Bank of Ireland
Investment Markets

Defined Benefit Transfer Values – Stick or Twist?

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The decline in the number of Defined Benefit Pension Schemes has been well publicised over the last number of years. For many Schemes, a combination of increased longevity, low interest rates and changes in accounting rules have resulted in scheme liabilities outweighing assets. This has led to a funding deficit and an increasing cost burden on sponsoring employers.

There are just over 600 Defined Benefit Schemes in Ireland, with numbers declining steadily each year. Many Schemes are either; closing to new entrants, closing to future benefit accruals or winding up altogether. An added problem for Employers and Trustees is that for many Defined Benefit Schemes, deferred members outnumber current active members. Deferred members are former employees who still have a benefit entitlement in the scheme and have not yet retired. In an attempt to ease the administrative and financial headache associated with these scheme members, many Trustees and Employers have contacted former employees and reminded them of the option they have to transfer out to alternative pension arrangements. Sometimes a financial incentive to do so is offered.

WHAT DEFINED BENEFIT SCHEME MEMBERS NEED TO CONSIDER IF OFFERED THE OPTION OF TRANSFERRING OUT:

The first and most important factor to understand is that in all probability you will be transferring to a Defined Contribution arrangement. In doing so, the investment risk in relation to the pension fund passes from your former employer, to you personally.

WEIGH UP THE CURRENT POSITION OF THE DEFINED BENEFIT SCHEME

On first impressions, a Defined Benefit pension scheme is the best type of pension you can have - the "Rolls Royce" Pension. It promises to pay you a pension based on a percentage of your final salary, so planning for the future is easy. But, and there always is a 'but', this depends on the scheme's ability to fund its' pension obligations for all members going forward. Benefits under Defined Benefit Schemes are not guaranteed. If a scheme's assets are not sufficient to pay the benefits and the employer is not in a position to meet the shortfall, the pension promised to you may have to be reduced.

Consequently, the current fund position of the scheme is an important consideration if you are offered a Transfer Value. If the scheme is not fully funded, this will be reflected in the Transfer Value provided to you. That's not to say that if a scheme is currently in deficit, it will remain so, or that an employer company will not be in a position to eliminate the deficit going forward. The opposite is also true. A currently fully funded scheme may not remain so. Consideration therefore needs to be given to the financial health of the Scheme and the future financial health of your former employer – in so far as this can be determined.

IS AN ENHANCED TRANSFER VALUE BEING OFFERED?

Some schemes offer an enhanced Transfer Value for a period of time as an incentive to transfer. In most cases, this is an enhancement to bring the Transfer Value closer to what would have been available if the scheme was fully funded. If taking any Transfer Value into a Defined Contribution arrangement, you will need to calculate the assumed level of investment growth required on that transfer value, to provide you with the same or higher level of benefits than the Defined Benefit Scheme promised to pay. This is known as the hurdle rate. The required level of investment growth may well be accompanied by a level of investment risk that you are uncomfortable with. For this reason, historically, many deferred members of Defined Benefit Schemes decided to remain in the Scheme. The financial pressures on employers outlined above however have made people reconsider.

WHAT ARE THE OPTIONS AVAILABLE AT RETIREMENT?

An additional advantage in taking a transfer payment to a Defined Contribution arrangement relates to the options available at retirement. Defined Benefit Schemes only offer the option of an annual pension and/or a lump sum at retirement. Lump Sums are calculated by a formula relating to final salary and service, with a maximum lump sum payable of 1.5 times final salary. All Defined Contribution arrangements (including Personal Retirement Bonds) now have access to an additional set of options. In addition to the option of an annual pension, Defined Contribution pensions can pay Lump Sums of 25% of the accumulated fund at retirement, and invest the remainder in an Approved (Minimum) Retirement Fund (A(M)RF) post retirement. An A(M)RF is a personal asset. It provides greater flexibility in terms of how income is accessed post retirement, when compared to the traditional Defined Benefit annual pension, but there is a risk that you could out live your A(M)RF if you draw funds out too quickly. If you die before your A(M)RF is spent however, it can be passed on as part of your will.

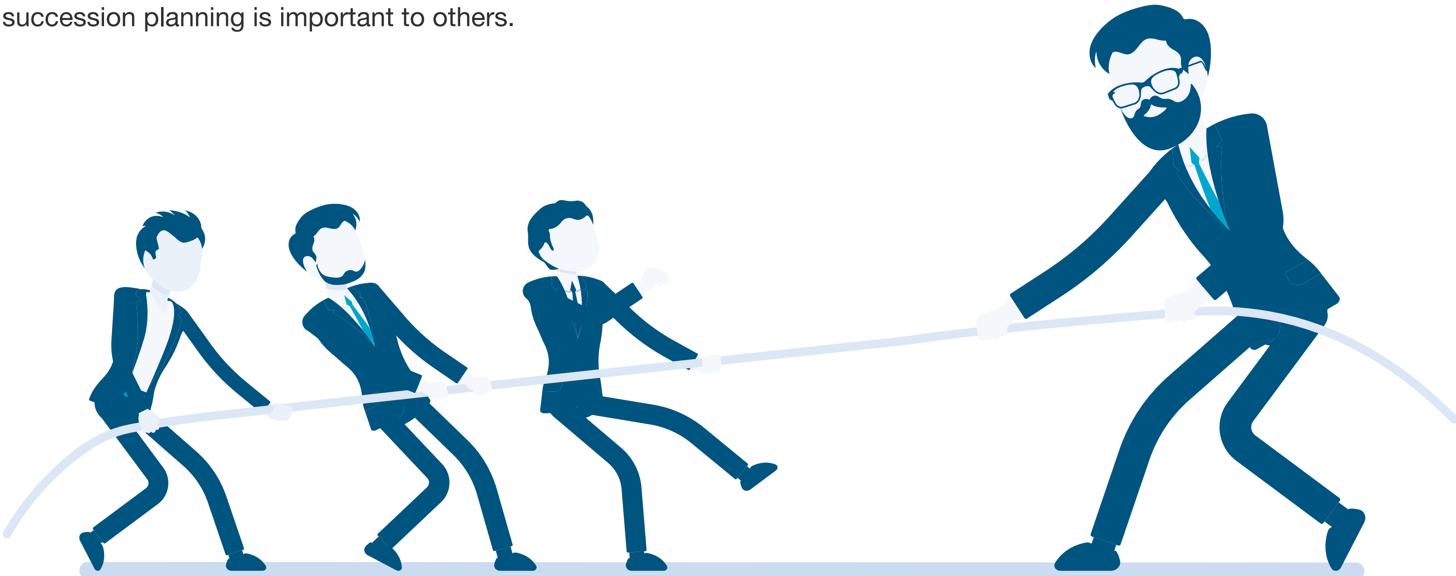
These additional options offer greater control and flexibility and have made the Transfer decision more appealing to some. There may be potential for greater lump sums, and the flexibility in terms of access to income, and for succession planning is important to others.

CONCLUSION

Deciding on whether to take a Transfer Value from a Defined Benefit Pension Scheme is an important decision and it cannot be reversed. It is important that all of the options available are reviewed and considered carefully.

If you stay in the Defined Benefit Scheme, the current financial health of the Scheme may well improve or dis-improve over time. Transferring out may well give you greater flexibility in terms of when and how to access your benefits, what the Pension invests in, how much income to take (you would no longer be limited to a specific amount each year) etc.

There are risks involved in either option; however an enhanced Transfer Value does reduce the risks of taking a Transfer Value somewhat. The greater the enhancement the lower the hurdle rate the invested Transfer Value will have to earn in a Defined Contribution arrangement to get the same value as the Defined Benefit pension given up. Each individual case will be different and will need to be looked at based on its own merits. Independent financial advice is very important.



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