Institute and Faculty of Actuaries

Freedom and choice in pensions

Institute and Faculty of actuaries response to the HM Treasury

11 June 2014

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Freedom and Choice in Pensions Consultation
Pensions and Savings Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

11 June 2014

Dear Sir/ Madam

IFoA response to Freedom and Choice in Pensions

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HM Treasury's consultation 'Freedom and Choice in Pensions'. This response has been written by members of the IFoA who work in Defined Benefit (DB) and Defined Contribution (DC) pensions, life insurance and finance and investment.

The key points we raise are:

i. The IFoA welcomes changes to pensions that reduce barriers to choice and incentivises individuals to consider a broad range of options as they prepare for retirement, but we also recognise that increased flexibility could increase the likelihood that not all scheme members will reach outcomes that are in their best interests.
ii. We expect the changes to the pensions tax framework will encourage innovation in the market. However, there are barriers to achieving flexibility in the market, which we suggest should be addressed.
iii. As long as individuals under-estimate their expected longevity and the variance around that longevity, insufficient capital to support retirement will remain a risk to financial security in the later stages of life. Actuaries have significant expertise in analysing mortality experience and understanding the difficulty in predicting life expectancy and we would welcome the opportunity to discuss the key factors in longevity in greater detail.
iv. We would encourage the development of a comprehensive approach to guidance, which provides appropriate support for all members of pension schemes, both occupational and individual, considering those leading up to, at the point of and after retirement. This should cover all the options available under the new flexible regime, ensuring customers are aware of all potential outcomes throughout their decision-making.

A.1 The government welcomes views on its proposed approach to reforming the pensions tax framework.

1. Should a statutory override be put in place to ensure that pension scheme rules do not prevent individuals from taking advantage of increased flexibility?

The IFoA welcomes changes to pensions that reduce barriers to choice and incentivises individuals to consider a broad range of options as they prepare for retirement. While the IFoA is supportive of

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creating a level playing field for all scheme members having access to flexibility, we wish to bring to HM Treasury's attention the possibility of unintended consequences that require further consideration:

- The principle of greater flexibility increases the possibility that not all scheme members will reach the outcomes that are in their best interests.
- Dependent on the wording of the override, and the nature of the particular scheme, this could have significant cost implications for schemes. For members with a DB and a DC entitlement in the same scheme, if implementation of the override enables members take all their tax free cash (derived from their total benefits) from the DC pot (rather than pro rata from each), this could be advantageous to members.. Further, if the override were to require legacy schemes to develop new operational systems, it may be significantly more costly and disruptive than encouraging movement to new schemes. While the cost burden of meeting the override may initially fall on scheme providers, scheme members may ultimately pay the price.
- The increased flexibility, to a greater or lesser extent, will also affect employers, trustees and product providers which we have considered in responses to other questions. Dependants may also be subject to altered financial circumstances because of decisions taken by scheme members.

We would urge HM Treasury to consider the extent to which an override is required; the specific wording used for an override; and the potential consequences of an override for a range of schemes and stakeholders.

2. How could the government design the new system such that it enables innovation in the retirement income market?

A significant proportion of IFoA's members' work for providers, or provide advice to sponsors and trustees within the broader retirement income market. As legislation has changed over time, our members have been closely involved with the evolution of retirement income products and, based on our experience, we would expect the changes to the pensions tax framework to encourage innovation in the market. As an example of this, the IFoA's Pensions and Long Term Care Working Party recently published a paper *How pensions can meet consumer needs under the new social care regime*[1], which considers how a range of existing and new products might facilitate the use of retirement assets to meet potential retirement liabilities.

However, the existence of innovation and the development of new products will not remove all barriers to achieving the flexibility in the market. Examples of barriers for pension providers are:

- Sales processes – would providers be willing to offer products to potential policyholders who had not received advice?
- Solvency – product providers must meet the new requirements arising from Solvency II. The implementation of Solvency II will determine whether providers participate in specific parts of the retirement income market.
- Legislative and regulatory inter-action - cross-government departmental working may be required to implement the necessary legislative changes.

In places, current regulatory boundaries will need to be addressed if scheme members are to make full use of the new flexibility. It is important that regulatory requirements are proportionate. For example, although we understand the need to avoid abuse, there are currently complex requirements, in relation to recycling, cessation of contributions following flexible drawdown and a second Lifetime Allowance test at age 75. If these are continued into the new framework, they will both complicate the provision of guidance at retirement under the proposed guarantee (could a typical member with a small pot be expected to take these constraints into account?) and limit product development (if only

[1] IFoA (2014) How pensions can meet consumer needs under the new social care regime

because of the complexity and therefore cost of the sales process that would be required to address them).

Retirement decision-making should also incorporate the revised arrangements for ISAs. The increased contribution limits could make the choice of investment product more challenging, as individuals consider what flexibility would mean for them.

3. Do you agree that the age at which private pension wealth can be accessed should rise alongside the State Pension age?

Ultimately, the answers to questions three to five are for policy-makers to decide. However, there are a number of points we suggest HM Treasury considers.

If the policy intention is that individuals should be encouraged to fully understand how long they are likely to live, the requirements of the Pensions Act 2014 to adjust State Pension Age will be the starting point for developing that knowledge. Whether legislation is needed to reinforce that knowledge is a matter for political judgment.

4. Should the change in the minimum pension age be applied to all pension schemes which qualify for tax relief?

The IFoA does not have a response to this question as it is for policy-makers to decide.

5. Should the minimum pension age be increased further, for example so that it is five years Below State Pension age?

There is benefit in making the obvious statement that the earlier individuals can access their pension assets, the greater the likelihood that they will spend them earlier. As long as individuals under-estimate their expected longevity and the variance around that longevity, insufficient assets to support retirement will remain a risk to financial security in the later stages of life. The IFoA emphasises this is a policy decision and it is for Parliament to determine the trade-off between maximum flexibility and determining the protection required to ensure financial security in the latest stages of life.

However, actuaries' expertise is analysing mortality experience and understanding the difficulty in predicting life expectancy and we would welcome the opportunity to discuss the issues around longevity in greater detail.

A.2 The government welcomes views on its proposed approach to supporting consumers in making retirement choices.

Over the last decade successive governments have moved towards adopting, and implementing, Auto Enrolment (AE). Based on evidence so far, the "nudge" approach adopted for AE is expected to lead to greater participation in workplace saving as anticipated by behavioural economics theory. However, recent FCA research has indicated that inertia can lead to poor outcomes where the default route does not lead to the best outcome, in particular, with the high proportion of pension savers not exercising their Open Market Option[2], even where their provider's annuity terms are uncompetitive.

Against this background, while many savers will welcome the increased flexibility afforded by the pension reforms, the IFoA would encourage HM Treasury to consider how behavioural economics could be applied to "nudge" consumers towards an appropriate approach following retirement, as well as whilst working.

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[2] http://www.fca.org.uk/news/tr14-02-thematic-review-of-annuities

Under the proposed framework, the "easiest" route may be for savers to take their DC pot as a lump sum at retirement, as this avoids having to choose a decumulation provider. This is unlikely to be optimal as a route for helping savers fund their future retirement income needs, particularly if taking lump sums were to give rise to substantial tax charges.

We therefore recommend that the Government conducts research into what arrangements might be put in place to ensure that inertia nudges savers in a direction that is likely to be appropriate, rather than inappropriate, and that schemes ensure their default framework best supports appropriate outcomes. The form that this might take is beyond the scope of this response, but consideration could be given to requiring schemes and providers to put in place an appropriate default decumulation vehicle, analogous with AE requirements. The IFoA would welcome the opportunity to discuss potential default paths with HM Treasury.

Any such vehicle would need to meet minimum standards, likely to include capped charges and flexibility to allow a subsequent active choice. It might also include the option to annuitise at a later age, when longevity risk pooling becomes more important and outweighs the perceived reduction in value due to the cost of providing a guaranteed income within regulatory requirements.

6. Is the prescription of standards enough to ensure the impartiality of guidance delivered by the pension provider? Should pension providers be required to outsource delivery of independent guidance to a trusted third party?

There are advantages and disadvantages to the provision of guidance by pension providers. We would however ask that Government defines 'guidance' within the proposed new framework. The spectrum from information to advice is broad; it is important that both those charged with providing guidance, and those who will receive it, have clear expectations around its scope and content.

We suggest a disadvantage is that even if independence is achieved, the public perception may be that this is not the case. Although guidance may be free to the scheme member, ultimately someone will have to pay for the provision of guidance. If providers were to pay for guidance, it is possible that costs will be passed to scheme members albeit in an indirect manner. A more cost efficient way might be through the outsourcing of guidance to a central, independent third party such as the Money Advice Service or The Pensions Advisory Service, although costs may still be directed to pension scheme members.

Alternatively, to help reduce the compliance cost and address a perception of 'first mover disadvantage', which may prevent providers from getting involved, the Financial Conduct Authority (FCA) could develop (in consultation with industry) a new way to offer guidance in a way that is streamline and focused on consumer outcomes. This 'new way' could include setting out good practices (building on a 'Simplified Advice' policy framework) and the introduction of 'kite-marked' or explicitly FCA approved products and services. This could give consumers confidence in the products and services provided and reduce cost and compliance risk for companies.

A potential advantage of pension providers delivering the guidance, as opposed to a third party, is that they will have relationships and rapport with customers, including access to relevant data, and so be better placed to give personalised guidance.

7. Should there be any difference between the requirements to offer guidance placed on contract-based pension providers and trust-based pension schemes?

The focus should be on consumer outcomes; therefore, we would suggest that the guidance requirement generally should not be different.

However, the IFoA recognises that care would be needed to develop rules appropriate to the many types of pension scheme. It should be noted that the cost of this guidance may fall in different places. Within a trust-based scheme, the employer may (but may not) pick up administration costs in some circumstances, which may include guidance. Whereas, in a contract-based scheme, the cost will fall to the provider, although this is likely to be recouped from members within the total expense charge.

We would also encourage HM Treasury to recognise that certain types of schemes may lead to complexity. The structure of hybrid schemes could be a hindrance to such a standardised approach. Small self-administered schemes are a niche product, but the requirements of members may require special consideration.

8. What more can be done to ensure that guidance is available at key decision points during retirement?

We would encourage the development of a comprehensive approach that provides appropriate support for all members, considering those leading up to, at the point of and after retirement. This should cover all the options available under the new flexible regime, ensuring members are aware of all potential outcomes throughout their decision-making. The provision of a comprehensive approach to guidance could have considerable cost implications.

As the legislative changes mean that the requirement for guidance is likely to extend beyond one purchasing decision at the point of retirement, the IFoA believes it would be appropriate to consider the benefits and risks of delivering guidance through other channels, as opposed to just face-to-face - online resources could facilitate an individual's better engagement with their pension provision.

A.3 The government would welcome views on the options outlined in point 5.15, including their likely complexity, and the burdens they might place on scheme sponsors and HMRC.

9. Should the government continue to allow private sector defined benefit to defined contribution transfers and if so, in which circumstances?

The Government has indicated in its consultation document that it is considering a number of options in relation to future transfers from private sector DB schemes, ranging from the removal of the right to transfer (except in limited circumstances), to leaving in place the existing option and therefore allowing DB members access to the full flexibility which will be available to DC members.

The IFoA recognises the need for the Government to consider the impact of any proposal on the wider economy, individual pension schemes and the tax system.

We appreciate there are merits for each of the options mentioned. However, our view is that the Government's starting point of adopting an outright ban is unnecessary. Our suggestion would be for the Government to allow members the full flexibility, with any restrictions being kept to a minimum and based on evidence, or research, to justify their need.

Points in favour of this view include:

- We agree with the comment in paragraph 5.3 of the consultation document that transfer activity is currently low, so any increase will be from a low base.

- If there is a material increase in transfers then pension schemes may need to disinvest. The typical asset allocation of UK pension funds has changed considerably in recent years[3], with schemes having a greater allocation in lower risk assets. Where disinvestment is required, this is more likely to come from return seeking assets, which means there is a limited impact on lower risk assets such as gilts or bonds.
- There is already a great demand for low risk assets and this is anticipated to continue, so the impact of an increase in transfers will only have a small impact on the demand.
- Removal of the right to take a transfer value (an option that has been enshrined in UK law since 1986), will be seen negatively by DB members and contrary to the "freedom and choice" promised to DC members.
- Any perceived reduction in demand for gilts and bonds will be partially offset by maturing DC pots (to the extent that holders seek to invest all or part of their pot in low risk assets, or choose to purchase an annuity).
- Even if there is a ban, there is still a need for trustees to retain and keep under review a cash equivalent transfer value basis – for example, transfer values would still be needed for calculations in Pension Sharing on Divorce cases. Governance costs would still be incurred as a result.
- Removing the option to transfer DB liabilities removes one of the tools available to scheme sponsors to help them de-risk pension schemes more quickly, for example, through bulk early retirement exercises where members are encouraged to transfer to an insurer and reshape their benefits in a form that better suits their personal circumstances (some of which are listed on the next page). It should be noted that such transfers are not always in the best interest of members. De-risking of pension schemes is likely to be helpful to the wider economy as it allows companies to invest more in their businesses. There are complex trade-offs for policymakers to consider in determining appropriate courses of action in the public interest.

Before any decision is taken to introduce a ban, we believe further research should be carried out to explore the potential impact on the bond market. The IFoA would welcome the opportunity to discuss this with HM Treasury. We would suggest that the impact on the bond market, from allowing DB members the same flexibility as DC members, is far less significant than the impact of allowing DC members to take the whole of their pension pots as cash.

If an outright ban is considered by the Government to be a step too far, we agree that there are other measures that could provide protection against the risks that the Government perceives will arise relative to the scenario whereby full flexibility is allowed.

The Government has set out several changes to the transfer regime that could be considered in order to protect against the risks of full flexibility. We have commented on these below and also included some further options.

- Require members to take financial advice before a transfer can take place. We note that there are several types of DB transfer where advice is not required (e.g. transfer to an occupational DC scheme). We believe that imposing the requirement to seek financial advice would ensure that where members do transfer, they do so in full knowledge of the benefits that they are giving up. This would help mitigate the risk of members wanting to take advantage of the increased flexibility, but failing to understand the consequences on their benefits. The need to avoid this becoming a tick-box exercise should be considered.
- Limit the transfer option to be subject to a minimum age, thereby transforming it into a retirement rather than investment option. The potential for age discrimination would need to be considered.

[3] PPF (2013) Purple Book – pg. 56, Table 7.2

- Capping the annual amount that a member can transfer. This option could have the effect of increasing scheme running costs as affected members may take several years to transfer away their DB liabilities and therefore require the calculation of several transfer values. The approach might not be practical for some schemes as partial transfers are not permitted in all schemes, which would effectively result in a trapping of member's benefits in the DB scheme. This is particularly true where the individual has had long service with one employer relative to those individuals who have switched employers several times.
- Allowing DB transfers, but ring-fencing the funds (for tax treatment purposes) has some merit, but would lead to increase in administrative complexity and potential confusion for members. It is not clear whether the intention is for the fund to be subject to the current tax rules or those that applied prior to 27 March 2014.

Before any restrictions are implemented by the Government, it is important to consider how it would respond to potential criticism from members who:

1. Are single and who would have converted their pension into a higher single life pension but may not be able to do so in the future;
2. Are in ill health and who would have converted their pension into a higher impaired life pension but who could not in the future;
3. Have emigrated and who would have taken their pension with them but who could face future restrictions; and
4. Participate in a scheme where the sponsor becomes insolvent and have their benefits reduced on wind up and who claim that they would have avoided this loss by transferring out if the Government had not removed the transfer option.

The same four questions affect trustees if the Government adopts an approach whereby trustees need to approve DB transfers on an individual scheme basis.

10. How should the government assess the risks associated with allowing private sector defined benefit schemes to transfer to defined contribution under the proposed tax system?

Ultimately, it is for the Government to decide which risks are significant and the approach to monitoring these. However, we believe several risks that might arise if DB members are allowed to benefit from the full DC flexibility include:

- Lower income and greater reliance on the State in later life through members spending their pot(s).
- Members choosing to adopt inefficient, or inappropriate, personal investment strategies during the decumulation phase.
- Members not being able to estimate their own life expectancy, being more likely to underestimate, leading to pension pots being depleted more quickly than if the variation in life expectancy were understood.
- Increases in annuity rates if only the relatively healthy choose to purchase annuities; and
- An increase in pension liberation cases.

A.4 The government would welcome views on any potential impact of the government's proposals on investment and financial markets.

It is unlikely that the changes will have a major impact on capital markets, but they will have an impact on the shape of the retail wealth management / savings product market, with the potential emergence of new products to meet the needs of consumers. The IFoA would welcome the opportunity to offer our support to HMT in creating a policy framework that enables consumers to make better decisions about their long term financial planning.

Should you wish to discuss any of the points raised, please contact Philip Doggart, IFoA Policy Manager (Philip.Doggart@actuaries.org.uk/ 01312401319) in the first instance.

Yours sincerely,

Nick Salter
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