BARNETT WADDINGHAM

beyond the expected

DB to DC transfers

The current landscape

Transfers from defined benefit (DB) schemes are a hot topic at the moment with huge amounts of money being transferred out of schemes over the last few years and much regulatory focus, press coverage and commentary.

It is vital that members make informed decisions that lead to good outcomes from transferring and giving up an income for life in exchange for flexible access to their benefits.

This is the first in a series of articles in which we will look at the DB transfer landscape, putting in place support for members, improving the member experience, and the make-up of a 21st century defined contribution (DC) decumulation vehicle to receive DB transfers.

Background

Non-pensioner members of DB pension schemes have long had the right to transfer the value of their benefits to another approved arrangement. When DB schemes were open to new entrants, it was relatively common for members to transfer from their previous employer's scheme to their new employer's scheme when they changed jobs.

As DB schemes increasingly closed to accrual, and then to new entrants, this option became less frequent and transfers tailed off.

In the mid-2000s, as scheme sponsors became increasingly aware of the risks in their schemes, a new phenomenon came into play – the enhanced transfer value, with the enhancement, usually paid in cash, designed to incentivise the member to transfer from their DB scheme to a DC arrangement. Some scheme sponsors began to run large scale exercises for their deferred member populations, especially those who could access their benefits immediately (members aged 50 and over until 2010 and, after then, members aged 55 and over).

The cash enhancement option was effectively removed with the publication of the Code of Good Practice for Incentive Exercises in 2012 (and revised in 2016)[1] following reservations about the cash incentive having undue influence on members' decisions.

The Code has set out an industry agreed structure for designing, communicating and implementing transfer exercises and has had an extremely positive impact on the market.

A perfect storm

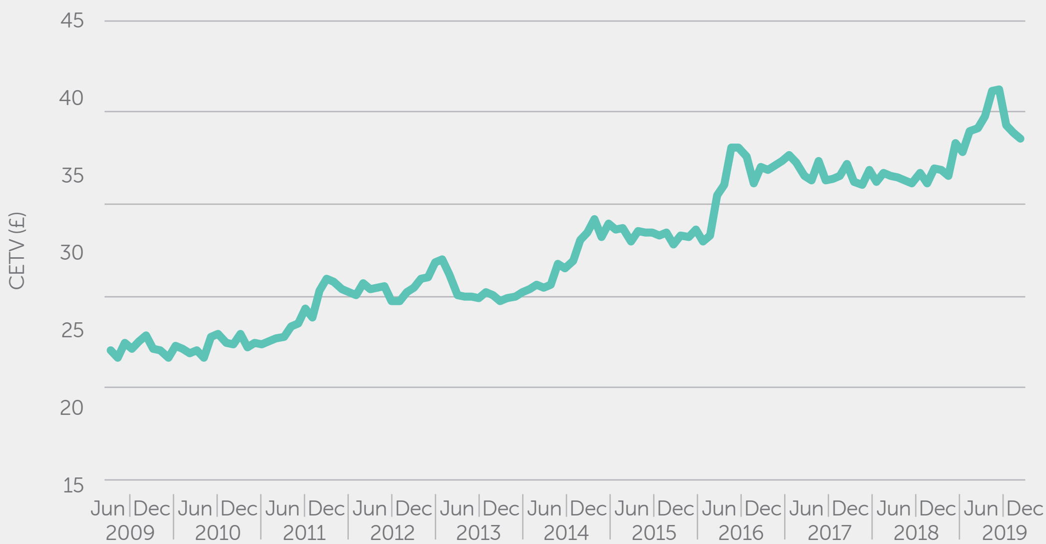
In his 2014 Budget, George Osborne announced the introduction of the "pension freedoms" with effect from April 2015. This extended and relaxed the existing drawdown provisions for members of DC schemes and also brought in the option for members to completely cash-in their DC fund (subject to tax).

Consideration was given to extending this to DB schemes but the complexities of DB administration (and the risk of getting it wrong) meant that it was unlikely any sponsors or trustees would take this on and the legislation was never introduced. Consequently, to access the freedoms, DB members have to transfer to DC schemes, either before or at the point of access.

1 incentiveexercises.org.uk

At the same time, a combination of increasing life expectancy (which seems to have tailed off somewhat in recent years), reducing interest rates and an increase in asset de-risking in DB pension schemes has driven a substantial increase in the transfer values available to members.

ILLUSTRATIVE CASH EQUIVALENT TRANSFER VALUE OF £1PA (INFLATION-LINKED) FOR A 60 YEAR OLD MEMBER



Over the last ten years, the level of transfer values have risen by around 50%, a fact that has been well publicised and has driven up member initiated demand for transfer values. Alongside large scale Code-compliant transfer exercises being run by scheme sponsors looking to de-risk their schemes and settle liabilities, the number of DB transfers has increased significantly over the last few years.

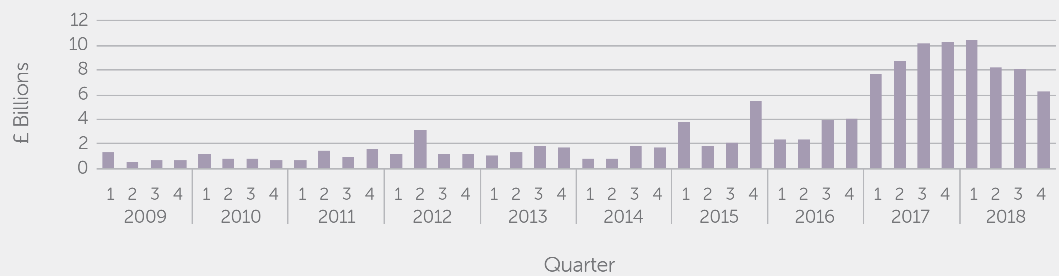
The Pensions Regulator[2,3] estimates that between April 2016 and 2019 there were approximately 400,000 transfers from DB schemes and that approximately £47bn was transferred out in between April 2017 and 2019. Most of these will have been transfers to DC arrangements.

2 www.thepensionsregulator.gov.uk/en/about-us/freedom-of-information-(foi)/number-of-transfers-out-of-db-schemes-since-april-2015-

3 www.thepensionsregulator.gov.uk/en/about-us/freedom-of-information-(foi)/number-of-transfers-out-of-db-schemes-in-2018-19

The chart below illustrates the change in the transfer amounts paid out of UK pension schemes over the last ten years. Whilst this is based on DB and DC schemes, the sharp increase since 2015 illustrates the effects of the pension freedoms on DB schemes. (The Office of National Statics (ONS) has since stopped publishing this data.)

ONS DATA - "PEN: EXP: TRANSFERS TO OTHER PENSION SCHEMES"



Based on this information, transfer payments look to have peaked in late 2017 / early 2018 with a tail off over the rest of 2018. This pattern is probably a reflection of the incidence of sponsor-driven bulk transfer exercises which typically take a year or more to investigate, design and implement, due mainly to getting the member data and calculation routines in order. This means that many sponsors and trustees who started to think about transfers when the freedoms came into force were implementing exercises or embedded "business as usual" options from the second half of 2016.

Whilst transfer volumes in 2018 are less than in 2017, we expect that the general level of 2018 transfer volumes will continue for a few years yet.

It hasn't all gone smoothly

Exercises initiated by scheme sponsors and/or trustees should comply with the Code of Good Practice and this will lead to well-run exercises with members having a smooth experience and making better decisions on whether to transfer or not. By and large, these are not a concern.

Unfortunately there has been some high profile bad practice from certain member adviser firms in relation to DB transfers.

For example, the Rookes Review[4] of the British Steel Pension Scheme's (BSPS) PPF entry exercise revealed that nearly 8,000 of the 44,000 non-pensioner members transferred out of the BSPS, some having been targeted by firms of member advisers acting in unscrupulous ways (such as paying introducers, inducing members to attend sessions by providing a free lunch, etc.).

The Financial Conduct Authority (FCA) review of a sample of the advice provided in these transfers showed that in nearly half of the cases the advice was clearly unsuitable or it was not clear whether the advice was suitable or not. 26 firms had their advice practices assessed and 10 firms had their permissions restricted as a result.

The BSPS case is somewhat unique in its combination of a distressed employer, PPF entry and the geographic concentrations and close-knit communities of scheme members. These factors undoubtedly facilitated some of the unscrupulous behaviour observed.

The FCA collected and reviewed transfer data from 3,015 member adviser firms which showed that around 162,000 of 235,000 members had been advised to transfer between April 2015 and September 2018.

4 www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/rookes-review-british-steel-pension-scheme-members.ashx

More recently, the FCA collected and reviewed transfer data from 3,015 member adviser firms (99% of the market) which showed that around 162,000 of 235,000 members had been advised to transfer between April 2015 and September 2018[5]. Of these transfers, nearly 1,500 firms had advised 75% or more of the members they advised to transfer. Given that the FCA's guidance is that advisers should start from the position that a transfer is not in the member's interest, it has stated that these results were concerning and it would be investigating further.

> An important point here is that the transfer take-up rates of the main firms involved in giving transfer advice to members in Code-compliant exercises (either bulk exercises or embedded "business as usual" transfer options) is nowhere near this high; it is much closer to 20% to 30% on average. These firms are included in the data collected by the FCA.

Following this review, the FCA began to approach the firms in its survey, starting with the most active, to get a full assessment of the approach to DB advice. One of the most active firms, LEBC, has since voluntarily ceased to advise on DB to DC transfers citing[6] the FCA review as the reason. This was a major development since LEBC were widely regarded as one of the leading advisers in the market and had been appointed to provide advice to members in many bulk transfer exercises and business as usual transfer options.

It could be inferred, however, that the main adviser firms remaining in the market have satisfied the FCA that their advice processes are sound when measured against the higher level of scrutiny now being exerted by the FCA.

Contingent charging and other concerns

Concerns have also been expressed over the structure and level of charges that some advisers deduct from members' transfer values if they are advised to transfer (known as "contingent charging" and allowable under the existing regulations). Anecdotally these have been as high as 3% of the transfer value[7] (with no cap) leading to many members paying significant sums running into many thousands of pounds for the advice. In these cases, members advised not to transfer bear no charges.

> There are advantages and disadvantages of the contingent charging structure.

5 www.fca.org.uk/news/press-releases/fca-announces-further-action-defined-benefit-transfers

6 www.bpmarsh.co.uk/2019/09

7 data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/charging-structures-for-financial-advice-on-defined-benefit-pension-transfers/written/96069.html

On the plus side it enables access to advice for members who otherwise could not afford to take it. On the downside it means that the advice for members who don't transfer is being subsidised by the charges on those who do. It also introduces a perceived conflict of interest for the adviser who is only remunerated if the member transfers.

FCA consultation

There has also been a focus on the suitability of the receiving vehicles that members have been recommended to transfer to and the level and transparency of the charges in them, both for administration and investment management as well as ongoing adviser fees.

Better times ahead

The Pension Transfer Gold Standard

In response to the BSPS issues, the Personal Finance Society, in conjunction with some of the larger firms involved in giving DB to DC transfer advice, has set up the Pension Transfer Gold Standard[8] which sets out nine principles that firms should adopt when giving transfer advice:

1. Helping clients understand when advice is appropriate
2. Ensuring advice supports the client's overall wellbeing in the context of their stated objectives
3. Ensuring client understanding and acceptance of all charges
4. Ensuring the most appropriate and updated technical skills are applied
5. Transparent management of Conflicts of Interest
6. Helping clients understanding the cost of transferring benefits
7. Avoiding unregulated investments and introducers
8. Transparency in advice processes and outcomes
9. Promoting the Consumer Guide to the Pension Transfer Gold Standard.

Almost concurrently, PASA (the Pensions Administration Standards Association) has published its DB Transfer Guidance[9] with the aim of:

- Improving the overall member experience through faster, safer transfers
- Improving efficiency for administrators
- Improving communications and transparency in the processing of transfers.

We strongly support both of these initiatives and believe that their wide adoption will give rise to better experiences and outcomes for members investigating a DB transfer.

8 www.thepfs.org/about-us/initiatives/the-pension-transfer-gold-standard/

9 www.pasa-uk.com/news/press-release-pasa-launches-db-transfers-guidance-support-members-making-better-choices

FCA consultation CP19/25

In July 2019 the FCA published Consultation Paper CP19/25 "Pension transfer advice: contingent charging and other proposed changes"[10]. In this paper, the FCA sought responses from the industry on the following proposals (amongst others):

- Banning contingent charging for DB pension transfers except for specific groups of consumers with certain identifiable circumstances (such as those who have a specific illness giving rise to a materially shortened life expectancy or those facing serious financial hardship such as losing their home because they cannot keep up with their mortgage payments)
- In the minority of cases where contingent charging is permitted, advice firms will have to charge the same amount, in monetary terms, for advice as they charge in non-contingent cases
- A short form of advice ("abridged advice") that can result in a recommendation not to transfer that falls outside of the proposed ban on contingent charging (with a commensurately lower fee)
- For members advised to transfer, introducing a requirement for adviser firms to consider the member's workplace pension scheme (if any) as a suitable receiving scheme and justifying any advice to transfer to a different arrangement.

> Whilst the FCA has not yet published its response to the consultation, we believe that the proposals in CP19/25 will improve the member experience and lead to better outcomes in DB transfer advice, especially where the member has sourced the advice themselves.

Members advised in bulk transfer exercises that comply with the Code of Practice cannot be charged contingent fees; the fees are a fixed fee per member advised and are picked up by the scheme sponsor.

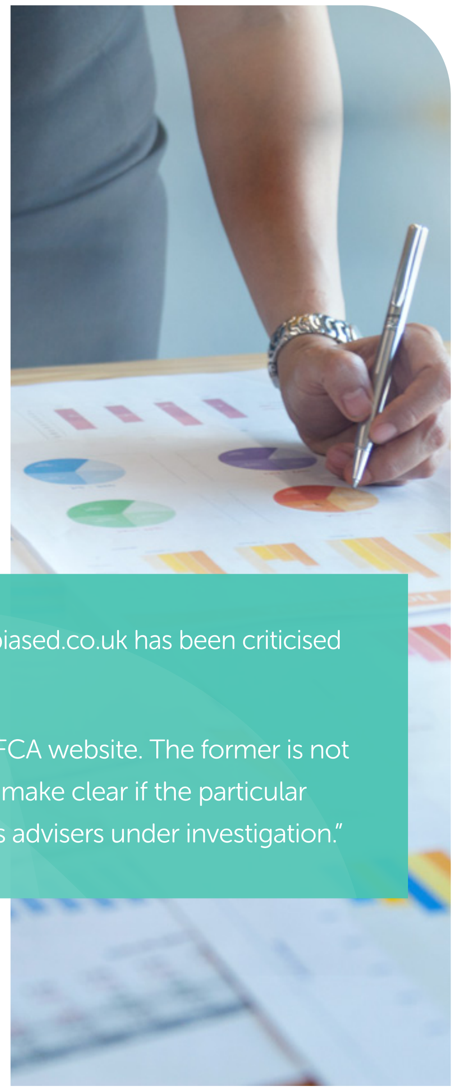
10 www.fca.org.uk/publication/consultation/cp19-25.pdf

What does this mean for members?

The number of member advisers who have the necessary qualifications and permissions to advise on DB to DC transfers has fallen significantly over the last few years as a result of:

- The FCA's increased scrutiny and guidance on transfers from DB pension schemes
- Professional Indemnity insurers becoming increasingly aware of the risks involved in such advice and raising the premiums they charge for insurance for this line of business accordingly and / or restricting some firms on the number of cases they can advise in a year.

It is likely to reduce further if the FCA bans contingent charging as proposed in CP19/25.



The traditional route of finding an adviser on www.unbiased.co.uk has been criticised in the Rookes Report:

"Instead, members were referred to Unbiased or the FCA website. The former is not unbiased and the latter is not easy to use, nor does it make clear if the particular firm of advisers deal with DB transfers. It also includes advisers under investigation."

We expect more firms (particularly the smaller ones) to cease providing DB to DC advice over the next few years with perhaps a few new entrants to the market. This raises the spectre of a capacity crunch for members looking to find a suitable adviser.

Conclusion

Despite some adverse publicity recently, we do not believe that the demand for member transfer advice will fall away significantly over the next few years.

This demand will come from the members themselves as well as from scheme sponsors and trustees looking to settle liabilities and de-risk their schemes.

Sponsors are required to put support in place under the Code of Good Practice for bulk transfer exercises and are increasingly providing support for embedded business as usual options. In the past, trustees have been reluctant to provide support to members who have initiated a potential transfer, perhaps being wary of being seen to endorse or promote transfers.

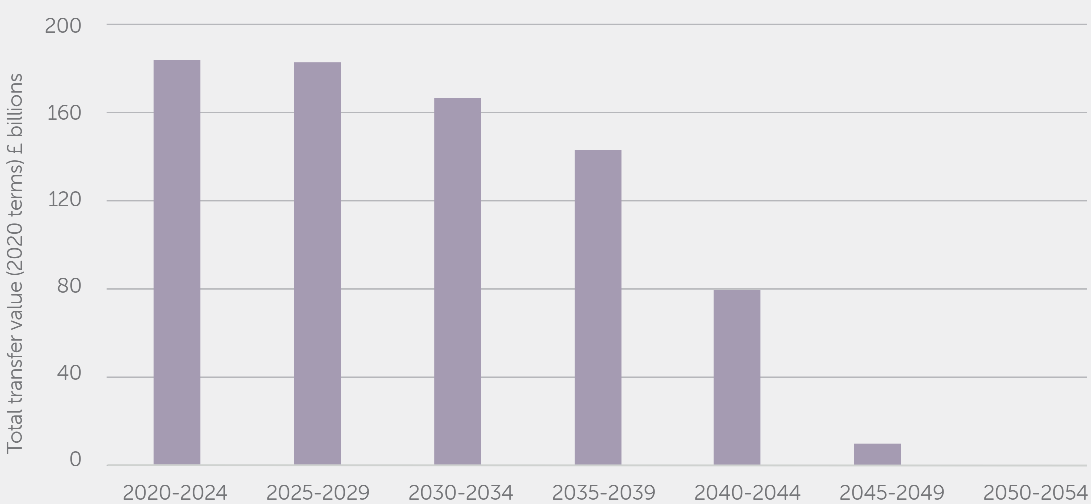
We believe that not providing some form of support to members looking to investigate a transfer will now be a bigger risk than providing some support, regardless of who has initiated the request. Sponsors and trustees should look to put a robust process in place to improve member outcomes and reduce the charges for advice (payable either by the sponsor or member).

What does the future transfer market look like?

The PPF's 2019 Purple Book[11] covers around 5,420 DB schemes (those that are eligible for the PPF) and 10.1 million members, 58% of whom (5.9 million) are non-pensioners and who could therefore choose to transfer out of their schemes. A rough estimate of the total current transfer values for these 5.9 million members is around £775 billion.

Assuming that members look to access their benefits between ages 55 and 65, either by drawing a pension from the scheme or transferring to a DC arrangement, the potential maximum flow of transfer values into the adviser market is shown below:

POTENTIAL PIPELINE OF TRANSFER VALUES IF MEMBERS ACCESS BENEFITS BETWEEN 55 AND 65



11 www.ppf.co.uk/purple-book

This suggests that around £180 billion of transfer value could be in scope in the next 5 years (in respect of around 1.4 million members). Clearly this is an overstatement as not all members will look to take advice on transferring. The actual pipeline for transfer advice will depend on:

- The actual ages at which members draw their benefits from age 55 onwards
- The numbers of members wanting to investigate a transfer before age 55
- The incidence and scope of any bulk transfer exercises that may be run by scheme sponsors

Another way to look at the potential pipeline is to base the projected flow on a percentage of the non-pensioner members coming into scope each year.

There are 5.9 million non-pensioner members in private sector DB schemes and if 2% of them wanted advice each year this would give around 120,000 members requiring advice each year for the next few years (so around 600,000 members over the next 5 years). This is slightly higher than what the market has seen in recent years.

However, with the number of advisers reducing, the advice market may not be able to cope with these numbers, particularly for members looking to find an adviser with no support from the scheme sponsor or trustees.

We believe this will lead to an increased incidence of sponsors and trustees partnering with a trusted firm of member advisers having carried out appropriate due diligence. This may then in turn increase the number of members who engage with an adviser, especially if this advice is funded by the scheme sponsor.

Partial transfers

The analysis above is based on transfers taking place on an “all or nothing” basis. Whilst there are some schemes currently offering partial transfers, they are very much in the minority. Partial transfers would seem to offer members the best of both worlds; the ability to transfer some of their pension to access the freedoms whilst retaining an income for life from the DB scheme.

However, there are some practical issues to offering partial transfers:

- The presence of GMPs which cannot be split
- Different tranches of benefits having different increases or ages at which they can be taken unreduced.

> These features effectively mean that it is not possible in most schemes to offer members the option, for example, of taking 50% of the full transfer value and leaving 50% of the full pension in the scheme.

There are also issues relating to leaving small benefits (or tranches) of benefits behind in the scheme which are disproportionately expensive to administer, how many options are given to members (full flexibility on the percentage transferred or a limited selection) and the number of times a member can take a partial transfer.

None of these issues are insurmountable, but trustees and scheme sponsors have probably not thought too closely about offering a partial transfer option in the absence of any significant numbers of requests for them from their members.

Trustees and sponsors will be required to undertake Guaranteed Minimum Pension (GMP) equalisation exercises over the next year or two. Unless these exercises are used, via GMP conversion, as a way of simplifying benefits we do not envisage a large increase in the numbers of schemes offering a partial transfer option (absent any legislation forcing such an option). In any event, we believe that partial transfers will become less relevant over time as the employment and pension histories of members changes (see next section).

Characteristics of members in the pipeline

We would expect that most members who have transferred since the pensions freedoms have been at (or very close to) the point of accessing their benefits. Whilst the transfer advice must be a recommendation based on the member's personal circumstances, we could typically split the members who transfer into three very broad groups:

1. Long-serving scheme members whose DB pension makes up most if not all of their retirement provision (excluding the state pension). These members are likely to have significant transfer values regardless of their level of earnings whilst in employment and are potentially able to retire earlier because of this.

   The main drivers for transferring for these members are likely to be the desire for control over their pension assets, the presence of significant other assets that can provide retirement income and concerns over inheritance tax and leaving a legacy.

2. Intermediate-service members whose DB pension may well represent most of their retirement provision with most, if not all, of the rest being made up of DC benefits. The transfer value may still be significant compared to other pension benefits but when they can retire will depend on their overall pension benefits.

   The transfer decision for these members is likely to be driven by the desire for flexibility and reshaping their pension income and concerns over health and life expectancy.

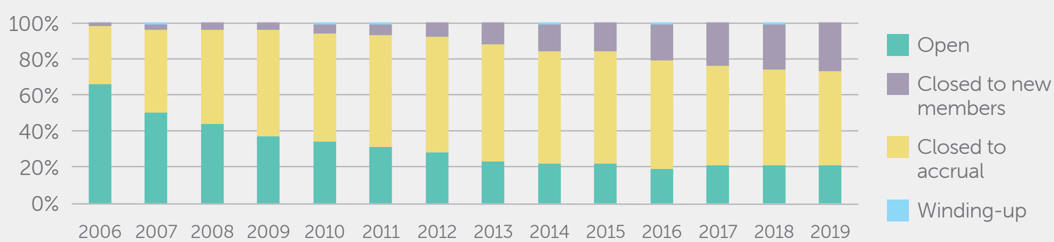
3. Short-service scheme members whose DB pension only represents a small part of their retirement provision. These members are likely to have pension benefits from other employments, some of which may also be DB. The transfer value may be relatively small but when they can afford to retire will depend on their other pension benefits.

   The drivers for transferring for these members are likely to be the access to flexibility since they have material retirement income from other sources.

We would expect the profiles of members transferring in the next few years to be similar to those above. However, the last decade or so has seen the increasing closure of UK DB schemes to new entrants and future benefit accrual, as illustrated below.

DISTRIBUTION OF MEMBERS BY SCHEME ACCESS

Source: PPF



This is likely to mean that further along the pipeline of potential cases, DB service is likely to be shorter and members are more likely to have DC benefits in addition. Transfer values are likely to be relatively lower on average (in absolute terms because of the shorter service), than those going through the pipeline in recent years or the next few years. The implications of this are:

- Members are more likely to be familiar and comfortable with DC pensions and the options under them
- Members are more likely to have a significant existing DC arrangement with the ability to access the freedoms that could receive the DB transfer
- Partial transfer options will become less attractive for members as if they don't transfer they can retain their DB income for life and their more flexible DC funds.

The net effect of these implications is likely to be a reduction in the number of DB members being advised to transfer.

Conclusion

There is likely to continue to be significant numbers of members seeking advice on transferring at retirement over the next 10 years. However, the number of advisers able to give that advice is likely to reduce meaning members may face difficulties in finding an appropriate adviser.

We expect to see more trustees and sponsors putting support frameworks in place to enable members to access this advice from a trusted adviser in a cost effective way. Given the likely capacity crunch, trustees and sponsors should seek to engage with the adviser firms quickly if they have not done so already.

The pension history of these members will change over time and will probably lead to fewer members being advised to transfer in the long-term.

Impact on schemes and sponsors

Whilst we expect significant demand from members for transfer advice, we also expect further demand for advice to be generated by scheme sponsors looking to implement bulk transfer exercises and / or business as usual transfer frameworks.

This is being driven by the following:

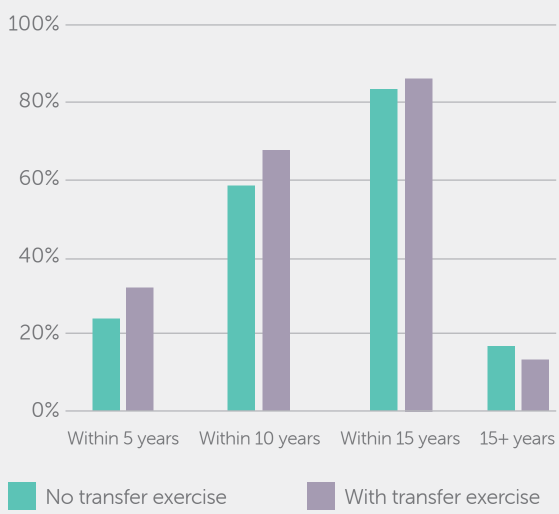
- Member transfers settle liability and remove risk. For most schemes the transfer value will be considerably less than the cost of securing benefits with an annuity provider or consolidator. As schemes de-risk over time, this difference is expected to get smaller but transfer values should still remain the most cost-effective method for the trustees and sponsor to settle liabilities.
- The Pensions Regulator expects scheme sponsors and trustees to discuss and agree a long-term funding target for the scheme that reflects the way that liabilities will eventually be settled (buy-out, consolidator transaction or run-off). Member transfers will clearly be part of this discussion as they could have a material impact for some schemes on the timeframe in which the scheme reaches its final endgame state.

For example, our 2019 bulk annuity report[12] illustrated how a transfer value exercise could reduce the ultimate cost of buying-out benefits, thus bringing the endgame forward

IMPROVING BUY-OUT AFFORDIBILITY - MEMBER OPTION EXERCISES

- Our recent FTSE350 survey[13] revealed that a bulk transfer exercise with a moderate take-up rate could increase the number of schemes that could buyout in the next five years by a third

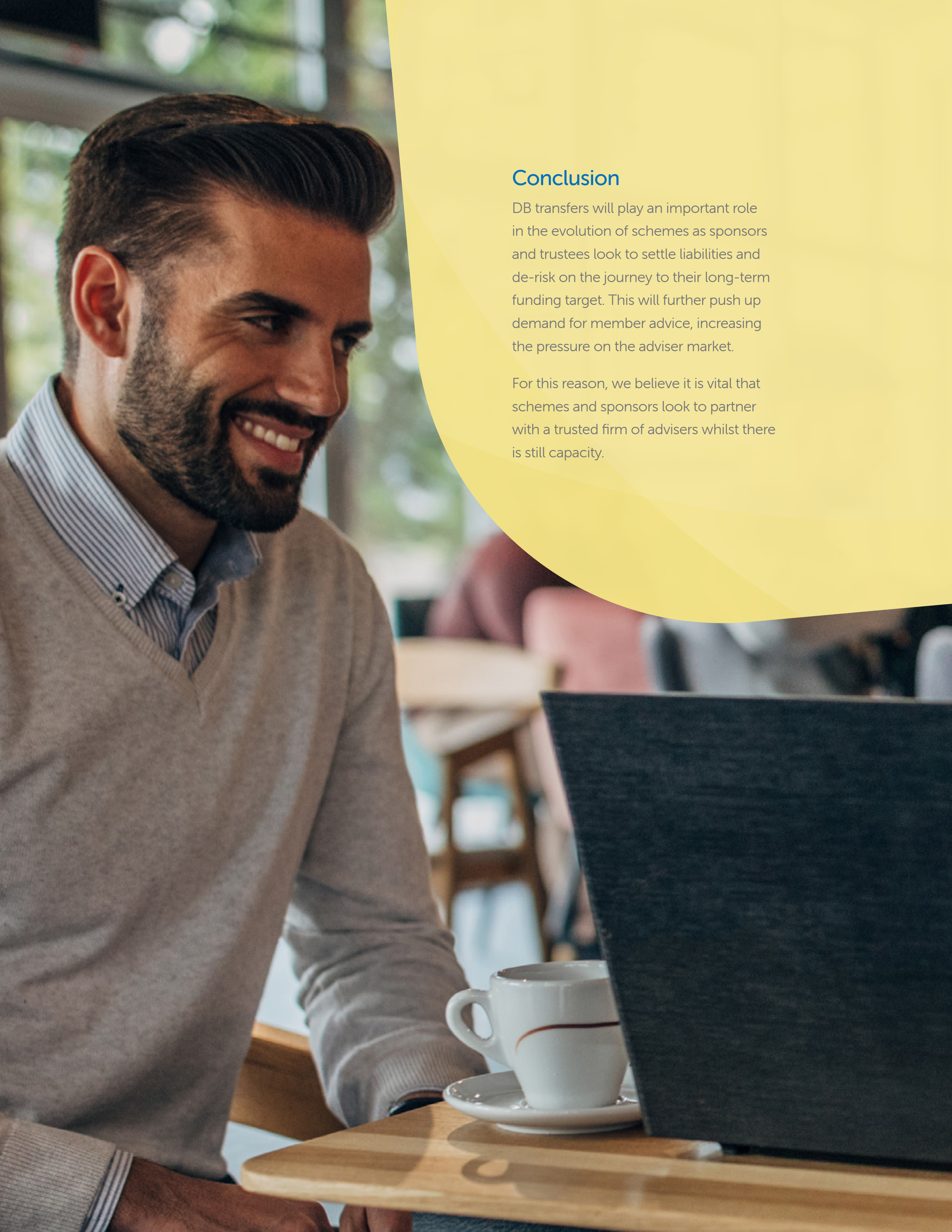
PROPORTION OF SCHEMES ABLE TO BUYOUT WITHIN A CERTAIN TIME PERIOD



Member transfers do have some secondary effects on the scheme as well:

- Sponsors and trustees will need to think about liquidity issues (especially in a bulk transfer exercise). Many schemes are now net disinvestors and paying transfer values will exacerbate this. In addition, transfer values are guaranteed for three months and trustees have three months to pay the transfer value once the member has notified them of the intention to transfer. So there could be a maximum of a six month period between the calculation of the transfer value and it being paid. Sponsors and trustees will need to think about how to mitigate adverse movements in the underlying scheme assets over this period
- Transfer payments will reduce the maturity of the scheme as the longer term liabilities will be settled. The Regulator's new funding guidance is expected to require the scheme to be funded on the long-term target once the scheme reaches a certain level of maturity. Whilst it is unclear what exactly this maturity measure will be, transfers are almost certainly likely to bring forward the date this is met

13 www.barnett-waddingham.co.uk/comment-insight/research/ftse-350-pensions-liability-management-under-the-spotlight



Conclusion

DB transfers will play an important role in the evolution of schemes as sponsors and trustees look to settle liabilities and de-risk on the journey to their long-term funding target. This will further push up demand for member advice, increasing the pressure on the adviser market.

For this reason, we believe it is vital that schemes and sponsors look to partner with a trusted firm of advisers whilst there is still capacity.

Summary

DB transfers have been occurring at significant levels over the last few years, driven by the perfect storm of the new pension freedom legislation and high transfer value levels resulting from low interest rates and increasing life expectancies. There have been some issues along the way but we believe that the new initiatives coming into play and an increased FCA focus will improve the member experience leading to better decisions and outcomes.

We believe that the demand for DB transfer advice will continue to be high, driven by member demand and scheme sponsors and trustees looking to settle benefits and de-risk. This is likely to lead to a capacity crunch as the number of firms with the regulatory permissions to give DB transfer advice reduces as a result of increased regulation and PI insurance costs. Whilst there may be some new entrants to the advice market, it is likely that members may have difficulty in finding a suitable trusted DB transfer adviser.

For this reason we believe that scheme sponsors and trustees should be looking to put in place an arrangement with an advice firm so that their members have access to transfer advice from a trusted adviser on which the sponsor and trustees have done some due diligence.

> The risk of doing nothing in this area is now higher than the risk of doing something to support members.

Barnett Waddingham works closely with the adviser market and has carried out due diligence on many of the specialist forms offering DB transfer advice. We can help sponsors and trustees select an appropriate adviser firm to partner with.

The next article in this series will cover putting in place a support framework including selecting an adviser.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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