three month window. Your transfer value will be paid in cash and there is nothing wrong with keeping it in cash for a few months until you are sure as to when you want to make withdrawals and how you want to invest the balance.

Investing your transfer is likely to be a 30 year exercise so taking a few months to sort it out is inconsequential in the long term.

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Smaller transfers which are a minor part of your overall assets can be dealt with quite quickly. However, if the transfer value is a major part of your overall net worth and long term financial security taking six months to work through it is not unreasonable.

Three months to make a decision on the transfer and three months to sort out an investment plan and re arrange your other investments to take account of the new funds.

THREE THINGS TO WATCH OUT FOR

As you go through these three steps here are three things to look out for:

1. MISLEADING TVAS REPORTS

Many advisers use an externally produced and semi-automated report based on a Transfer Value Analysis System (TVAS). These reports include a number of graphs and factors including;

- The critical investment return calculations at normal retirement age and early retirement
- Projections for the personal pension cash sum and income based on a range of returns which don't take account of inflation

These reports use a methodology and set of assumptions that ignore recent pensions rule changes and the preference by the vast majority to use flexible drawdown in retirement rather than buy an annuity. This is particularly perplexing given that a defined benefit pension holder already has an annuity, such that if this is the form of retirement benefit they want, the best option in the vast majority of situations will be to stay in the scheme.

The TVAS calculations assume that following the transfer the individual will use their transfer fund to buy an annuity at the normal retirement date of the scheme. They make an assumption as to the cost of this annuity in years to come and then work back to an investment return needed on the transfer value to get to a fund big enough to buy this forecast annuity.

The FCA has from time to time critiqued the assumptions used in these calculations and set guidelines as to what these should be. They have also recently warned of advisers over relying on the output from these reports and not considering other suitability issues.

However to date there has been no alternative methodology put forward by FCA and there is still a tendency by advisers to rely heavily on the critical yields generated by TVAS reports to decide whether to recommend a transfer or not.

As already discussed in this guide if you are attracted to an annuity style guaranteed income in retirement, unless you have a life threatening illness or are concerned over the long term security of your scheme then you will most likely be best served by staying in your scheme. A TVAS calculation is most likely simply going to emphasise this assertion.

In a scenario where you dismiss annuities and consider drawdown as the way to invest a transfer value then the critical investment return can be much more simply calculated as on page 8, with only one assumption, that of the inflationary increases on the defined benefit scheme pension and one judgement call, which is to speculate how long you, or in the case of a couple we, might live.

Pension projections can be much simpler too if they use a real investment return after inflation and allow the individual to select the end date for the income they would like to plan. By using these two more simplified and appropriate calculations, with significantly fewer forward looking assumptions individuals can get a real sense of investment return challenge and the outcome possibilities.

Credence Tips

TVAS reports can throw up misleading critical yield calculations. As you approach normal retirement the time to make up the gap between the transfer value and the forecast annuity cost can lead to high critical yields. These can be further distorted when the projected fund crosses the lifetime allowance.

The TVAS critical yield is not the return you must make on your pension fund post transfer to match the benefits you have left behind, unless you intend to do this by buying an annuity.

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2. EXCESSIVE INVESTMENT RISK

Having secured a generous transfer offer the next thing is not to lose it. Here a few things to watch out for:

- Unregulated investment schemes - often referred to as UCIS schemes (not to be confused with highly regulated UCITS funds). These will often be based around esoteric investments like car parks, timber or foreign property and often promise very high returns. There have been a number of high profile collapses of such schemes in recent years with investors losing most of their money or taking many years to get back a lot less than they originally invested. Those running these schemes choose to do them outside of the reach of the regulator for a reason and they are best given a very wide berth.

- Being a forced seller of investments at a loss to fund income – it's important to make sure your investments are planned with your anticipated withdrawals in mind to ensure a long enough investment time horizon. Volatile investments, whose values move around significantly in the short term often produce higher longer term returns. However, they can be a disaster for someone needing to make regular withdrawals who ends up being forced to sell them when values are depressed. This can be avoided if they can be segregated from the withdrawal funding and can be left to recover.

- Pure capital growth investments – income producing investments tend to be less volatile in value than pure growth investments as the prospect of future income payments helps stabilise their price. Additionally once you have removed your tax free cash sum from your pension all further withdrawals, be they by you, your spouse or ultimately by your children will be taxed as income. Capital gains tax rates have been and continue to be lower than income tax rates, so if you have the option to hold growth investments personally outside of the pension wrapper this will likely reduce the tax on profits in the future.

3. EXCESSIVE FEES

Different advisers charge differing amounts for initial advice and intermediary services and ongoing services. However it's not just the adviser's fees you need to concern yourself with, it's important to keep a track of all your costs as you transfer out and on an ongoing basis. These may include:

- Advice fees
- Pension account fees
- Fees for administering withdrawals
- Investment fees and fund charges

There is no right or wrong answer to what these should all add up to but as a general rule initial fees should be no more than 3% of the transfer value.

It’s impossible to invest outside of straightforward deposit accounts without incurring some ongoing costs the key point to ensure is that all additional ongoing costs need to bring added value such that your prospective after costs investment returns are better than a deposit account with as much certainty as possible.

Excessive ongoing costs are potentially more damaging to the long term success of a transfer than a high initial fee and can turn what could be a relatively low risk investment strategy with a low target return into a high risk exercise just to overcome the cost hurdle.

CASE STUDIES

CASE STUDY 1: MARY AGE 55

1. Mary age 55 has been offered a transfer value of £310,000 from her previous employer, a FTSE 250 company, in return for giving up a projected pension at 65 of £19,800 p.a., estimated at £15,900 p.a. in today's money. Mary is widowed with one daughter age 25, owns her own home with no debt and has £150,000 of other savings including ISAs. Mary has had a serious, life limiting illness. In this case the transfer value represents 19.5 times the current value deferred pension.

WHY MARY TOOK THE TRANSFER VALUE

- The investment return Mary would need generate on the transfer value in a drawdown account to match the FS scheme pension to age 80 would be just 1.8% per year after fees and this is considerably older than she would expect to live given her prognosis.
- She will have immediate access to £77,500 of tax free cash and can used the balance of the fund to provide income now allowing her to contemplate retirement 10 years earlier. Whilst this could have been achieved from the FS scheme it would have resulted in a significantly lower pension.
- After taking the tax free cash sum Mary can expect to be able to draw around £10,000 per year from her pension without eating into its capital value or paying very much income tax. If she wants to plan for an income that would last at least 20 years she could take £15,000 per year as a pension assuming a real investment return of 2.5% after fees and allowing for inflation. Bear in mind these pensions would be payable 10 years ahead of the scheme pension and after having withdrawn £77,500 of tax free cash.
- Whilst she forgoes the security of lifetime income, the new rules will allow her to pass on any residual unused pension fund to her daughter.

CASE STUDY 2: MICHAEL AGE 56

2. Michael aged 56 was offered a transfer value of £618,000 from his previous employer, a top 5 UK accountancy firm, in exchange for a projected pension of £34,700 p.a. at age 63, equivalent to £29,200 p.a. in today's money. Michael was still working, had a mortgage still to repay and has two children, both out of college and working. Michael and his wife anticipated two reasonable inheritances from their respective parents. The transfer value here was 21 times the current value deferred pension.

WHY MICHAEL TOOK THE TRANSFER VALUE

- Whilst Michael's pension had generous annual increases, the transfer value was equally generous.
- A 5% p.a. return net of fees on investment in a drawdown account would be able to match the scheme benefit to age 90.
- Michael took the £154,500 tax free cash available from his transfer value and used it to pay down some loans, clear his mortgage and put £20,000 into ISAs.
- He placed the balance of the transfer value with his existing pension drawdown worth £151,000 account leaving him with a combined drawdown account value of £615,000 from which he does not expect to have to draw income from for another 5-10 years.
- The drawdown account is forecast to be able to generate sufficient income to take Michael a higher rate tax payer in retirement along with the state pension, whilst preserving capital for the children.

CASE STUDY 3: STEPHEN AGE 54

3. Stephen age 54 had opted for enhanced protection at A-day in 2006 based on a pension valuation of £2.1m of his deferred defined benefit pension from a FTSE 100 company. In late 2011 he was offered a transfer value of £3.6m for the same pension in lieu of a pension payable at age 60 of £120,000 p.a. The transfer value was approximately 30 times the deferred pension value in 2011. In taking such a large transfer value that had grown by more than 5% p.a. Stephen broke his enhanced protection and fell back to primary protection.

WHY STEPHEN TOOK THE TRANSFER VALUE

- The transfer value looked generous and enables Stephen control of a significant family asset.
- Stephen and his wife had other assets and investments and were therefore not reliant on the guaranteed income in retirement provided by the defined benefit scheme.
- The company had recently had to make some very large contributions to make up scheme deficits, whilst it was not the primary reason behind the decision to transfer out, there were some niggling doubts about the long term covenant of the employer.

Three years later Stephen's fund is now worth £4.2m and in 18 months time Stephen will have access to his cash sum if he requires it. This will be five years ahead of when it could be taken had he stayed in the scheme and similar in size.

It looks like Stephen won't need the income at 55 and will continue to grow the fund a while and in any event will be very happy spending only the income from the invested pension fund and keeping the capital intact. With the abolishment of the death tax Stephen and his wife will have the option to pass on at least £1.5m each of pension funds to each of their two children in today's values.

About Credence International

ABOUT US

Credence International is a Wealth Management and Advisory Firm established to create a unique private client proposition. In a world where lifestyles, economies and technologies are constantly evolving, we were established to give our clients enhanced solutions in a simplified form. Our private clients benefit from our years of experience in:

- Private Equity
- Financial Advice and Planning
- Asset Management
- Investment Management
- Discretionary Trading
- Investor Visas

Our group structure allows us to offer private client's investment propositions that were previously only available to highly affluent individuals. We can show our clients unique, exclusive opportunities and give 'whole of the market' advice. This gives us an impartial advantage. We are focused on quality, detail and transparency. We spend time understanding our clients' needs and deliver beyond their expectations.

WHY US

We offer a unique and compelling experience to our expanding base of clients and partners. We have absolute focus in our business and in order for us to succeed, our clients must also succeed. We strive to fully understand our clients' needs and align our interests with theirs. We keep in close communication throughout the relationship and provide an educational framework so they fully understand the financial decisions they make. This leads to positive outcomes and long fruitful relationships. We aim to build increasing wealth under management and this can only be achieved by offering a proposition that is concise and reliable.

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