Guide 1

A General Guide to Defined Benefit Vs Defined Contribution Pension Schemes

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Thinking about giving up your Defined Benefit Pension? What you should consider before seeking advice

In 2015 new pension freedoms were introduced that gave people more choice over what they could do with their pension pots. For various reasons, many people are therefore considering transferring their pension from a "Defined Benefit" (DB) scheme to a "Defined Contribution" (DC) scheme. While both types of pension scheme provide income for people in retirement, there are some important differences between the two.

Whether it is potentially a good idea for you to sacrifice the benefits promised to you under your own DB scheme and transfer your pension "pot" to a DC scheme will depend on your personal circumstances and various factors such as your attitude to risk and uncertainty.

We have produced this guide to explain, in an unbiased and general way, the differences between the two types of pension. The purpose of this guide is therefore neither to promote DB to DC transfers nor to discourage them, but rather to help you become more aware of the many factors that have to be considered by anyone before deciding whether or not to trade in their DB pension.

The view of the Financial Conduct Authority (FCA) is that

"In most cases you are likely to be worse off if you transfer out of a defined benefit scheme, even if your employer gives you an incentive to leave…"

PS18/20 FCA Policy Statement Oct 2018

Before we start looking at the pros and cons of the two types of pension, there are a few things to be aware of at the outset:

- A DB to DC transfer is irrevocable. You cannot subsequently change your mind if you wish you hadn't made the transfer
- If you have already started receiving benefits from your DB pension scheme, you cannot usually then give them all up for a cash transfer payment. Occasionally a scheme will offer you a deal where some of your pension benefit can be given up in return for a lump sum
- There are some types of DB pension schemes where cash transfers are not possible. These are mainly public sector schemes (such as for nurses, teachers and civil servants)
- It is a legal requirement to obtain qualified, regulated financial advice prior to requesting a transfer of a DB pension pot valued at £30,000 or more

What do we mean by a DB scheme?

In the past, many people built up a pension through their employer based on how long they worked for the firm and how much they earned. The amount of pension they would get was determined by the rules of the pension scheme. These schemes are therefore known as "Defined Benefit" pensions. Someone who has a DB pension is guaranteed to receive a pension income at a defined level for the rest of their life.

What do we mean by a DC scheme?

Most pensions offered to employees these days are based on the amount of money (or "contribution") paid in to the scheme. Contributions may come from the employer as well as the employee but not necessarily so. Someone who has a DC pension scheme can receive a pension income only for as long as there is still money in their pot. The duration of that income is determined by the quantity/level of withdrawals made and the growth achieved by the fund in their pot.

Key Advantages of a Defined Benefit Scheme

- Your pension lasts as long as you do so there is no danger of you running out of money.
- Your pension is unaffected by the ups and downs of the stock market. All the investment risks are carried by the scheme and you don't have to pay advice charges or fees for the on-going management of the fund
- There is some measure of protection against inflation, which helps maintain the spending power of your pension. This varies from scheme to scheme but there is a legal minimum that all schemes have to offer.
- There is something for a surviving spouse after you die and sometimes also for other surviving dependants. These provisions also vary from scheme to scheme, but spouse's pensions of half the scheme member's pension are common.
- Under current tax rules, you can build up pension rights worth £1.03 million over your lifetime. A pension pot valued above this level can incur tax penalties. For the purpose of this tax comparison, the way a DB pension value is calculated is different from the way a DC pension value is calculated. In some situations, a pension left in a DB scheme can be under the tax limit when its DC equivalent could be over the limit.

It is precisely these advantages that prompt the FCA to encourage caution before considering transferring your pension from a DB scheme in to a DC scheme. A DB pension offers a level of financial certainty during retirement, at a time in life when we are generally least able to regenerate any income or wealth we lose

What are the key risks or disadvantages?

- The main risk to your income in retirement if you are in a DB scheme is that your employer goes bust and your pension goes in to the Pension Protection Fund. In this situation, you will still receive pension benefits, but they are likely to be lower than the defined benefits originally promised.
- There is little flexibility regarding how and when you draw your benefits and restrictions on who can inherit them when you die.
- The less time you live in retirement, the less value you receive from your pension

The infographic below highlights some of the factors that are typical of people who prefer to stay in a defined benefit pension scheme (see figure 1)

Figure 1: Some factors that lead people to choose to keep their defined benefit pension rights

Key Advantages of a Defined Contribution Scheme

- There is greater flexibility to access your pension early (from aged 55) and you have greater choice over how you spread your income and spending through retirement, rather than having a rigid amount throughout.
- There is generally the potential to draw a larger tax-free cash lump sum than if you remain in a DB scheme.
- You can leave your pension to a wider range of people after you die and they, too, can pass it on after they die. With a DB pension it is most likely that when you (and perhaps any spouse) die, your pension dies too.
- If you are someone who knows they have a life expectancy well below average, a transfer to a DC pension scheme may result in you realising greater value from your pension than if you remain in a DB scheme (this is because the transfer value will reflect average life expectancy)
- Your investment fund will be unaffected by what subsequently happens to your employer's business.

What are the key risks or disadvantages?

- You carry all the investment risk yourself. If your investments do badly, your retirement income is at risk.
- There is no protection against inflation.
- You take on the uncertainty about how long you are going to live. People tend to under-estimate how long they are going to live, so there is a chance that you will run out of money prematurely or, conversely, live overly frugally in retirement for fear that the money will run out.
- As well as the risks, you take on the costs of managing your pension funds. These are likely to include the costs of initial and ongoing advice as well as product fees and charges.

The infographic below highlights some of the factors that are typical of people wanting to seek advice on a transfer to a defined contribution pension scheme (see figure 2)

Figure 2: Some factors that lead people to explore a transfer to a defined contribution scheme

To repeat the point that we made in the introduction, the purpose of this guide is neither to encourage nor discourage DB to DC pension transfers. Rather, we hope it will help familiarise you with some of the key issues to consider if you are thinking about such a transfer.

The FCA is clear that a sensible starting point is the assumption that you are likely to be worse off if you transfer out of a defined benefit pension scheme.

This presumption should help you to ensure that you assess the value of what you already have by way of guaranteed pension rights in a DB arrangement.

Before investing in professional, tailored advice it is crucial that you consider the risks as well as the advantages a DC pot may hold for you and compare these carefully against the relative security of the DB pension you would be giving up.

We have listed some sources of further information you may find useful on the back of this booklet.

Further information you may find helpful

The Pension Transfer Gold Standard is a new initiative launched in April 2019 that aims to improve consumer awareness of what good advice looks like and raise professional advice standards in the Pension Transfer arena.

You can find out more about the Gold Standard and access further information on the Personal Finance Society website: www.thepfs.org/ptgsconsumer

Royal London have produced a useful guide on reasons to leave your company pension and reasons to stay. You can access this guide here:

5 Good Reasons.pdf

An independent company called Money Alive have produced a short video that gives you some basic details about the different types of pension schemes. This will help you understand some of the issues around different pension arrangements. The video can be accessed from the Personal Finance Society website page above or using the link below:

Video: Money Alive - Stay or transfer?