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Comparing a Defined Benefit scheme to a Defined Contribution scheme

The pension flexibility rules for defined contribution (DC) schemes were introduced on 6 April 2015, and since then, there's been an increase in the transfer activity from defined benefit (DB) to DC schemes.

While the transfer value available will always be a major factor in any decision to transfer, there are many other important issues that should also be considered.

It's a legislative requirement (under section 48 of the Pension Schemes Act 2015) that appropriate independent advice must be taken where a DB transfer value is more than £30,000, and any transfer process should start from the assumption that making a transfer from a DB scheme isn't suitable.

This guide is designed to give information that can help achieve the correct outcome for the client and adviser.

The advice process

The advice process should include an assessment of whether it's better for a client to remain in their DB scheme or transfer to a DC arrangement and a personal recommendation to transfer should only be made if it can be clearly shown that a transfer is suitable and, in a client's, best interests.

To demonstrate this, the main factors to take into account are:

- the client's intentions for accessing pension benefits
- their attitude to, and understanding of the risk of giving up safeguarded benefits in a DB scheme or flexible benefits in a DC scheme taking into account.
  - the risks and benefits of staying in the ceding arrangement;
  - the risks and benefits of transferring into an arrangement with flexible benefits
  - their attitude to certainty of income in retirement;
  - whether they would be likely to access funds in an arrangement with flexible benefits in an unplanned way and the likely impact of this on the sustainability of their funds over time;
  - their attitude to, and experience of, managing investments or paying for advice on investments as long as their funds last, and
  - their attitude to any restrictions on their ability to access funds in the DB scheme.
- their attitude to, and understanding of, investment risk, and
- their realistic retirement income needs, including:
  - how they can be achieved;
  - the role played by safeguarded benefits in achieving them;
  - impact on those needs if a transfer is made, and

- alternative ways to achieve their objectives instead of a transfer.

You should do a full analysis of a client's options included in an Appropriate Pension Transfer Analysis (APTA). This will include a Transfer Value Comparator, which aims to compare the transfer value offered by the DB scheme against the cost in today's money of buying the same level of benefits in a DC scheme through an insured annuity.

It's clear that any proposed transfer involves many considerations and requires thorough investigation before a firm recommendation on whether to proceed or rule out a transfer can be made.

Differences between a DB and DC scheme

A good understanding of the differences between the various types of DB and DC schemes is also essential before a recommendation to transfer can be made. While the aim of both DB and DC savings is to help provide funds for a client in retirement, there are noticeable differences between the two.

It's also worth bearing in mind that each DB scheme or DC scheme will have its own scheme rules or similar documentation. In practical terms, these should be checked as part of the advice process to allow a specific comparison to be made between the existing DB scheme and the DC scheme identified as the recipient of a possible transfer. For example:

• accrual rates and commutation factors will vary between DB schemes, and

• not all DC schemes will offer the full range of flexible options when taking benefits

The table below highlights the main differences you'll find between a traditional private sector DB scheme and a personal pension (PP) arrangement (this isn't a definitive list):

	Defined Benefit (DB)	Personal Pension (PP)
Set up	Is set up by an employer for the employees who are eligible to join. Trustees are appointed to run the scheme and make sure that members' interests are looked after.	Can be set up on an individual or on a group basis. PP schemes are typically offered by pension providers.
Administration	The trustees are the scheme administrators for reporting purposes.	The pension provider is the scheme administrator for reporting purposes.
Investment	The trustees are responsible for monitoring the investment of the assets held in the scheme so that liabilities can be met. They may delegate investment activities to a fund manager or investment adviser.	The investment risk is the responsibility of the individual and they decide what investment choices are made and how often these are reviewed.
Contributions	The sponsoring employer will contribute to their DB scheme. Each active member may also be required to make contributions or may choose to do so.	These can be paid by the individual, their employer or a third party (on the individual's behalf).

Tax relief	Personal contributions are usually deducted from gross pay before income tax is Calculated. This is known as the 'net pay method and provides automatic tax relief at an individual's highest marginal rate.	Personal contributions are paid net of basic rate tax and are deducted from net pay after income tax is calculated. This is known as the 'relief at source, method. An individual who pays income tax at higher than basic rate can claim any extra tax relief due from HM Revenue & Customs. However, the extra tax relief isn't invested in the individual's pension arrangement.
Annual allowance	A notional value is given to the benefit accrual in a tax year and this notional amount is tested against the member's annual allowance.	All contributions paid to the arrangement in a tax year are tested against the individual's annual allowance.

	Defined Benefit (DB)	**Personal Pension (PP)**
Benefit	The aim is to provide a guaranteed level of benefit with the funding position checked regularly to make sure that all benefits can be met. Benefits are based on salary, service and the scheme accrual rate.	The size of the retirement fund is based on contributions made, the fund(s) invested in and the charges applicable to the commitment's arrangement.
Benefit options	Typically, benefits will be provided as a tax-free lump sum and taxable pension. It should be possible to commute a small pension if its value is below a certain level.	Depending on scheme rules and the size of fund, options could include a tax-free lump sum and taxable pension, tax-free lump sum and flexi-access drawdown, a taxable lump sum (UFPLS) or a small lump sum.
Lifetime allowance	A notional value is given to the benefits being taken and this notional amount is tested against the lifetime allowance. Typically, this will be 20 times the initial annual pension plus any tax-free lump sum.	The value of the benefits being taken are tested against the lifetime allowance (there is no test for a small lump sum).
Pension increases	Scheme rules will generally include provision for a pension to increase in payment. Increases must be at least the statutory minimum.	If a pension is chosen, this can be set up or without increases to the payment. There are no statutory minimum increases.
Retirement age	Benefits can be taken in full from age 55 but there may be an early withdrawal penalty for taking benefits before the scheme normal retirement age.	Benefits can be taken from age 55 and it may be possible (depending on scheme rules) to take benefits in states over a period of time.

Ill-health benefits	It's possible for pension benefits to be taken on ill-health grounds earlier than age 55, while benefits can be taken as a lump sum on serious ill-health at any age. DB scheme rules will set out the terms and conditions to be met for each, including the period of service included (for example actual service or prospective service to normal retirement age) when calculating the benefits to be paid.	It's possible for pension benefits to be taken on ill-health grounds earlier than age 55 while benefits can be taken as a lump sum on serious ill-health at any age. PP scheme rules will set out the terms and conditions to be met for each service.
Death before taking benefits	A lump sum and taxable spouse's or civil partner's pension will normally be payable on death of an active member. The lump sum will typically be a multiple of salary, and the pension will be a percentage of the member's entitlement or salary on death of a deferred member, a spouse's or civil partner's will normally be payable based on a percentage of the member's deferred pension. Pension benefits can only be paid to a member's dependants. It should be possible to commute a small pension if its value is below a certain level.	Depending on the scheme rules, a beneficiary may have the option of a lump sum, an annuity or a flexi-access drawdown arrangement in their own name. Benefits can be paid tax-free up to the lifetime age 75 (subject to conditions), but are taxed at the beneficiary's marginal rate where death occurs after age 75. It may also be possible for funds to be passed down the death generations, which can be attractive from an estate planning perspective. PP death benefits are likely to be different to those from a DB scheme so are an important factor to consider.

	Defined Benefit (DB)	Personal Pension (PP)
Death after taking benefit	A pension in payment may continue for the remainder of any guaranteed term. In addition, a spouse's, civil partner's or dependent's pension may also become payable.	For an annuity in payment, this may continue for the remainder of a guaranteed term and may include payment of a dependent's pension if chosen by an individual when they took their benefits. For funds in drawdown, scheme rules will determine the options available but these could include a lump sum, an annuity or a flexi-access

		drawdown arrangement in a recipient’s own name.
Risks	One of the main advantages of a DB scheme is that it promises a guaranteed level of benefit if the scheme is adequately funded.	The individual is responsible for the investment choice and form of benefits taken. Investment volatility, life expectancy and inflation could all provide risks, and investment performance may not meet the individual’s expectations on returns. Clients should be made aware that the value of their money in a PP can fall as well as rise. The value of a client’s pension pot at their chosen retirement date may be less than has been paid in.
Protection of savings	If the employer becomes insolvent and there aren't enough assets in the scheme, the scheme may be taken on by the Pension Protection Fund (PPF).	If a UK pension provider gets into financial difficulties, there should be protection in place for PP arrangements through the Financial Services Compensation Scheme (FSCS).
Regulation	These schemes are regulated by The Pensions Regulator.	Are regulated by the FCA.

New Pension Selected from Research

Any financial review and personal recommendation to transfer benefits from DB to DC will include an adviser’s assessment of the suitability of the receiving scheme, the investment choices, benefits, and options that are available.

The NEW plan should offer the full income and death benefit flexibilities that were introduced for DC schemes in April 2015. They give clients more control over their pension savings and also a wide investment choice that can be tailored to meet their individual risk appetites.

An adviser should be comfortable with the investment choices that are made for the client as they may lose features, protections, guarantees or other benefits when they transfer. Remember that a transfer to a Personal Pension is moving to an investment-based product where the client's capital is at risk and the final value of their pension pot may be less than has been paid in.