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Issues advising defined benefit members

On the face of it, defined benefit (DB) pensions are very attractive for pension scheme members: a known pension, usually defined as a fraction of final salary, is provided for each year of service.

However, it is hard to imagine a greater gulf between perception and reality. The reality of DB pensions is not straight-forward at all. While the employer promises to provide a pension on retirement, the law protecting members is weak and the pension promise is subject to change. Members face several risks and must bear these risks in mind when making any decisions connected to their pension arrangements. No matter how well funded or how strong a sponsoring employer, there is no DB benefit that is completely void of risk.

DB members have limited control over their pensions. Scheme rules will state the level of benefits and the level of contributions. It is common for membership to be a condition of employment with no option to decline membership or subsequently withdraw.

While defined benefit membership is often effectively a spectator sport for members (no decisions to be taken), there are other times when members need financial advice.

There are several scenarios, outlined below, where important decisions can arise that can have a serious impact on the eventual benefits. The right course of action will often depend on individual circumstances with the result that the member will benefit from such financial advice.

Joining the scheme

The first decision that can face a member is whether or not to join the pension scheme. Often, a member of a defined benefit scheme has no decision to take as membership is often a condition of employment. While employed, the only decision is whether to pay additional voluntary contributions (AVCs) to the scheme's AVC facility or to a separate PRSA AVC.

Of course many defined benefit schemes are now closed to new members, but if membership is open the member may need to consider the risk that the benefits as described may not be delivered. Assuming membership is a condition of employment, the person may have to consider whether to take up their employment offer if there is an associated defined benefit scheme with a high underlying risk that the benefits as described will not be delivered.

It is often very difficult to foresee possible risks over a long future period – many members joining a pension scheme will not retire for over 30 years and will hope to receive benefits from the scheme for many years after that. The major factor that has to be taken into account when considering the future benefits is the security of the scheme (this is influenced by a huge range of factors such as the type of employer, funding position of the scheme, likely continuation, size, etc.). The career plans of the individual will also have an impact.

Funding problems

As has been well documented, the majority of defined benefit pension schemes are facing a funding crisis. The culmination of poor investment performance and continuing improvements in life expectancy has led to large deficits in many schemes. A weak funding position increases the risks to the promised pension.

Sometimes, when a plan changes, a member is offered the choice of paying increased contributions for a certain level of benefits or perhaps unchanged contributions for a lower level of benefits. This can be an individual decision but it is often the case that it is better value to pay the increased contributions. Any decisions made in this regard need to be carefully considered and are dependent on the quality of the scheme and the alternatives available.

Defined benefit, in the past, appeared good value for members of the scheme but the promise is only as good as the assets backing the promise and the employer's commitment. Pension law does not protect employees in Ireland so there is no safety net if things go wrong.

Leaving service

On ceasing service with an employer before reaching normal retirement age, members will stop accruing pension benefits and will have a decision to make regarding the benefits accrued prior to exit. The two main options open to members are to:

1. Keep their accrued pension in the scheme which will then be payable from the scheme's retirement date.
2. Transfer the value of the benefit to another arrangement. This could be the pension scheme of a new employer or a personal pension arrangement such as a PRSA or a personal retirement bond. Transferring to a PRSA is more complicated if the value exceeds €10,000[1].

When a member leaves and is offered a transfer value, typically the transfer value is less than the cost of replicating the benefits e.g. by buying an annuity. If the scheme is underfunded, the transfer value is usually reduced to reflect the underfunding. The decision whether or not to take a transfer value is heavily dependent on the likely future continuation of the scheme – will it continue as is, continue with a reduction to accrued benefits or wind-up? If we were certain that the benefits would be paid as promised, it is generally better not to take a transfer value. However, the situation is usually quite uncertain.

If there is a doubt over the future payment of benefits or we predict that the funding level may fall in the future then it could make more sense to take a transfer value. The decision that must be taken is whether the increased certainty of removing the transfer value from the DB scheme into the control of the member is a strong enough reason to compensate for its reduced value. This is subjective so it generally depends on the members' individual circumstances and their appetite for risk, and of course financial advice will shed light on the appropriate approach.

Retirement

Early retirement is usually subject to the consent of the employer or the scheme's trustees and in current times this consent is often withheld. In situations where a member is permitted to retire early, the pension will be paid for longer period and therefore, on early retirement, accrued pensions are usually reduced to reflect the extended period over which the pension would be paid. The relative attractiveness of early retirement varies.

An important consideration regarding early retirement is that early retirees are better protected than employed and deferred members. If the scheme is wound-up, the assets will be distributed with regard to the priority order of liabilities set out in legislation. This priority order currently ensures that the pensions (excluding future increases) payable to current pensioners and those past normal retirement age must be provided before the assets are used to provide other benefits. Therefore, early retirement improves security.

On retirement, whether at normal retirement age or any other age there is currently an option to take part of the fund as a tax free lump sum. The tax implications and conversion rates used are often a source of confusion to members.

Conclusion

Pensions can be a minefield for DB scheme members. Benefits, which are described often in concrete terms (albeit with accompanying small print pointing out that benefits are subject to change), are in reality, uncertain. It is crucial that DB members understand their pension scheme entitlements and the associated risk so that they can properly evaluate their financial circumstances. With the complex and often risky nature of DB benefit schemes there is much more to think about than just the number on a benefit statement.

1 A Certificate of Benefit Comparison is required for any transfer from an occupational pension scheme to a PRSA. The member must have no more than 15 years' service in the occupational scheme and the member must pay for the completion of the Certificate of Benefit Comparison which must be completed by an actuary.