PENSIONS

A GUIDE TO

DEFINED BENEFIT SCHEMES

Interface

Independent Financial Advisers - Financial Life Planners

FEATURE ISSUE | FEBRUARY '19

IF YOU ARE CONSIDERING TRANSFERRING YOUR FINAL SALARY PRESERVED BENEFIT PENSION TO A PERSONAL PENSION YOU MUST READ THIS FIRST...

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There are two main types of pension scheme in the UK: Understanding the differences between a Defined Benefits Pension and a Defined Contribution Pension

The first type of pension is called a defined benefit or final salary or scheme which is a company pension scheme set up an employer for their employees. They promise to pay you a guaranteed pension for life and they are almost always seen as the best type of pension that you can have.

The amount of pension that you receive is based on your salary, and the length of time that you work for your employer. Final salary schemes are attractive to their members because the pension scheme takes all the risks and it has to pay you the promised pension regardless of how the scheme's underlying investments perform. This means that final salary schemes are risky for employers but not for employees. The final salary pension is not linked to the pension scheme's underlying investment performance and the member gets a set pension, on a set date, payable for life, with no risks.

The second type of pension is called a personal pension or a defined contribution scheme. In this scheme all the money that is paid in contributions goes into a pension fund in your own name. How much you receive on retirement depends on how well your fund grows and how much income your money can purchase when you retire. You can start contributing to a defined contribution pension yourself (a personal pension) by choosing your own pension provider. If you are employed and your employer does not provide a defined benefit scheme it is a regulatory requirement that they automatically enroll you into their defined contribution scheme (a group pension plan - GPP).

The final salary scheme was predominant during the time when people were likely to have only one job during their lifetime and then retire with their guaranteed final salary pension. Today, employment is very different, and people can expect to have lots of different jobs with different employers and build up several different pensions during their working lives.

In addition, people are living longer which is good news for them but not for the final salary scheme because they guarantee to pay their members an income for the rest of their lives, and as people live longer, the pension scheme must pay for longer. Because of these changes final salary schemes have become expensive to run and most private sector final salary schemes have been closed and replaced by defined contribution schemes.

A significant number of people in the UK have final salary pension benefits in the form of preserved pensions, either as a result of their final salary scheme closing, or as a because they have changed employment. Their best option is usually to leave their money in the final salary scheme rather than transferring it to a private pension because of the guaranteed income that they will provide.

The pension freedoms introduced by the government in 2015 gave new flexibility, freedom, and choice to personal pensions that makes them more attractive and some people may be attracted to transferring their preserved pension to a personal pension in order to benefit from that flexibility. However, this is only likely to be the right decision for a minority of individuals.

If you are considering transferring your preserved pension to a personal pension proceed with caution - A time to stop and think

If you are considering transferring your preserved pension from a defined benefit (final salary) scheme to a defined contribution scheme (personal pension) it is essential that you take your time and understand the risks. There are both pros and cons to transferring and the right decision depends on your circumstances. For most people the right decision will be to remain in their defined benefit scheme and not to transfer. However, for some, transferring will be a good decision, unique to them, because of their circumstances, because of their life choices, and because of their personal preferences.

Transferring is a one-off irreversible decision and it is vital that you obtain comprehensive advice from an independent financial adviser who is both qualified and authorized to provide such advice. This may be one of the biggest financial decisions that you will ever make, and it may affect your financial well-being for the rest of your life (and that of your dependents if applicable).

You should eye with extreme caution any adviser who only charges a fee if you decide to transfer: The only way that they will get paid for any work that they do will be if you transfer and that could prejudice their advice. This is a complex area requiring specialist knowledge and you should expect to pay a reasonable fee to receive advice whether your ultimate decision is to transfer or to stay where you are.

TRANSFERRING IS A ONE-OFF IRREVERSIBLE DECISION

Defined Benefit (final salary) scheme characteristics

Every scheme is different, but they all work on the same principles so that when you reach the scheme's normal retirement age, you get paid a proportion of your salary as a pension for the rest of your life. Your benefits are defined, and they are based on your final salary which is why it is usually referred to as a 'final salary scheme'.

The amount that you receive is based on your salary and the number of years that you are a member. The exact proportion of your final salary that you will receive as a pension depends on the scheme's accrual Rate. For example, if the accrual rate is a sixtieth, and you have worked for thirty years, you would receive thirty sixtieths, or half of your final salary as a pension when you retire.

Some schemes have moved to a different basis of defining salary in order to reduce the cost. One variation is known as a 'career average' scheme where the pension is not based on your final salary, but an average of your salary throughout your career with that employer.

When you are employed, and an active member of the pension scheme, the amounts of pension you are being promised increases each year as your salary increases. However, if you leave your job before retirement, or the pension scheme closes, you will become a deferred member with a preserved pension, and you will normally have to wait until the scheme's retirement age before you can draw your pension.

The scheme administrator calculates the amount of your preserved pension and this remains in the scheme until you retire. The scheme also gives it some protection against inflation by revaluing it every year until you take it, and this helps to maintain its real value.

When you reach the normal retirement age of the scheme which is typically sixty or sixty-five, you are able to take your pension. Sometimes the scheme will allow you to take your pension earlier than planned, however, they usually reduce the amount of your pension because the scheme will have to pay you the income for longer and they may apply what is called an 'actuarial reduction'.

At retirement, you have the option to take a lump sum from the scheme as well as receiving an income, and this is commonly called 'tax free cash' because the lump sum is tax free. This tax-free cash is only available once at the very start, and its modern name is Pension Commencement lump sum (PCLS), however, this is a bit of a mouthful, so people prefer to describe it as 'tax free cash'.

Your pension is paid to you every month, like a salary, and will continue for the rest of your life. It is important to appreciate the benefit of your income being index linked, which means that your income usually increases each year, so its value can keep up with inflation. Your regular monthly pension income is then taxed just like an income from a salary or wage from a job. While it only effects people with very large pensions there can also be another one-off tax to pay when you first take your pension which will be discussed later.

When you die the scheme will usually pay a pension to your dependents, this will typically be your spouse or civil partner. The amount of the dependent pension is usually a proportional of your own entitlement for example your spouse could receive an income of half or two thirds of the pension that you would have had.

You should look at the scheme rules to understand who would be eligible to receive any of these death benefits and how much they might get. The rules are often different depending on whether you die before or after you have retired.

There are a lot of important features in a final salary scheme and one of the main advantages of being a member is that you do not have to worry about any of the investment decisions. The scheme is responsible paying your pension and your benefits are guaranteed. The only exception to this is if both your employer and the pension scheme become insolvent though if this happens you will become eligible for the government's compensation fund, the pension protection fund (PPF).

Whether you decide to stay, or you decide to transfer there are both advantages and disadvantages. If you stay in your final salary scheme, it offers you a guaranteed income for life, which is inflation proofed, and can provide regular income for your direct dependents on your death. But final salary schemes do not have the flexibility of personal pensions and there is not usually a lump sum to pass on when you die. It is therefore vitally important to understand and appreciate the differences between the two types of pension and assess which is best for your personal circumstances.

Revaluation of your preserved pension

When you stop working for your employer, or if the scheme is would up, you become a deferred member. You usually cannot start taking the pension that you have built up until the scheme's retirement age, so the pension scheme will preserve your pension until you retire, and you start to receive the benefits.

A few decades ago some of the lower quality private schemes did not revalue your benefits, they were maintained at the same monetary value as they were at the date that you left the scheme and they did not increase. Inflation eroded the real value of your pension and they were described as 'frozen'. While schemes today increase each year, the term has remained in common language and people sometimes still erroneously describe their preserved pension as 'frozen' even though that is no longer usually the case.

Until you take your pension benefits the regulations demand that your preserved pension is kept safe and secure by the scheme trustees and they revalue your pension each year until you retire. The final salary pension scheme and your former employer work in partnership to ensure that your pension fund is secure and well-funded.

Revaluation of your pension is best explained by an example: If by forty-five you have built up an annual pension of £12,000 in your final salary scheme and you changed your employment, you will then stop building up any more pension benefits and you will become a deferred member of the pension scheme. If the pension scheme's retirement age was sixty-five, the trustees will then top up the £12,000 preserved pension for the next twenty years until you reach sixty-five. This means that at age sixty-five you could retire with an annual pension of say £18,000 and not just the £12,000 you had built up on the day you left your job.

The rules which determine the amount of the revaluation depends on when you were a member of the scheme and when you left.

The regulations have set the minimum amounts that schemes must pay, and these have changed several times over the years. You may see terms like 'pre-1998 GMP' and 'post-1997 benefits' on your pension statement. This means that the revaluation that you will receive will vary depending on exactly when you were employed and when you were building up benefits. For example: someone who is an active member of a scheme for five years between 1990 and 1995 is likely to get a different revaluation rate from someone who was an active member for five years between 2000 and 2005. The specific dates you started and left your job is important because you get the revaluation rates that apply for that period of time.

The revaluation rates used in different time periods are usually linked to inflation because revaluation is designed to inflation proof your preserved pension. If the scheme revalues your preserved pension each year by the amount of inflation its real value is not being eroded over time and it maintains its purchasing power.

While the regulations set the minimum amount of revaluation, pension schemes can choose to pay you a higher rate of revaluation.

Revaluation is an important factor and the scheme's booklet and their website should be consulted to ensure that the scheme's revaluation policy and their actual increases in practice are fully appreciated. If the scheme provides a generous revaluation policy this will provide you with another reason to stay in the final salary scheme.

Your final salary options at retirement

You will normally retire and receive the pension benefits from your final salary scheme at the scheme's retirement age which is typically, sixty or sixty-five.

Sometimes the pension scheme will give you the option of taking your pension benefits early and if this option is available an actuarial reduction may apply. In addition, some schemes may allow you to take you benefits early if you suffer ill health. If you take your benefits early the amount of your annual pension may be reduced. The scheme actuaries will assess your longevity and work out how long you are likely to live for and how long the scheme is likely to pay you a pension. They work out the cost of paying those benefits over a longer period of time and reduce the pension accordingly.

Alternatively, the scheme may allow you to delay taking your pensions until after the normal retirement age if you don't need the income. However, they may or may not apply an increase for taking your pension later and there may be no financial advantage in delaying. The scheme rules need to be consulted because all final salary pension schemes are different.

Whenever you choose to start taking your pension income, you have the option of receiving a one-off cash lump sum. The pension commencement lump sum is always paid to you tax free and it is commonly known as 'tax free cash'. Some final salary schemes give you tax free cash automatically and the amount of the lump sum is based on the size of your pension.

Other final salary schemes offer you tax free cash as an option, where you can choose how much you want to take subject to an overall cash amount. With this option you would exchange some of your retirement income for a larger tax-free lump sum. However, you should be aware that the more tax-free cash you take the less retirement income you will receive. The rate of exchange is known as the scheme's commutation factor which represents how much tax-free lump sum you will get for every one-pound you give up in pension income.

For example, if the scheme commutation factor is 12 and you took £12 worth of tax-free cash it will reduce your annual pension income by £1. If you took £120 of tax-free cash it would reduce your annual pension income by £12, taking £1200 of tax-free cash will cost you £120 of annual income, and so on, and this allows you to balance your need for a long-term retirement income with the need for an immediate lump sum.

Many people take the maximum lump sum that their scheme will allow because they are tempted by its tax-free status. However, if the cash is not required and it is subsequently invested for income, it might be difficult to match the income that is given up and this decision needs to be considered carefully. If you are optimistic about your longevity, then taking the maximum pension and the minimum tax-free cash may prove to be your best option. Your tax-free cash decision is a once only choice so it is important to consider it carefully and get it right because you cannot go back and change your mind at a later date.

Your pension from your final salary scheme is usually index linked so that it is not only guaranteed for life it usually increases each year. These increases are usually linked to an inflationary measure so that it will tend to keep up with inflation. At 65 you are looking ahead for another 20 or 30 years or more, and if you cast your mind back in time thirty years and consider what prices were then, to what they are now, you can see that index linking is an extremely valuable benefit.

The age at which you can take your pension benefits, the pension and lump sum options available to you, and what happens to your pension once it has started being paid to you, should all be considered carefully in any pension review.

Taxation of your final salary scheme

Whenever benefits are drawn from your final salary scheme whether you are an active or a deferred member HMRC will need to know the full details so that they can apply the correct level of taxation.

The government has set a limit on the amount that you can save in a pension fund called the 'lifetime allowance'. The limit was set £1,000,000 in 2017 and it has increased each year by inflation.

With a final salary pension the limit is tested when you first start taking your pension. HMRC multiplies the amount of your initial pension income by twenty and this amount is tested against your lifetime allowance (LTA).

For example, if you retire today, and your final salary pension provides you with an annual pension of £25,000, then it would have a lifetime allowance value of £500,000. Your tax-free cash would also be added to this amount and if this was £75,000 the total would be £575,000. This amount would be added to any other pensions that you have (not including your state pension) and the total amount tested against your allowance. In this case, if this is your only pension, then no tax would be due because your lifetime allowance is not exceeded. Your statement will show how much of your LTA has been used as a percentage of the maximum.

It is a requirement that everyone has to be tested but this tax does not affect many people because their pension funds do not exceed the LTA. If your total pension benefits do exceed the limit, there will normally be tax to pay, but only on the excess amount, and this will be calculated by the scheme who will pay the tax on your behalf and reduce the amount of pension that is paid to you.

The tax that affects almost everyone is income tax because your pension income is assessed for income tax the same as you pay tax on a salary or other income. The pension scheme will deduct the appropriate amount of tax from your pension income and send it to your HMRC on your behalf.

It surprises some to discover that their state pension is also taxable. However, the tax is not deducted from the state pension but is it is collected by making additional deductions from your final salary scheme pension. On the other hand, national insurance is not payable from pension income and currently people who are over 65 or over do not have to pay NI on any other income either.

PROCEED WITH CAUTION, TAKE TIME TO STOP AND THINK

Final salary scheme death benefits

Final salary pension schemes will normally pay death benefits to your direct dependents which would typically be your spouse or civil partner, but it may also include your children.

They have their own special terms and conditions and the death benefits will differ from scheme to scheme. One example is who is eligible to receive death benefits, if you are not married the scheme might pay death benefits to a partner only if you have been living together for a certain length of time.

The amount of cash or pension anyone receives following death normally depends on whether you die before or after you have retired and started to receive your pension.

If you die before you retire, then any eligible beneficiary would normally receive a set percentage of pension you would be due to receive. For example, if the scheme promised a fifty percent dependent's pension on death and the day you die you are entitled to a £12,000 annual pension then your spouse would receive a £6,000 annual pension for the rest of their lives. This would normally be paid from the date of death and increase each year to keep pace with inflation.

If death occurs after retirement and the pension has already started, then any eligible beneficiaries would normally receive a percentage of the pension you were receiving in a similar way as if death occurs before retirement. Some schemes may also have a guaranteed period where they pay out a guaranteed pension for a set period of time.

For example, if you retired at age sixty, and were receiving a £12,000 pension, but then died at age sixty-three, if the scheme has a five-year guarantee period, the scheme would continue to pay the £12,000 pension to any chosen beneficiary for another two years.

Sometimes there is an option on death for an amount to be paid out as a one-off cash lump sum instead of an ongoing income.

A pension paid to your dependents would be liable for income tax at their rate of tax.

Final Salary Scheme Risks

Your final salary pension scheme is a partnership between your former employer and your pension scheme trustees. Your former employer is responsible for paying the right amount of money into the pension scheme and the pension scheme's trustees are responsible for investment decisions, managing the scheme, and paying out the pension benefits to the members. The trustees calculate how much money is needed to run the scheme, and it is the responsibility of the employer to fund it.

If the investments within the pension scheme do not perform as expected or the trustees underestimate how much money they need the pension scheme could be left without enough money to provide the promised pension benefits to the members. If this happens the pension scheme will ask the employer for more money. However, there is a risk that the employer could not pay the money needed to top the pension scheme investments because they could be in financial difficulty or they may even have become insolvent.

In these circumstances, the pension scheme may have to ask for assistance from the pension protection fund or PPF. The PPF is a compensation scheme set up for final salary pension schemes that are unable to pay their members the promised pension benefits. The PPF takes over the scheme and becomes responsible for paying the pensions. While this means that your pension is protected, the PPF does not pay exactly the same benefits to you as if you remained in your own salary scheme because the benefits are usually restricted to ninety percent of what you would have normally received from your original scheme.

For example, if you are entitled to a £12,000 annual pension the PPF would only pay a pension of £10,800.

There is also a limit applied to large pensions and the PPF may not increase your pension each year in the same way that the original scheme would have done. The PPF is a great safety net in case your scheme or employer becomes insolvent, but it won't give you the same benefits as your original scheme.

The solvency of your existing scheme and your former employer are important considerations and you need to be aware of whether your scheme is in surplus or has a deficit. If it is in deficit the trustees can provide you with their plan for putting their scheme back into surplus. The funding of your scheme is likely to fluctuate over time and it needs to be monitored so that you know your position.

Transferring your final salary scheme to a personal pension

If you decide to transfer your preserved pension to a personal pension the trustees will send a 'cash equivalent transfer value' (CETV) to the new personal pension that you have chosen.

When you transfer the first decision you have to make is where to invest your funds because you are responsible for the investment decisions. You will now be in control and you can draw funds from your pension at any time from age fifty-five because there is no set retirement date.

The flexibility provides several choices: For example, it allows you to draw the tax-free cash and leave the remaining funds invested until a later date. Alternatively, you could draw a regular income at a level that you determine, or you could draw a series of lump sums at any time that you choose.

You could even draw out all of your funds in one go but this is not usually sensible because you could be taxed very heavily. After you have drawn out the 25% tax-free cash any additional withdrawals are taxed as income and if that amount exceeds the higher tax rate bands you could be taxed up to 45%.

If you wish you could leave the whole fund invested indefinitely and the whole fund would then pass on your death tax free. If this is your intention you may need to consider setting up a suitable Trust to control who it is paid to. You could choose to pass the whole fund to your spouse, your partner, your children or grandchildren, a charity, or anyone else. Unlike a final salary scheme, a personal pension puts you in control and provides more choice of where the death benefits are paid.

Your choice on the level of income that you draw is a nice choice to have but with it comes a responsibility: if you draw out too much you could deplete the fund and have no money left. You will have to monitor, adjust your withdrawals, and budget accordingly. You might live longer than you expect and not have enough money to support you in the long term.

If there is money left in your pension when you die that can pass to anyone of your choosing.

You are responsible for how your pension is invested and you will have to ensure that you are comfortable with the level of investment risk. You will have to take some risk so that the pension fund will produce growth to sustain your income however you have to be comfortable with the fact that it could even fall in value. If you do not take enough risk, it may not produce the necessary growth to sustain your chosen income withdrawal, and if this is the case you will either have to lower the amount of your income withdrawals or accept that the fund may run out at some point in the future.

Transferring out of a final salary scheme is a one-off decision because after you have transferred you cannot change your mind and transfer back. The pension scheme trustees have a duty to ensure that you have received specialist advice from a regulated pension specialist as part of your decision and they will not allow you to transfer until you confirm that you have received this advice.

There are advantages and disadvantages if you transfer out of your preserved pension. You will lose the security of a guaranteed income for life, and you will expose yourself the risk of running out of money before you die. However, you gain a great deal of flexibility in terms of when and how you take your pension and you get the option to pass on any of your remaining pension fund to your family or anyone else of your choosing when you die.

If you are considering transferring your preserved pension it is essential that you take professional advice

Regulations are in place to ensure that transfers out of final salary schemes are only ever done when it is in the member's best interest. The 'suitability' of the transfer must be comprehensively assessed and documented by a pension specialist. The trustees of your final salary scheme will advise you of these formal requirements if you request a transfer value. If your CETV is more than £30,000 the trustees cannot allow a transfer to proceed until they have written confirmation that you have received the appropriate advice.

The pension specialist must be independent and have no connection to the final salary scheme. They must have the required qualifications and they must hold the specialist authorization from the FCA.

The advisor will need to gather comprehensive information about you including your financial situation, your family circumstances, your attitudes, your preferences, and your health. This research is done in order to gain a full understanding of you and your unique circumstances.

They will obtain information from the trustees of your preserved pension which will then be analyzed and compared with the option of transferring to a personal pension. The advisor will always start from the position that you should stay in the final salary scheme and they will only ever recommend a transfer where it can be clearly demonstrated that it is in your best interest.

The adviser will then be able to provide you with a recommendation based on your personal circumstances as to whether or not you should stay in the final salary scheme or transfer out. In the majority of cases a review would result in a recommendation that you stay in the scheme because retaining a guaranteed income is in your best interest.

Even if the recommendation is for you to stay in the final salary scheme the decision is always yours and you could choose to ignore the advice and transfer anyway. However, you should always think very carefully before ignoring any advice that you receive from a professional advisor.

If the recommendation or your decision is to transfer, the trustees will need to be informed and they will require full details of your professional adviser and confirmation from them that full advice has been provided. The trustees have a duty to ensure that you have received advice and that the advisor is appropriately qualified and authorised. The trustees will also confirm that the personal pension that you are transferring to is a genuine and legal scheme They cannot transfer your money out of the pension scheme until they have completed these checks.

These regulations are in place to make sure that transfers out of final salary pension schemes are only ever done when they are most suitable, and these systems are in place to protect scheme members and help to protect them from scams.

What is the critical yield and why is it important

If you request a transfer value, the pension scheme's actuaries will calculate how much your pension is worth today as a cash value called your cash equivalent transfer value or CETV. When you became a preserved pension member the final salary scheme would have calculated the value of your pension and then they assess how much it will cost the scheme to provide you with that pension from when you retire until you die.

The trustees are providing you with two options: either remain in the scheme where they take responsibility and hope that their calculations of the cost of providing you with the pensions are correct, or you take that sum and you take over the responsibility of using that sum of money to provide you with an income.

If you transfer to a personal pension the amount of fund growth that you obtain is one of the biggest factors on whether the benefits that you obtain from the personal pension will match the benefits that you would have received if you stayed in the final salary scheme.

Your pension advisor will analyze the numbers and provide you with a personalized transfer report. The report will show how much your cash equivalent transfer value would have to grow each year on average to be worth the same amount as the pension your final salary scheme is promising to pay you at retirement. This annual growth rate is what is called the critical yield.

If you transfer out of the final salary scheme and your new pension fund grows by more than the critical yield, then you are likely to be better off by transferring, but if it grows by less than the critical yield, then you are likely to be worse off.

In order to calculate your critical yield a set of assumptions must be made including how long you are going to live and what the future rate of inflation is going to be. However, these assumptions may turn out to be wrong so that even if your new pension funds do achieve the critical yield you might still end up in a worse position than if you had stayed with the guaranteed income from your final salary scheme.

If you decide that your critical yield is unachievable, or that trying to achieve it would mean taking more risks than you are comfortable with, you would almost certainly be better off staying where you are. Even if it appears achievable, that does not necessarily mean that the transfer is in your best interest.

Critical yield is a helpful measure and an important factor in helping you understand the risks involved in the transfer, but it is still only ever a best guess and it is only one of many factors to consider in any pension transfer review.

Personal pension retirement options

Unlike a final salary scheme, a private pension has no set retirement date. When you reach the age of fifty-five you can access your pension at any time, and you control when and how much of your money you want to take.

Whenever you decide to access your pension, you have several options on how you take your benefits. You can use some or all of your pension to provide a guaranteed retirement income by buying an annuity from an annuity or an insurance company. This would pay you a guaranteed regular income for the rest of your life which would provide you with certainty in the same way that your final salary pension would.

When you buy an annuity the level of income you receive depends on your health and any options you choose. If you want your income to increase each year you would get less in the early years than if you opted for a level annuity. If you chose spouse's benefits this would also decrease the amount that the insurance company was prepared to pay. If you have health issues you may qualify for a higher annuity because the insurance company may consider that they will have to pay you the pension for a shorter period. In general, the poorer your health the higher the income you are paid, and the more options that you choose the lower the income you are paid.

You should note that the purchase of an annuity is a once only decision and usually cannot be reversed. Many people buy annuities with spouse's benefits which reduces the income provided and if their spouse dies before them the income does not increase. Effectively they have paid for insurance on which no one will claim. Annuities provide guarantees but they are usually very inflexible, for example they cannot be applied to a new spouse if you subsequently marry after starting your annuity.

As an alternative to buying an annuity you could use some or all of your pension to provide a flexible retirement income. Your personal pension must be a flexi-access drawdown pension in order to benefit from this option and you may like to ensure that your personal pension is of this type when you transfer to avoid having to transfer again in the future. Your pension fund remains invested and you draw an income from your pension fund as and when you need it. This means that your income can be stopped, started increased, reduced, or changed, as you wish.

While flexi-access drawdown provides you with flexibility, it carries risks because the income you withdraw is not guaranteed, and your pension remains invested, so it is subject to the fluctuations of your underlying investments. You can take a cash lump sum, or series of lump sums, directly from your pension whenever you need them, or you could even take the whole of the pension in one go (subject to taxation) as a single lump sum. You do not have to choose just one option and you can mix different options. For example, you could buy an annuity with part of your pension fund which would provide you with a guaranteed income and leave the rest invested. The flexibility allows you to make changes over time depending on your circumstances and your preferences.

In my case study below there is an example of a client who takes her cash lump sum to pay off her mortgage and leaves the rest of her pension fund invested. When she retires, she can decide to purchase an annuity or she can access income via drawdown, the choice is always hers to decide at a later date.

If you decide you do not need your personal pension and you do not want to draw the benefits, you can leave some or all of your pension invested and leave it to your family or any beneficiary of your choice when you die.

Taxation of your personal pension

One of the advantages of a personal pension is that all growth within the fund is allowed to grow tax free however when you withdraw money from your personal pension fund the HMRC becomes involved.

The HMRC looks at the total value of your pension benefits because the government has set a limit on the amount of tax-free benefits that you can take out of a pension which is called the life time allowance. The limit was set at £1,000,000 in 2017 and it has increased each year with inflation. Although everyone has to be tested, most people do not have to worry about a tax for exceeding the limit of over one million pounds.

The test is done every time you take any money out of your pension. For example, if you retired and you drew out £100,000 to buy a retirement income, this amount would be tested against your lifetime allowance. In this case no tax would be due, but you would have used up some of your tax-free limit (just under 10%). However, if your pension benefits exceed the LTA there would be tax to pay on the excess which would be deducted from your pension benefits before you receive them.

The tax that affects almost everyone is income tax because your pension income is assessed for income tax in the same way as any other earned income. The pension company will receive your notice of coding from HMRC and they will send the appropriate amount of tax to HMRC on your behalf.

As mentioned earlier you do not have to take all or indeed any of your pension if you don't want to and you might want to leave some, or all of it, untouched and pass it on to your family or other beneficiary when you die. However, the HMRC will do a final lifetime allowance test on your seventy-fifth birthday on any money you have left in your pension fund and tax could apply at that stage.

Personal pension death benefits

One of the benefits of having a private pension is that when you die whatever is in your pension fund can be passed on to your beneficiaries. These might be those dependent on you such as your spouse, partner, or children but you can also leave your pension fund to anyone or any organization of your choice. A personal pension provides you with full choice and flexibility so that you can leave all of your pension to one person or organization or share it amongst several.

Whoever receives your pension they will have a choice of taking the pension fund as a cash lump sum, buying a guaranteed income by purchasing an annuity, or transferring it to a new pension fund in their own name. They can then take an income as and when they want it, or they can leave it untouched and pass it on to someone else when they themselves die. This enables your pension fund to pass down through the generations. Your beneficiaries can choose a combination of these options and they can choose whichever option best suits their circumstances at the time of your death.

Taxation on your death follow similar rules to those mentioned above. First HMRC considers the LTA in the same way that it applies to you when you are alive.

If you die before the age of seventy-five, and any lump sum or income your beneficiaries take from the pension fund is normally tax free irrespective of the age of beneficiary. However, if you die after the age of seventy-five then tax is potentially due on any lump sum or income your beneficiaries take and any money they receive is added to their income in the tax year of receipt and is taxed as earned income.

Personal Pension Risks

When you decide to transfer your benefits out of your defined benefits scheme into a personal pension you become responsible for the management of your pension and all the risks and responsibility pass from the final salary scheme to you. You have to make all of the decisions regarding how the fund is invested and when and how you are going to access your funds. You are likely to require ongoing professional advice which you will need to pay for.

Holding your transferred pension in cash is generally not a good idea and you will need to decide which funds to invest in. If you are not an experienced investor and you are not comfortable with choosing and managing your own investments, you will normally engage a professional investment adviser to help. They will assess your circumstances together with your attitude and your capacity for risk and recommend an appropriate investment portfolio which they will usually monitor on a regular basis. This investment recommendation is normally done at the same time and in coordination with your request to transfer.

You must feel secure with the overall level of risk taken and appreciate that you may have to sacrifice the potential of higher growth in order to achieve a level of volatility and risk that you are comfortable with.

If your pension funds do not grow as much as you anticipated your fund may not be sufficient to provide you with the income you want or that you could have had if you had stayed in the final salary scheme.

Therefore, it is vital to choose the right investment funds with the right level of investment risk and also to regularly review the investments to ensure that they are on track to meet your retirement needs.

When you retire instead of your final salary scheme paying you a guaranteed pension for the rest of your life, you will have to decide how you want to use your pension to provide you with an income.

You will either have to buy an annuity to buy a guaranteed income or you can choose to keep your pension funds invested and take a regular or flexible income directly from your investment funds.

You should be aware that annuity rates vary over time and the annuity rate that is available when you transfer to a personal pension may not be available when you decide to buy an annuity. If annuity rates have fallen from your expectations the fund may not buy sufficient income to match your requirements. Worse still if your investments have not increased as much as expected and annuity rates have fallen as well you could suffer a double hit to your income expectations.

If you decide to start taking an income directly from your personal pension you will need to carefully consider how much money to take out each year. The more you take out the less money is left to take as income in the future and taking higher levels of income will erode the value of your pension funds faster. Ideally you would draw out a lower level of income so that the pension fund increases or at least maintains its value however this depends on your circumstances and preferences. After all, one of the reasons to transfer was to provide you with flexibility and put you in control.

If you draw out too much from your personal pension, and at the same time your investments fail to perform as well as you had assumed or even fall this might lead to you running out of money altogether and having to rely on other assets or income from other sources to meet your retirement needs.

If you stay in your final salary scheme there is no risk that your retirement income would run out and all of the investments and income decisions are made for you by the scheme's trustees. If you transfer out, you may end up with less retirement income than if you had stayed in the final salary scheme so you need to carefully consider the risks of transferring your preserved pension to a personal pension.

How to avoid becoming a scam victim

Victims of pension scams in 2018 lost an average of £91,000 each to fraudsters. They reported receiving cold-calls, offers of free pension reviews and promises that they would get high rates of return – all of which are key warning signs of scams.

The FCA has reported that their research has showed that many pension holders believed they were too savvy to be scammed, but they were still caught because pension scams are often very sophisticated and difficult to spot. Scammers will target people from all walks of life and with any size pension. The best way to protect yourself is to always check the FCA register to make sure that anyone offering you pension advice, or any other financial service is authorised by the FCA.

In 2018 The FCA launched ScamSmart to help people avoid investment and pension scams. Check any offer that you have received or heard about before you take any action.

Research by the Money Advice Service suggests that there could be as many as 8 scam calls every second – the equivalent of 250 million calls per year.

In an attempt to stop the scammers a pensions cold-calling ban came into effect on the 9th January 2019. If you receive a cold call about your pension, get any information you can, such as the company name or phone number, and report it to the Information Commissioner's Office via their website or call then on 0303 123 1113.

If you think that you may have become a victim of a scammer you should phone your existing pension company immediately because they be able to stop the transfer. Then you should report immediately to ActionFraud either online or by phoning 0300 123 2040

You might receive a phone call, an email, text, or perhaps a glossy brochure in the post, that suggests that you go to their website to obtain details of how to claim a free review of your pension. The scammers are well rehearsed and appear to be very professional. I have heard of many cases where they offer a fast approaching deadline and they will even send around courier to collect your signed paperwork, in one case we heard of a courier completing a round trip of 200 miles just to collect the signatures. People would not allow someone to do this with the sale of their house so why do they allow strangers to walk off with their pension funds – perhaps because they can't visualize it in the same way.

You should always take your time when making financial investment decisions and never do anything in a hurry and without taking appropriate professional advice. Remember that if an offer sounds too good to be true, it almost certainly is.

VICTIMS OF PENSION SCAMS IN 2018 LOST AN AVERAGE OF £91,000 EACH TO FRAUDSTERS.

A defined benefit pension review for a client who decides to stay in the scheme

Brian is fifty and he is married to Ann and they have two children in their early teens. For the last ten years Brian has worked for ABC & Co and he enjoys his job and he intends to work for them until he is sixty-five. They have a reasonable amount of savings which they have invested cautiously because they do not like taking risks. They are both in good health.

Brian has not thought about retiring except that he expects to retire at about sixty-five. When Brian was in his thirties, he worked for XYZ & Co and he was a member of their final salary pension scheme. His latest pension statement says he has a preserved pension of £12,000 per year which will be paid to him when he reaches the scheme's normal retirement age of sixty-five.

Brian is reviewing his pension and he has obtained a transfer value of £300,000 from XYZ & Co pension scheme administration department. He researched a pension specialist who was both qualified and authorised to provide advice on transfers of final salary pensions and he asked them to conduct a pension review and he agreed their fee. The following month he received a report and discussed his options with his pension specialist.

The report was lengthy and analyzed his situation and the pension in some detail and considered his options.

It considered: Brian's personal and financial circumstances, his attitude to risk, his current state of health, his life expectancy, his family and dependents, his savings and other assets, when he wants to retire, and any requirement that he might have for financial flexibility before and after retirement.

The report considered that the benefits of his final salary scheme are guaranteed; the level of inflation proofing provided both before and after retirement; and the amount of income and tax-free cash being offered by the scheme compared to what would be potentially available from a private pension. The differences in taxation between the schemes. The benefits payable to his family on his death if he remains in the final salary scheme, compared to those from a private pension. The risks involved in investing in a personal pension. The critical yield was specified and explained, as were the assumptions used in the analysis. The financial health of the final salary scheme and his former employer were also considered and discussed.

After consideration of the pension advice, Brian decided that staying in his final salary scheme was his best option. He does not like taking risks and he likes the security of a guaranteed retirement income at age sixty-five which will then be paid to him for the rest of his life. He also likes the fact that the pension will be index linked

Brian did not like the idea that his personal pension would be invested where its value could rise or fall, because he perceives that to be a risk. He also gets peace of mind knowing that Ann would receive a guaranteed dependent's pension when he dies.

Brian is expecting to live to an old age and to require his pension for a very long time. He does not intend to retire before sixty-five so does not require the flexibility of retiring early. He was grateful for an explanation about the PPF though he believes that it is unlikely to be required because his scheme is in surplus and his former employer is financially strong. In addition, he does not want to worry about regular reviews of his personal pension's investment performance.

He is pleased to understand the differences between final salary schemes and personal pensions, but he does not consider the flexibility of the latter to be an important factor

He was grateful for the advice and very glad that he obtained a detailed report from a pension specialist so that he could understand his options. He believes that the fee was money well spent to provide him with the confidence that remaining in his preserved pension is the correct option for him. He is also aware that should his attitudes or circumstances change he could review it again and consider a transfer in the future.

A defined benefit pension review for a client who decides to transfer to a personal pension

Barbara is fifty-five and has two grown up children. She is single, having divorced several years ago. Barbara owns her own home and has an interest only mortgage which is now due for repayment. She has a small amount of savings but not enough to repay her mortgage. Barbara is in reasonable health and is comfortable taking a moderate amount of risk with her savings and investments.

Barbara has a good job, enjoys working and currently has no set retirement plans. Up until five years ago, Barbara used to work for Jones & Co, and she was a member of their final salary pension scheme.

Her latest pension statement says she has a preserved pension of £12,000 a year which will be paid to her when she reaches the scheme's normal retirement age of sixty-five in ten years' time. Barbara has been reading about the recent pension changes and she would like to review her preserved pension. She is attracted to the idea of receiving a cash lump sum to repay her mortgage and she would like to advice to see if transferring her preserved pension to a private pension can help her. Barbara asked the Jones & Co. pension scheme administration department if she has the option to transfer her preserved pension out of the final salary scheme and they have sent her a formal letter offering her a £300,000 transfer value.

She researched a pension specialist who was both qualified and authorised to provide advice on transfers of final salary pensions and she asked them to conduct a pension review and agreed their fee. The following month she received a report and discussed her options with her pension specialist.

The advisor conducted a full review to see whether it would be in Barbara's best interest to leave her preserved pension in the final salary scheme or transfer it to a private pension in Barbara's own name. The report was lengthy and analyzed her situation and the pension in some detail and considered her options.

It considered: Barbara's personal and financial circumstances, her attitude to risk, her current state of health, her life expectancy, her family circumstances, her mortgage debt was considered as well as her savings and other investments, when she wants to retire, and any requirement that she might have for financial flexibility before and after retirement.

The report considered that the benefits of her final salary scheme are guaranteed; the level of inflation proofing provided both before and after retirement; and the amount of income and tax-free cash being offered by the scheme compared to what would be potentially available from a private pension. The differences in taxation between the schemes. The benefits payable on her death if she remains in the final salary scheme, compared to those from a private pension. The scheme's normal retirement age, and early retirement options were also considered. The risks involved in investing in a personal pension. The critical yield was specified and explained, as were the assumptions used in the analysis. The financial health of the final salary scheme and her former employer were also considered and discussed.

After receiving advice from the pension specialist Barbara decided to transfer her preserved pension to a private pension in her own name. She will be able to take a lump sum from her new pension and pay off her mortgage. She does not need to take any income at this time because she is still working, and she can leave the rest of her pension invested until she decides to retire. She intends to make contributions to build up her new pension by utilizing the payments that she would have otherwise been paying in her monthly mortgage payments.

Barbara understands that the final salary scheme would have provided her with a guaranteed income at retirement. However, she needs the flexibility to access her pension benefits now and take a one-off lump sum to re-pay her mortgage. This option is not available with her final salary scheme.

Having transferred and taken a lump sum out of her pension, she knows she must ensure her retirement plans are monitored to remain on track. She knows that when she does decide to retire, the amount of her income will no longer be guaranteed and will be dependent on how well her pension funds grow in the meantime. When she retires, she will have to decide how to generate a retirement income either by purchasing an annuity or by taking income directly from her pension. She appreciates that this can be complex, and that she will need ongoing professional advice. She understands that her future retirement income will not automatically be inflation proofed and understands that she is giving up this benefit. Also, any lump sum or income she takes from her pension will erode its value and she is aware that if her pension funds perform badly, she could receive less than projected.

Barbara understands the difference between what will happen if she dies while still in the final salary scheme and if she died after having transferred to a private pension. She much prefers the fact that she can leave her pension directly to her two adult children and she understands that they can decide how they wish to receive any money left when she dies. Barbara understands that transferring out of the final salary scheme carries risks and the process is complex, however she is comfortable with the level of risk involved and she understands she will need to monitor the money in her pension funds carefully and carry out regular reviews. She understands that transferring her pension is a one-off decision and it cannot be changed.

Overall while Barbara knows that the final salary scheme provides her with certainty, she prefers having a private pension in her own name that can give her more flexibility and choice and allow her to pay off her mortgage.

With the help of her advisor, Barbara weighed up all the advantages and disadvantages of each option and decided that transferring out of the final salary scheme was the most suitable option for her.

THIS MAY BE ONE OF THE BIGGEST FINANCIAL DECISIONS THAT YOU WILL EVER MAKE, AND IT MAY AFFECT YOUR FINANCIAL WELL-BEING FOR THE REST OF YOUR LIFE...

Important: statement of limitation

This guide has been prepared to help you to understand how your final salary pension works and how to compare your final salary benefits with those that are available from a personal pension. It has been designed to be as jargon free as possible, but this area is complex, and you should not make a decision based on the content of this guide alone. The case studies have been prepared for illustration and to help you show the options available and that the decision to transfer or not depends on individual circumstance and individual preferences.

The guide has the aim of providing you with independent and impartial information which mentions the advantages and disadvantages of your different pension options. We believe that the more information that you have the better is the decision that you are likely to make, however, this guide should be regarded as a supplement, and not a replacement, for you obtaining good independent financial advice

SEEK PROFESSIONAL INDEPENDENT ADVICE BEFORE YOU MAKE YOUR DECISION

History, structure, and expertise

Interface Financial Planning started providing independent financial advice in 1992. From the beginning it had the aim of providing professional advice and quality service to people with modest income and wealth.

Its key value was putting people before profit, and contribution before reward. This mission statement has been our torch to light the path ahead and has been the reason that we have endured for over 24 years.

Alan has lead the company with his personal values of: Integrity, Compassion, Respect, & Loyalty, and he is proud that over the years he has worked with clients who share similar values. Like him they want to help others and make the world a little better.

Client care and service is important and he is proud that his first two clients from January 1990 remain his clients today.

We believe that every client should have access to highly qualified advice and expertise.

Technology is used to the full to maximise efficiency and engage expertise from throughout the UK. The business has been paperless for 10 years and for over 5 years has been 'cloud' based. This structure reduces costs and allows support staff to operate anywhere - from Colchester to Honiton to Leicester and elsewhere.

Clients are encouraged to access their online account where they can exchange messages and documents securely. They can view their investments and reports, and they have immediate access to their paper file. Clients love the transparency and openness of being able to view and print paperwork going back for years and many clients use it as a source of reference.

Owner, Director
Interface Financial Planning

Alan Moran is one of the most highly qualified advisers in the UK. He became a Certified Financial Planner in 1995 and he was one of the first Chartered Financial Planners in 2005.

He is a Chartered FCSI, a holder of the IMC certificate and member of CFA UK. His expertise has been called upon by The CII, The IFP, The Kinder Institute, and others, where he has trained and examined other financial advisers.

Alan Moran B.Sc. M.Soc.Sc. Cert.Ed. FPFS FSWW IMC CFP^{CM} RLP®
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Compliance

Readers should not rely on, or take any action or steps, based on anything written in this guide without first taking appropriate advice. Interface Financial Planning Ltd cannot be held responsible for any decisions based on the wording in this guide where such advice has not been sought or taken.

The information contained in this guide is based on legislation as of the date of preparation and this may be subject to change.

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(https://register.fca.org.uk) Financial Services Register No: 424729 Registered Address: 122 Hamstead Hall Road, Handsworth Wood, Birmingham, B20 1JB Registered in UK, No. 2644317

Design by: Rae Shirley Photography & Design
Ref:DBS FIG V1 FEB 2019

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