Exploring Group

Pensions

Issue 6

By Mattioli Woods

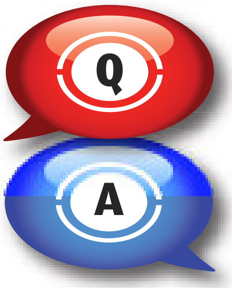
Exploring Group Pensions is designed and written for those who have an active role in the administration, management and auditing of group pension arrangements

In this issue:

Transfer exercises – the member perspective

Alice in Pensions Land

How safe is my pension?



Transfer Exercises
The Member Perspective

In previous articles we have looked at gradual wind-down strategies for final salary schemes and how a properly arranged transfer exercise can play a significant role. Such articles have been written from the employer's perspective, where reducing liabilities in the short-to-medium term has become a priority. In this article we explore such exercises from the member's perspective, and in particular investigate those scenarios where taking the transfer could prove advantageous (for both the member and their dependants).

Death benefits

Where a deferred member dies before drawing benefits, even if he or she is still working for the same company, then the benefits from the final salary scheme are likely to be quite modest. Specifically, the scheme itself may only provide for a return of the member's own contributions (with or without interest), along with a 50% spouse's pension in respect of the GMP entitlement only (which is typically very small). In contrast, where funds are transferred to an individual plan, then the full fund can normally be paid as a tax-free lump sum directly to beneficiaries and outside the estate for IHT purposes.

The authors, Mattioli Woods, specialise in this area of pensions consultancy, providing a trouble-shooting service for clients and advisers throughout the UK.

Mattioli Woods

Pension Consultants

Pension benefits

The benefit basis under most final salary schemes provides for a 50% spouse's pension (following the member's death in retirement) and escalation in payment – typically around 3% per annum. However, everyone's circumstances are different, and in this regard personal/family control of the underlying funds at retirement will enable a personalised approach. For example, a female aged 60 entitled to a final salary pension of £10,000 (with the above attributes) may prefer to use the underlying funds of say £225,000 (est.) to purchase a single life, level annuity of £14,715. This choice might be made due to the member's husband (if applicable) having sufficient pension benefits in his own right combined with the fact that it would take the lower, increasing pension of £10,000 (from the final salary scheme) some 13 years to catch up with the higher, level pension of £14,715 (assuming increases of 3% per annum).

The above assumes the securing of pension via an annuity, but perhaps those that stand the most to benefit from transferring are those longer-serving, senior staff with reasonable entitlements where the drawdown option is appropriate (taking into account overall finances). Below is a summary of two real life transfers which took place during 2007. Both individuals transferred from a final salary scheme (based on a 110% transfer value) to self-invested personal pensions.

A key point in respect of the examples below is that because the funds remain under member/family control, then on death the level of dependant's pension is likely to be significantly higher in comparison to the final salary scheme. Specifically, the maximum spouse's pension could be very close to (or even exceed) the amount of pension being drawn by the member. It is also the case that where funds had been transferred to a drawdown scheme, then upon death of the spouse, part of the remaining funds could be inherited by grown-up/non-dependant children (not an option where pension is being drawn from the final salary scheme).

Additional to the above is the added flexibility afforded in terms of drawing part or all of the tax-free cash entitlement early (must be over age 50) and varying the level of pension (via a drawdown arrangement) perhaps in order to complement a partial retirement strategy.

Solvency

Solvency of the sponsoring employer is one of the most important factors to be taken into account when considering a transfer from a final salary scheme. A number of high profile collapses have served to highlight the importance of this issue and have resulted in the setting up of the Pensions Protection Fund (PPF). The problem now is that the level of protection afforded by the PPF is only really understood by actuaries and not by the people the fund was set up to protect, i.e. the scheme members. Whilst the headline level of cover is 90% of deferred pensions, up to around £27,000 per annum, inflation protection is only provided in respect of the pension earned after 6 April 1997, and even then it is capped at 2.5% (rises are in line with inflation capped at 2.5% per annum).

For a typical final salary scheme with an accrual rate of 1/60th, 50% spouse's cover and pension increases at 3% per annum, we are reliably informed (by an actuary!) that the amount of cover provided by the PPF equates to a reduced transfer value of around 70% or lower.

Sample 1

Male aged 58, senior manager

Preserved final salary pension £23,414
Projected final salary pension at NRD £26,489

Reduced transfer value £362,717
Enhanced transfer value £409,757

Estimated max drawdown at NRD assuming nil growth on transfer £32,997
Estimated max drawdown at NRD assuming 5% per annum on transfer £42,114

Sample 2

Male aged 59, senior manager

Preserved final salary pension £36,947
Projected final salary pension at NRD £40,782

Reduced transfer value £560,415
Enhanced transfer value £645,601

Estimated max drawdown at NRD assuming nil growth on transfer £52,681
Estimated max drawdown at NRD assuming 5% per annum on transfer £64,034

Summary and conclusion

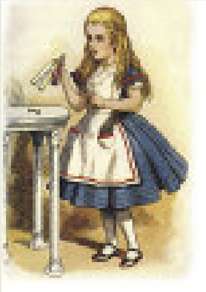
The above gives some idea as to why the transfer option is important and can provide a number of advantages to those members with the right set of circumstances. In this respect it is certainly not the case that this sort of planning should be avoided by those paternalistic employers who are fearful that such exercises will only leave their employees worse off. Indeed, with the potential benefits as highlighted, it is possible to provide members with a very positive message in terms of the additional flexibility a transfer may provide (much of which has arisen from, or has been improved by, the pensions simplification legislation).

The transfer option is important and can provide a number of advantages to those members with the right set of circumstances.

Mattioli Woods is one of the UK's leading and fastest growing consultancies in its area of expertise, the provision of pension and wealth management services for controlling directors, professional persons, owner-managed businesses and small to medium-sized PLCs. In particular, the practice has specialised in the application and provision of small self-administered pension schemes (SSAS) and self-invested personal pensions (SIPP), and Group Schemes.

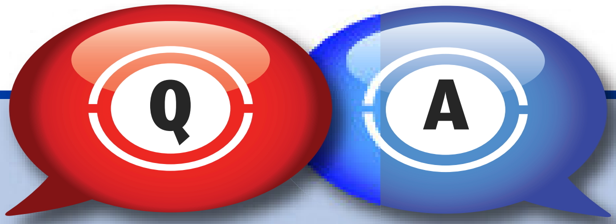
Alice in Pensions Land

Does art imitate life, or does life imitate art?
In 'Alice in Wonderland' Alice is subjected to a quite nonsensical world where things were not quite what they seemed, with the main character falling down a rabbit hole into a world far removed from our own where the rules of logic and common-sense do not apply.



Are the 'ins and outs' of our pensions legislation very much like the trial in the book where the King of Hearts turns to the jury and declares that they must consider their verdict before even a word of evidence has been presented, and where the Queen of Hearts had only one way of settling all difficulties, great or small, she said "off with his head"? How many more 'Mad Hatter's tea parties' do we need to go through before we actually stand up, as Alice put it herself, and declare that "it's the most stupid tea party I ever was at in all of my life"?

We are reminded of 'Alice in Wonderland' following our recent Cabinet reshuffle when Mike O'Brien, the Secretary of the State of Pension Reforms, was replaced by Rosie Winterton. Mike O'Brien had been the Minister of State for Pensions Reform since June 2007 and had been overseeing UK pensions reform as part of the Pensions Bill. The Cabinet reshuffle also saw Paul Myners resign as Chairman of the Personal Account Delivery Authority. Rosie Winterton is the 16th MP to have held a pensions brief since the Labour party came into power in 1997. And so we go back to the Mad Hatter's tea party where guests are required to keep moving around the table in order to find the first seat with an available clean cup – all change!



BACK TO BASICS

Sometimes we find that we concentrate on the more technical, complicated aspects of pensions legislation and how it affects clients now and in the future. However, sometimes the simplest questions are still as important to answer.

As an organisation we often get asked questions about the more basic aspects of pensions legislation and often, having spent much time discussing the complicated, we have to stop and think about the basic questions.

QUESTION
How safe is my pension?

ANSWER
This is quite a general question we have elected to focus on in this edition of Exploring Group Pensions, and something many clients have asked, albeit in different ways and in respect of different pension policies. As such, the answer itself is quite general.

The question as to how safe our savings are has been the topic of many news articles, and this has been covered by many people, but what about your pension?

Well, if you work in the public sector, your pension is backed by the government, so the poor taxpayer will ultimately end up footing the bill. Most public sector schemes are pay-as-you-go arrangements (though there are exceptions) and today's pension is funded by today's contributions.

But what if you are not lucky enough to be in a public sector arrangement? In previous articles we have focused on how the funding of a private sector final salary scheme works and that the scheme is as safe as the employer's ability to fund contributions and/or a deficit. The Pension Protection Fund (PPF) does offer some protection, but higher earners with long service will see their pensions entitlement reduced if the scheme goes into the PPF.

But what of money purchase schemes, either as a company basis or for the individual with a personal pension or a SIPP? The UK equity market, into which the majority of pensions funds are heavily exposed to, is down by approximately 32% over the last 12 months.

If you are in your 20s you have time to 'ride the storm'. Pensions are a long-term investment strategy. Regular contributions into pension schemes will benefit from pound cost averaging. However, what if you are approaching retirement?

Those pension schemes which have elected for more diversified investment strategies, looking at investments that cover all sectors, cash, fixed-interest, commercial property and equities, are faring better in this market. Schemes where the default investment strategies are the traditional 'managed' fund, and life styling options have meant that older scheme members have been more protected from the recent market turmoils.

With faith in our banks being questioned, thoughts turn to 'how safe is my pension provider?'

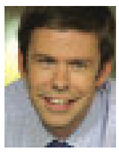
For those in a company money purchase arrangement, the pension scheme assets are held separately from the company assets. They belong to the member not the company and in the event of a company failing, then the pension benefits are not affected.

But what if the insurance company that holds your fund failed (and similarly if within a SIPP you had part of your investments held within an insurance company policy)?

In this case the benefits are protected by the Financial Services Compensation Scheme, which will protect the first £2,000 and 90% of the remainder. This also covers annuities for members who have already retired.

So how safe is my pension? How long is a piece of string? What is important, and what we have tried to instil in our readers, is that an understanding of how your pension works and where your pension is invested is vital, and with knowledge and understanding we will be able to weather this storm.

This newsletter was written by Karena Woodall and Martin Scarrott



Mattioli Woods
Pension Consultants

Issue 6 was produced in December 2008

Mattioli Woods plc, MW House, 1 Penman Way, Grove Park, Enderby, Leicester LE19 1SY. Tel: 0116 240 8700 Fax: 0116 240 8701