RESEARCH

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Pension flexibilities and defined benefit schemes

2015 research


0101010

Introduction

On 6 April 2015 the government introduced a range of legislative changes designed to increase the flexibility that individuals have when accessing their pension savings from age 55 onwards.

Although these changes apply mainly to defined contribution (DC) schemes, there is an inevitable knock on effect to defined benefit (DB) schemes as some members look to transfer out in order to have access to these flexibilities. There are also a number of minor changes that directly impact on DB schemes.

To find out how DB schemes are reacting to the new flexibilities we carried out an online survey. We received 35 responses to the survey from pension managers of schemes ranging in size from £40 million to over £40 billion and gained some valuable insight. We would like to thank everyone who took the time to respond.

Our research studies the impact of the new pension flexibilities on DB schemes and in particular focuses on three key areas:

- Additional Voluntary Contributions (AVCs);
- Transfer values; and
- Trivial commutation

In light of the pension flexibility changes, we trust that this information will assist employers and trustees in formulating appropriate strategies.

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AVCs

What's changed?

AVCs are usually provided on a money purchase (DC) basis. As such they fall within the remit of the new pension flexibility rules and there are now new options available to members.

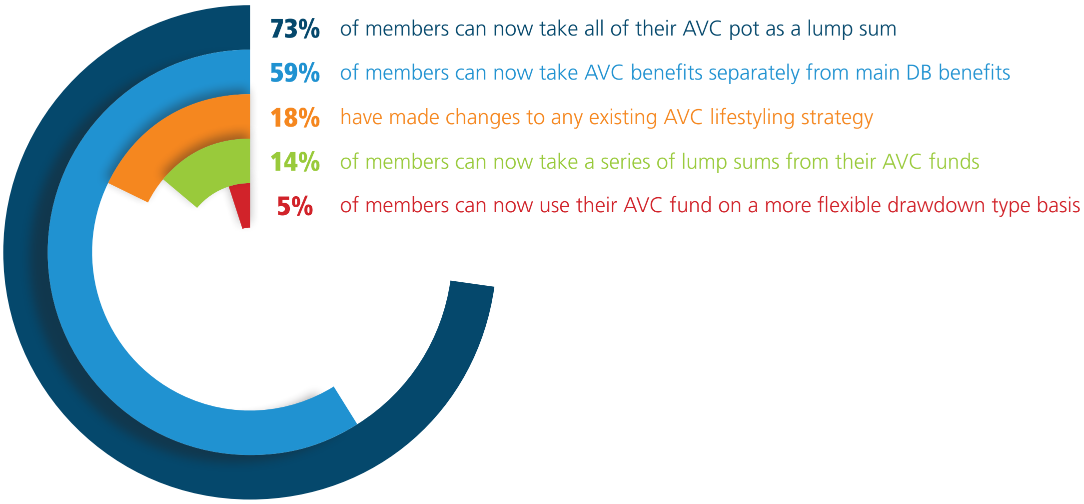
There is now potential for a scheme to allow members to take their AVC benefits separately from their main DB benefits. If the option to take AVC benefits separately to DB benefits is provided by a scheme, then the new flexibilities potentially include allowing the member to take:

- All of their AVC pot as a lump sum (subject to tax at the appropriate rate) from age 55 onwards;
- A series of lump sums (subject to tax at the appropriate rate) from their AVC funds from age 55 onwards; or
- All of their AVC fund on a more flexible drawdown type basis.

There is also the option for a member to transfer their AVC funds at retirement to a DC vehicle (in order to potentially take advantage of the new DC flexibilities) while taking their DB benefits as normal.

Research results

How have schemes dealt with AVC funds since April 2015?



The results show that the majority of schemes allow members to take their AVC benefits as a lump sum, but few schemes have gone as far as making full use of the DC flexibilities such as multiple lump sum payments and other flexible drawdown options.

Although over half of respondents stated that members may take their AVC benefits separately from their main scheme benefit, none of the schemes surveyed currently facilitates members to transfer their AVC funds at retirement to a DC vehicle while taking their DB benefits as normal.

Less than 20% of the schemes surveyed have made changes to the life-styling strategy of their AVC scheme since April 2015.

What now?

It is likely that an increased number of members will wish to transfer or cash in their AVC pot to make better use of the flexibilities available. Companies and trustees should give consideration to whether they require members to transfer in order to access these flexibilities or whether to develop and expand their current AVC offering in light of the new flexibilities.

Schemes may wish to review any AVC life-styling strategy that has been in place to date.

In particular, they may wish to consider:

- Amending the period during which switching from 'growth' to 'protection' type assets takes place to reflect the lower age at which AVC benefits may be accessed.
- Reviewing the target investment split at retirement and determining the target cash allocation based on a view of the future cash preferences of the scheme membership.

Transfer values

What's changed?

It is widely expected that there will be an increase in transfer requests over time as a result of the new flexibilities. In order to protect members, an additional requirement has been introduced from April 2015 for individuals to take advice from an independent financial adviser (authorised by the FCA) before a transfer can be accepted if the value is over £30,000. This advice could be funded by the employer if, for instance, the transfer was to a DC section of the same scheme or as part of an employer-led incentive exercise.

It remains the case that transfers are prohibited for all members who are already in receipt of their pension, and also for members of unfunded public sector pension schemes (in order to protect taxpayer interests).

Partial transfers are likely to become an increasingly attractive option to members as they give them the opportunity to access the new flexibilities, while retaining some degree of security from their DB arrangement. They can also help employers and trustees manage down the size of their DB scheme over time.

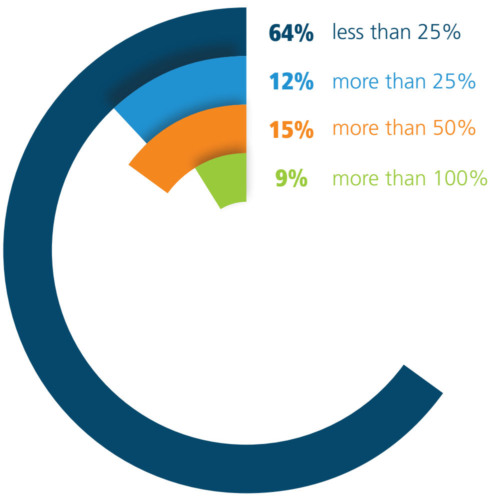
There are a few ways that partial transfers can be designed, which could potentially be used to help simplify scheme benefits; for example:

- Transfer of all benefits accrued post 6 April 1997;
- Transfer of the value of the guaranteed minimum pension (GMP); or
- Transfer of different tranches of benefits; for example, any Consumer Price Index (CPI) related benefits in order to help reduce any tranches of benefit which may prove costly to secure in the buy-out market.

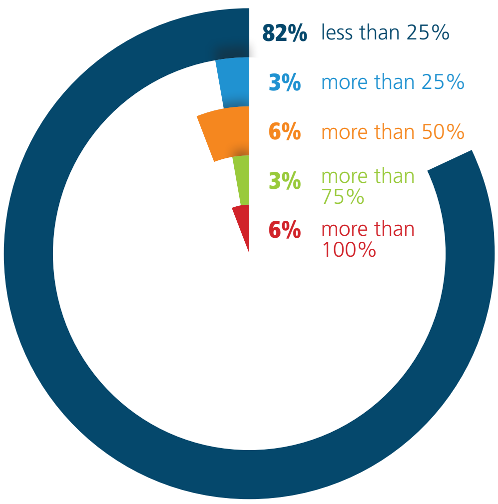
Scheme rules will typically need changing to facilitate such partial transfers.

Research results

Have you seen an increase in transfer value quotation requests post April 2015?

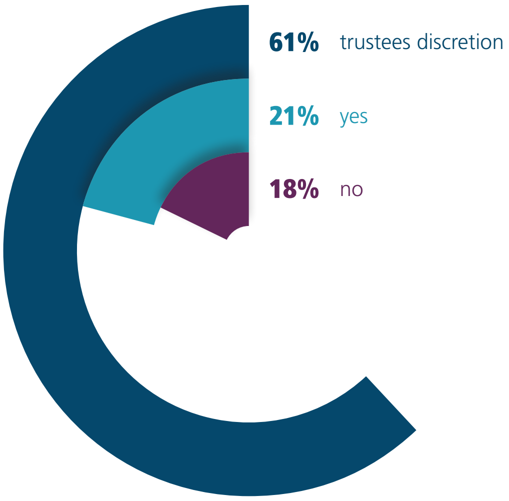


Have you seen an increase in transfer value payments post April 2015?

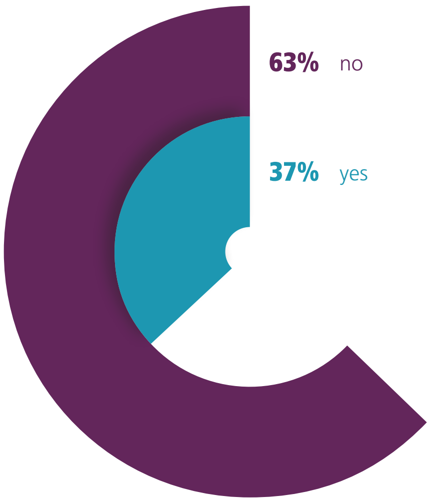


Our research shows that, while there has been an increase in transfer value activity since April 2015, only around one third of schemes responding to the survey had seen an increase in requests by more than 25% and less than a quarter of schemes responding had seen an increase in transfer payments by more than 25%. The new IFA guidance requirement could be a limiting factor on the number of transfers going ahead.

Have your rules historically allowed members to transfer right up to NRA?

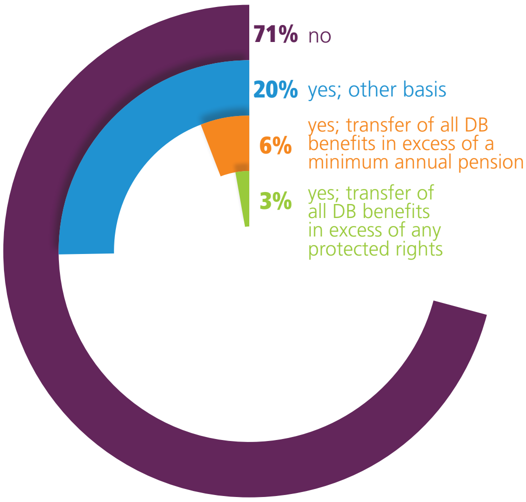


Have rules been amended post April 2015 allowing members the option to transfer up to NRA?

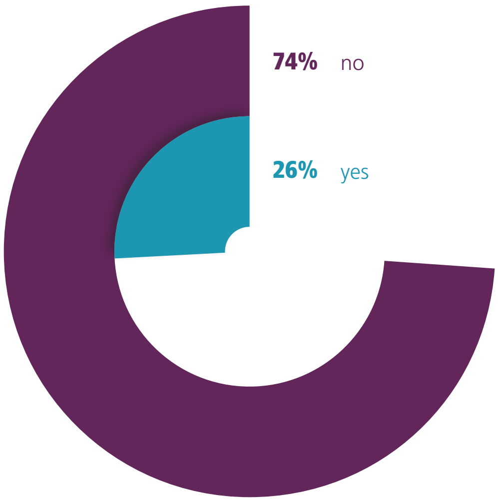


Our research shows that less than a quarter of schemes surveyed have historically automatically allowed transfers to take place right up to normal retirement age, however, this number increases to around 80% if we include those schemes which would allow transfer at the discretion of the trustees. Of those schemes whose rules did not already allow it as a right or a discretion, only around a third of respondents had amended their scheme rules to allow unconditional transfers up

Do you allow partial transfers and if so then on what basis:



Do you provide a transfer value quotation as part of any retirement options communications?



The vast majority (around 70%) of schemes surveyed do not currently allow any partial transfer of defined benefits. Also, only around one quarter of respondents routinely provide a transfer value quotation to members as part of their retirement options communications. Of schemes that do offer transfer value quotations at retirement as standard, around one third of the schemes surveyed are currently facilitating free access to an independent financial adviser when a member requests it. In addition, fewer than 30% of the schemes surveyed have amended their transfer value basis since April 2015.

What now?

Historically, most schemes have not allowed transfer values to be paid within twelve months of normal retirement age. In light of the new flexibilities, it will be worthwhile considering allowing the option to transfer right up to the point of normal retirement age. Schemes may wish to consider providing a transfer value quotation as part of their retirement options communication.

As a result of the increased transfer value activity (as well as economic reasons) many schemes should consider reviewing their transfer value basis. In particular, if members are taking transfer values at older ages the basis should take into account appropriate selection risks. If partial transfers are allowed it may also be appropriate to review the transfer basis in light of the profile of members who do actually transfer.

Trivial commutation

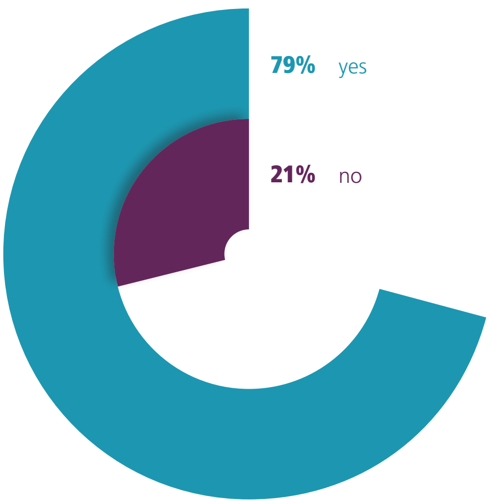
What's changed?

Trivial commutation and small lump sum commutation limits which changed as a result of the 2014 Budget continue to apply. Individuals with entire pension savings of less than £30,000 or savings within a single DB scheme of less than £10,000 may take their benefits as a lump sum. However, the age at which an individual can make use of these rules has been reduced from 60 to 55 as of April 2015. Scheme rules will typically require amendment to facilitate the new trivial commutation rules.

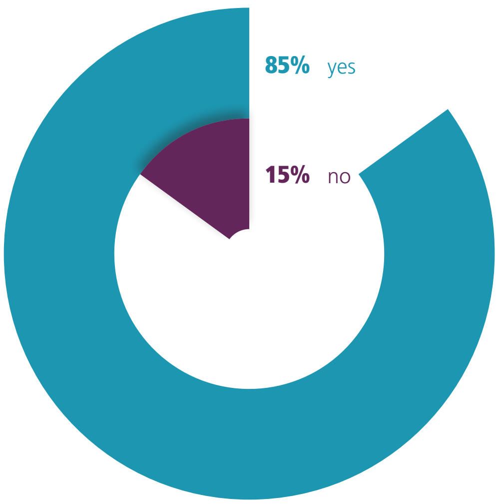
Schemes often routinely offer trivial commutation to a member (where applicable) at retirement. The new flexibilities open up the possibility for schemes to also run bulk trivial commutation exercises for all eligible members over age 55. It should be noted that any such exercise should be considered in light of the industry-wide Code of Practice on incentive exercises.

Research results

Have you amended your rules to facilitate the new trivial commutation rules?



Do you routinely offer trivial commutation to a member at retirement?



Over 85% of schemes in our research already routinely offer trivial commutation options to members at retirement. In addition, around 80% of schemes have amended their rules to allow for the new trivial commutation rules.

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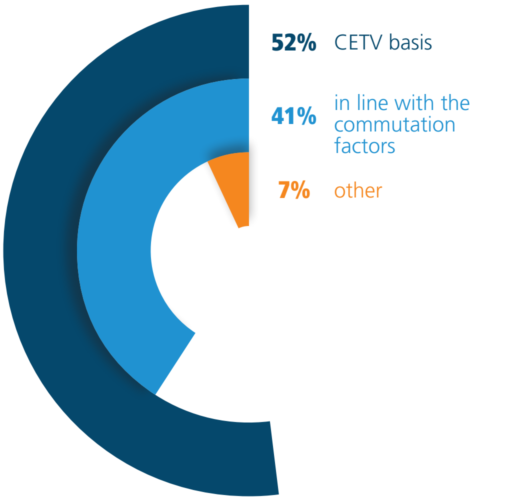
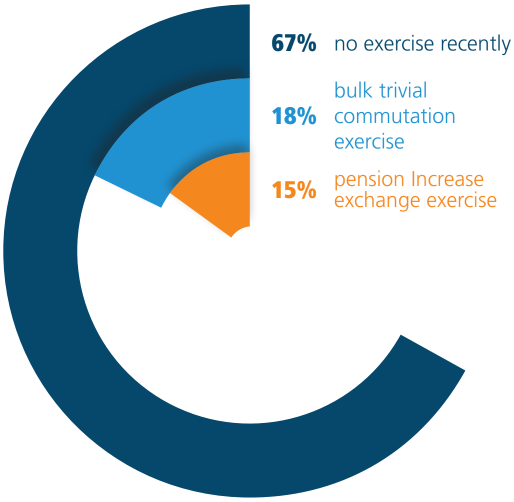
On what basis do you offer trivial commutation to a member at retirement?



Over half of the schemes participating in our survey calculate trivial commutation lump sums using the scheme's Cash Equivalent Transfer Value (CETV) basis, with the majority of other schemes calculating lump sums in line with the scheme's commutation factors.

Schemes which have carried out large group exercises



Our research reveals that around one third of schemes have recently carried out a bulk liability management exercise. Of those schemes, approximately half of these were Pension Increase Exchange (PIE) exercises and the other half were bulk trivial commutation exercises. The responses showed that the trivial commutation exercises were carried out on an 'opt-in' basis. The average take-up of the PIE option, where such an exercise was implemented, was around 30%.

What now?

The increase in trivial commutation and small lump sum limits mean that more members will be eligible for such payments. It may therefore be appropriate to review the conversion basis for these payments post April 2015. In particular, if both transfer value and trivial commutation quotations are to be made at retirement then the value placed on the benefits should normally be consistent. This consideration has led many schemes to adjust their conversion basis to bring it in line with the CETV basis rather than the commutation factors.

If you are planning an exercise, then you should consider whether:

- It is done on an opt-out or opt-in basis;
- To treat the exercise as a business as usual programme in terms of the voluntary code of practice on incentive exercises; or
- To provide access to an IFA either on a guidance or advice basis.

Thank you again to the people who took the time to respond to the survey.

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