Summary
- Currently any DB member can implement a cash equivalent transfer value to move into a DC scheme.
- The number of transfers is expected to increase as DB members wish to access the freedoms granted to DC scheme members in the Budget.
- This has led to a concern that a decline in DB scheme assets may impact on the wider economy, due to DB schemes being long-term investors in UK government bonds and corporate bonds.
- The industry expects a slow, steady stream of transfers instead of a mass exodus.
- The number of ETV exercises is expected to increase as a result of the changes.
- Concerns about the economic impact appears unfounded, according to industry observers, as insurers and annuity providers would still seek long-term investments.

The great escape

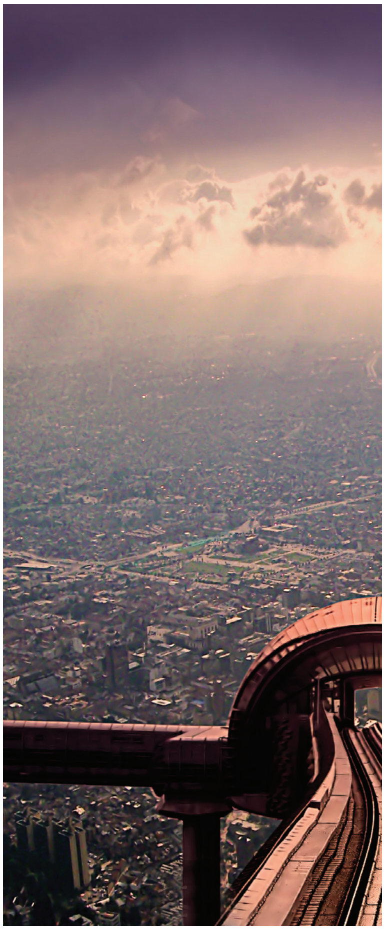
As the government consults on whether DB members should be allowed to continue to transfer into DC schemes in order to access the greater freedoms granted by the Budget, David Adams examines the potential impact the transfers would have on schemes, the industry and the wider economy

It was the highlight of George Osborne's Budget, a statement of his belief in the individual's right to control their own finances. Members of defined contribution (DC) pension schemes would now be given "complete freedom to draw down as much or as little of their pension pot as they want, anytime they want," he said. But these lines had been preceded by an important caveat: "There will be ... implications for defined benefit [DB] pensions upon which we will consult and proceed cautiously". Some people could end up with more freedom than others, it seemed.

Freedom and choice

At present, any DB scheme member has the right to a cash equivalent transfer value (CETV), which would allow them to transfer their DB pension rights into a DC pension pot. Until now, few have exercised this right. But with an end to the restrictions that effectively forced many DC scheme members into poor value annuities that could be changing. Some individuals would find the idea of transferring to a DC scheme to access their money in a more flexible way very attractive, such as those in poor health, or those trapped in failing DB schemes.

The Treasury's consultation paper, *Freedom and choice in pensions*, was published on 19 March and closed to feedback on 11 June. The primary reason for government caution, it stated,



was that large scale transfers from private DB to DC schemes could have a detrimental impact on the wider economy, because funded DB schemes play such an important role in long term investment in UK government bonds, corporate bonds and infrastructure.

The consultation asked respondents for their views on options including a removal of the right to transfer from private DB schemes to DC schemes; and the imposition of conditions such as capping annual transfer amounts or requiring trustee approval. It also sought views on transfers from public sector DB schemes. At the time of writing, the Treasury is assessing the feedback received, with further announcements expected in late July.

CETV enquiries seem to have increased since the Budget. In April Barnett Waddingham revealed a 60 per cent jump in the number of CETV quote requests in the three weeks following Osborne's announcement compared to the same period a year earlier. The firm has seen CETV quote requests being submitted at double the rate seen in 2013 during the two months up to June, according to Barnett Waddingham partner Simon Taylor, an increase due in large part to people acting in fear that the option could soon be closed, he suggests.

But many in the industry are confident that the government will allow DB to DC transfers to continue for private sector schemes. The Association of Consulting Actuaries chairman David Fairs says a ban on transfers would run against the principle of increasing flexibility, create significant problems for hybrid schemes and complicate the government's plans to support more defined ambition (DA) and collective DC (CDC) arrangements. He wonders whether developing a code of good practice similar to that used for enhanced transfer value (ETV) transactions could help.

"The primary reason for government caution was that large scale transfers from private DB to DC schemes could have a detrimental impact on the wider economy, because funded DB schemes play such an important role in long term investment in UK government bonds, corporate bonds and infrastructure"

Slow and steady

Aon Hewitt principal consultant Ben Roe believes that if transfers continue to be allowed there will be a steady, not dramatic, increase of transfers at retirement. "If there isn't a risk that transfers are going to be banned then we don't see a big rush of people wanting to transfer early," he says. "People will make the decision as they approach retirement."

Pension Administration Standards Association director Fergus Clarke also dismisses the idea of a mass exodus from DB schemes. "Our experience is that the proportion of those making the initial enquiry who actually go on to transact is small," he says. "Unless the employer is putting in strong ETV terms to make transfers more attractive there's no catalyst to change the level of transfers seen over the last few years."

As for those in the public sector seeking a transfer, the Treasury's consultation document quotes government estimates of a net cost for just 1 per cent of public sector workers transferring to DC schemes at £200 million, cost to be borne by the taxpayer and through higher contributions from remaining scheme members. It proposes removing the right to transfer, not just for unfunded but also for funded public sector schemes, "in the interest of fairness to members and consistency across schemes" (not an argument that will satisfy everyone).

"Transfers from unfunded

public sector DB schemes will almost certainly not be allowed," says Towers Watson senior consultant Fiona Matthews. "Money needed to pay the transfer value would count towards government borrowing, even though it would be used to extinguish a liability that might otherwise cost taxpayers more over the long term."

Spence & Partners head of corporate advisory services Alan Collins believes transfers from funded public sector schemes will continue to be permitted – in part simply because there will not be many of them.

But any increase in transfers in private sector schemes will mean employers and trustees will need to rethink the basis of CETV calculations, funding and accounting assumptions and investment strategies. "They're going to need to make sure that they've got enough liquidity to pay those transfer values," says Mercer partner in the financial strategy group, Matthew Demwell. "And as more funds get paid out it will change the balance of liabilities in schemes, so they will need to keep investment and hedging strategies under review."

ETVs

Will these changes also lead to more use of ETV exercises? "ETVs have had a bit of a bad name in the past, but the code of practice has given employers more confidence that they've done the right thing," says Demwell. "If trustees are prepared to pay out a higher transfer value there's less of an enhancement needed from the employer – which means they can offer more enhancements to more people."

Taylor also sees a positive future for ETVs. "I think employers will

be talking to trustees about these exercises, maybe running bulk exercises for members who are over 55," he says. "I think we'll see more focused exercises, encouraging people who represent higher liabilities to transfer out."

Economic impact

Meanwhile, industry observers seem bemused by the argument that more transfers would lead to negative economic consequences, because insurers and annuities providers would still be seeking long term investments. "Our experience is that there is far more demand for gilts and bonds than there is supply," says Matthews. "It could be several decades before demand reduces to the level of supply. There's also a positive economic impact, in that if people take their pensions as a lump sum tax revenues increase and so does [consumer] spending." It is also worth noting the view expressed recently by her colleague, Towers Watson senior consultant Paul Fishleigh, that increased numbers of transfers could increase demand for bonds as schemes shed liabilities and adjust investment strategies towards lower risk assets.

Matthews does see a need for further regulatory change; for the FCA to adapt its rules around provision of guidance and advice for individuals considering transfer offers, particularly in cases where the individual in question only has a small pension pot or does not want an annuity. At present FCA rules state that anyone transferring out of a DB scheme prior to retirement must undergo a green light test with an IFA to ensure they do not end up worse off in the longer term than if they had purchased an annuity at retirement. But if the transfer is going to happen at the point of retirement this is an unnecessary expense.

The industry's collective verdict appears to be that if the government does permit DB to DC transfers to continue, even a significant increase in transfer volumes is unlikely to have troubling economic consequences. A much more important priority would be to ensure that communications to scheme members are fit for purpose, says Taylor. "There's evidence that high earning, financially sophisticated members are already treating their DB scheme as an underwritten savings scheme, then using drawdown after transferring out. The challenge will be to make sure that the less financially sophisticated people understand what they're doing when they make these decisions."

Written by David Adams, a freelance journalist