The Actuarial Profession
making financial sense of the future

Consultation response
HM Treasury: Removing the requirement to annuitise by age 75

September 2010

About the Actuarial Profession

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.

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Dear Sir/Madam

Removing the requirement to annuitise at age 75

The Actuarial Profession is pleased to respond to HM Treasury on its consultation paper dated July 2010 in relation to its proposals to remove the requirement to annuitise by age 75.

Summary of key points

In summary, the Profession has concerns, outlined below, about some of the proposals. We would welcome the opportunity to discuss these concerns further with the Government.

We recognise that the decisions people have to make at and in retirement are complex and may involve significant risk of financial loss. We are concerned that the removal of the requirement to annuitise at 75 will be presented to the public, or may be interpreted, as an endorsement that annuities are less valuable than they really are.

Pension provision is complex and many people place more emphasis on cash today rather than long term guarantees. It is important that each person secures appropriate advice, suitable for their individual circumstances, to enable them to make the best decision for their financial future.

While removing restrictions and thereby increasing people's options might have superficial attractions there is always a danger that individuals may make ill-informed or bad choices with that given freedom. It should be noted that an earlier decision, in 1988, to remove the ability for employers to make occupational pension scheme membership a condition of employment alongside the creation of personal pensions may have contributed to some of the issues around mis-selling.

We suspect that the "capped drawdown" requirements might not always meet the stated policy purpose of avoiding people having to rely on state support. Any individual who lives longer than assumed by the drawdown cap will see a gradually reducing drawdown amount that could push them into reliance on state support. We consider that annuity purchase offers an insurance, which is not provided by "capped drawdown", against living longer than average. In our view the impact assessment does not address the possible implications to the state of people opting for “capped drawdown”, and subsequently finding themselves having to fall back on state support.

We consider there is a structural weakness in the regulation of trust-based occupational defined contribution pension schemes. Because the sale of the scheme to the employer is considered to be business to business it falls outside the protections afforded to the individual consumer. Many employees work for small businesses and if their employer “buys” a trust-based pension scheme option for them there is no formally regulated body held responsible for the product sale or advice. Employees would have to take up independent advice when it came to their retirement options.

We suggest the Government could consider a range of changes to the way in which defined contribution pensions are regulated at retirement. These changes include:

1. To make information provided to people at point of retirement simpler to understand.

2. Capped drawdown could only be permitted beyond age 75, where the fund size exceeds, say £150,000 to limit the risk of future reliance upon state benefits. Flexible (i.e. uncapped) drawdown means that the provider is relying upon other sources of income – including from the state and elsewhere – and may therefore be unable to give this guarantee.

3. To seek to achieve a balance between consumer protection and flexibility. There is an important role for the Consumer Financial Education Body (CFEB) and other regulators to ensure that there is appropriate information provided as a matter of course to anyone who attempts to apply for a drawdown product so that the risks and their alternatives are clear. Mandatory information provided pre-sale and at periodic reviews should illustrate the effect of variation in future income from the product due to scenario changes in asset values, long-term interest rates as well as allowing for the impact of mortality drag and the level of income drawn from the plan.

4. To require pension providers to adhere to strict service standards in allowing pension monies to be moved between providers at retirement.

Consultation questions

A1: What is the appropriate level for capped drawdown?

We suggest the Government could consider the possibility that many people who currently annuitise may be tempted into capped drawdown.

Drawdown will facilitate taking more income than an annuity provides in the early years of retirement as well as preserving funds in the event of early death. Many people may be attracted to this.

The downsides are that the expenses of running a drawdown policy are usually higher than running an annuity. The investment and longevity risks are higher, which may lead to a wide distribution of potential outcomes. For these reasons, drawdown is not usually regarded as suitable unless overall private savings are in excess of £100,000. However, the average drawdown policy size has historically been smaller, 90% of people have pots of less than £50,000.

The challenge will be setting a level of capped drawdown that will achieve the policy aim of preventing people relying on state support. The existence of means tested state benefits could justify advice to take drawdown policies. More money may be drawndown in the early years, while people maintain their pre-retirement standard of living. In later years, they may accept a lower level of income.

We would therefore suggest that a capped drawdown could be linked to the size of an individual's fund to manage the risk of people relying on state support.

A2: Reform of framework

We consider the proposals to reform the framework are appropriate.

A3: Definition of secure income

We broadly support this proposal and have one suggested change. The proposal is that pensions that are not indexed should have nil value. However, most people have historically purchased nil escalating pensions, which are worth more than nil.

We suggest taking these in at 75%, and including life annuity income. It is important here not to distort demand for index linked annuities over fixed annuities.

A4: Appropriate amount for MIR

It should be taken as the single person's pension guarantee level, i.e. £132 per week at present. There is then a clear link between the requirement and the policy intent. Having a different figure for different ages seems unnecessarily complex. Government may wish to consider in addition to exclude eligibility to means tested income benefits from anyone who has taken flexible drawdown.

A5: Different levels for single or couples?

Since pension policies are in individual names, the limit should be by individual.

A6: Review levels of MIR

The MIR level should mirror the means tested benefit it is pegged to. It is suggested that the average earnings number is revised annually and the proportion reviewed, say, every five years in light of experience and/or changes in the welfare state.

A7: Minimise burden

We agree that the provider should police the release of funds. We suggest the Government may need to consider what form proof of pension level is to be provided and how readily available it is. Where pensions are paid net of tax, it may be harder to demonstrate the gross income equivalent.

Paragraphs 19, 20 and 27 of Appendix C of the Consultation Paper appear to indicate that the Government is expecting about 4,600 organisations to be testing about 8,000 cases per year. We are concerned at the inefficiencies which this process would entail and the disincentive to volunteer to provide flexible drawdown, particularly since the consumer is free to take their entire fund in exchange for an income tax charge, which would be of no benefit to the service provider. This could be further exacerbated if guidance on how to perform the MIR became more complex.

We would suggest that the HMRC administer the MIR test. Individuals could apply to HMRC for a MIR certificate at a fee, to keep this cost neutral to the taxpayer, with a "re-test" fee where the individual did not wish to re-apply). HMRC would have the advantage of being easily able to check on the level of basic state and additional pension payable, check that no means tested benefits were currently being paid (with the support of the DWP), check that other sources of income were consistent with the individual's tax records, spot any attempts to defraud the system and ensure the MIR test is kept up to date and consistently applied (since someone processing one case every year or two would struggle to be up to speed on all of the intricacies and potential abuses).

A8: Legislative or regulatory barriers

Allowing annuities to be bought with longer protection periods than 10 years will place annuities on a level playing field with drawdown. We suggest increasing it to 20 years to be consistent with the maximum period allowable under drawdown.

Regulation requires a huge amount of information to be provided at the point of sale of a retirement product to the consumer. The volume and complexity of information can be off-putting, hamper understanding and can be a major factor in people making poor choices at retirement. We suggest consumers would benefit from reform to the provision and presentation of appropriate information at point of retirement.

A9: Other changes

<u>Regulatory challenges</u>

Contract based DC schemes set up by employers over the last 20 years are now producing an increasing number of retirements. In contrast with trust based schemes, the contract is between the employee and the pension company and there is no governance protection for the employee. It is the pension company which benefits from poor choices made by the employee. Employers who make advice available find that inertia and ignorance often means that very few people actually take up the advice.

Trust based pension schemes are not covered by FSA regulation. There is little protection for members where trustees do not put in place arrangements to support members making appropriate choices.

We suggest the Government could consider the merits of removing the ability of a provider to sell a pension annuity or drawdown policy on an 'execution-only' basis. A duty of care responsibility (on the provider, trustee, employer or adviser) could help ensure the member is able to make an informed and appropriate choice.

At present there is poor provision of advice for people with modest savings. There is though sufficient capability to advise people. Government may consider the barriers to taking advice at retirement are similar to the barriers for starting to save for a pension. If regulations were to change such that advice at retirement became more accessible then the market can and will supply the advice.

We suggest that CFEB could provide impartial, clear, expert information on request which will encourage people to seek advice on the choices they have to make at retirement.

A10: Unintended consequences

Without appropriate safeguards, the new rules will reduce the amount of annuity business written. Experience from the defined benefit pension buy-out market indicates that a lack of competition led to poorer value for the consumer.

It is vital that these rules, which will benefit a small minority of relatively wealthy savers, do not undermine a competitive annuity industry, particularly when millions of average savers could be affected if they do not have access to appropriate advice about alternative products.

The total exclusion of non-index linked annuities from the MIR could skew demand towards index linked annuities and result in customer detriment.

We would observe that, if it is the intention for a flexible drawdown policy to attract tax-exempt investment roll-up even where there are no restrictions on withdrawing the money, this would seem rather generous. We wonder what restrictions there would be on people using their Annual Allowance as an extension to their ISA (i.e. by contributing funds into a pension arrangement and then using their MIR certificate to convert it to a flexible drawdown pot which gets tax-free roll-up). It could be argued that a flexible drawdown pot is not tax exempt on the roll-up (or there is some kind of capital charge similar to the Irish 3% mentioned in paragraph B6 of the Consultation Paper), and that once an individual exercises a right to convert a pension to a flexible drawdown pot, then they are prohibited from any further tax-advantaged pension saving.

If you have any questions or would like to discuss any of these matters further, please do not hesitate to contact us. Should you wish to do so, please contact Audrey Cosens, Administration Manager, Professional Community Support Division on 020 7632 2118 or via audrey.cosens@actuaries.org.uk

Yours sincerely

C M Instance

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Chief Executive