Institute and Faculty of Actuaries

Pension transfers and exit charges

IFoA response to HM Treasury

21 October 2015

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

Pension Transfers and
Exit Charges Consultation
Consumer Issues Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

21 October 2015

Dear Sirs

IFoA response to HMT consultation on pension transfers and exit charges consultation

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMT's consultation on pension transfers and exit charges. This response has been written by members of the IFoA who work in either the pensions or life insurance industries, including for insurers active in the pre-retirement pension market.

2. The actuarial profession has extensive and long-standing experience in both the design and management of pension savings products, together with advising sponsors and trustees of pension schemes. Accordingly, we believe the profession has an important role to play in this process, and we would welcome the opportunity to discuss our response and further research with HMT.

General comments

3. As we have mentioned in earlier consultation responses, the IFoA welcomes the Freedom and Choice in Pensions initiative. We support the principle of giving individuals the opportunity to manage their retirement income in a way that reflects their specific circumstances. However, widening the choice available to pensioners is not without risk.

4. The IFoA also agrees that pension scheme members should not face unnecessary barriers when trying to access the new pension freedoms.

5. As noted in HMT's consultation paper, there is no universal definition covering fees and charges perceived as exit charges and so there is an element of subjectivity. The FCA and tPR's evidence gathering exercise should therefore be helpful in gaining clarity over both:

    a. the extent of charges; and
    b. the circumstances in which they are applied.

6. The consultation paper explains that a majority of individuals will not face some form of exit fee when accessing the new pension flexibilities. We agree that where exit penalties do apply, they are likely to be on policies / schemes set up in the 1980-90s, rather than on products sold more recently (or still available today). However, this still leaves a legacy issue, and we hope that the results from the FCA and tPR data gathering exercise will give a clear indication of the extent of the problem.

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7. In the sections that follow, we have limited our response to those consultation questions where we believe the IFoA's expertise can add value.

Early Exit Charges (Chapter 2)

General comments

8. The IFoA agrees that accessing the new pension freedoms should be as straightforward as possible for individuals.

9. We would expect that where early exit charges are applied, they will predominate in products and pension schemes set up in the 1980-90s or earlier. Few of these schemes are likely still to be open to new scheme members.

10. In certain older scheme charging structures, fees and charges were typically applied on early exit, where an individual was looking to exit before their agreed scheme retirement date.

11. In such charging structures, fees and charges applied on early exit do not represent new charges, but relate to costs already incurred by the scheme provider when the scheme was set up. These structures were designed so that:
    a. the initial set-up costs would be recovered ***over the period*** the scheme member remained in the scheme to normal retirement age, with the costs fully recovered by the time the member reached their normal retirement date
    b. an exit charge would be required, however, if the member left the scheme before the agreed retirement age. This charge would relate to the portion of the initial costs yet unrecovered at the time of exit.

12. The initial set-up costs to be recovered were largely the up-front administrative cost of setting up the pension scheme, and the payment of initial commission to financial advisors. Fees on early exit could also be applied to meet unanticipated early disinvestment costs from certain asset types.

    Charges need to be considered as a whole for a financial product. A single premium pension plan from the 1980s may have provided more than 100% allocated to a unit-linked fund (say 110%) but then assumed that a full 1% annual management charge was available to meet costs including marketing costs over the 20 years that the policy was deemed to be in force.

13. An alternative design of charging structure recovered commission and other set up costs from scheme members by applying larger charges in the early years of their scheme membership. It was common for just a small percentage of the premiums paid to be invested in the scheme, with the balance of the premium used to recover the scheme provider's initial costs.

Question 3: In your view, what would constitute an 'excessive' or unfair early exit charge? Please include any fees and charges that you would consider to be outside this definition and why.

14. Charges and fees that are not written into the terms of a contract are unfair; charges which are disproportionate in relation to the costs incurred are likely to be unfair.

15. It could be argued that exit charges and fees are fair if they are part of the contract terms and have also been disclosed adequately. However, as noted earlier the majority of pension arrangements with early exit fees and charges are likely to date from the 1980-90s (or earlier). The level and clarity of product terms disclosure prevailing over this period generally falls short of current standards, when many sales processes were geared to generating initial commission.

16. As these policies were written a considerable length of time ago, consumers are likely to consider exit charges a penalty for exit rather than reasonable recovery of initial costs. Even where charges can be justified in relation to initial costs, the level of such charges may appear excessive to the consumer particularly by comparison to current standards. However, in such circumstances customer perception should not sway the assessment of unfairness.

17. Where the level of product disclosure is limited, this is likely to impact pension scheme members' understanding of charges that could potentially be applied at some distant retirement date. In these circumstances any exit charge that acts as a barrier to accessing the pension freedoms could be perceived by consumers as 'unfair'.

18. The pensions environment has undergone considerable change since the 1980-90s, with new products typically offering no exit penalties. Consumers may therefore consider exit charges unfair in comparison with current products.

19. Charges linked to providers current administrative costs of exit would not appear excessive or unfair.

Question 5: How could the simplicity and transparency of market value adjustments and other investment deductions (as opposed to exit charges) be improved to increase customer understanding of such fees?

20. Actuaries have long been involved in the management of with-profits funds, and many of our members have the statutory role of With-Profits Actuary (WPA). WPAs advise on the fair management of with-profits funds, including taking into account the interests of different with-profits policyholders.

21. We agree that Market Value Adjustments, or now more commonly known as Market Value Reductions (MVRs), should not be regarded as an early exit penalty (and hence outside the main scope of the consultation). With-profits funds are designed to provide a 'smoothed' return to with-profit policyholders, with investment and wider fund performance pooled between these policyholders. When applied, MVRs are used to ensure that remaining policyholders are not disadvantaged by a policyholder exiting the fund. The use of MVRs is normally restricted to early exit.

22. The IFoA agrees that (lack of) terminal bonus should also not be regarded as some form of early exit penalty. Terminal bonus is normally payable at the end of the term of policy term, but is set on a discretionary basis and is not guaranteed in advance. However, providers should be encouraged to consider the new flexibility in pensions and ensure their bonus arrangements do not unnecessarily restrict consumers' ability to access pensions freedom at dates other than the policy maturity date.

23. We acknowledge that MVRs and the wider operation of with-profits funds are not always well-understood by with-profits policyholders; this also extends to the protective benefits of an MVR to remaining policyholders. However, there has been significant improvement in the

level and clarity of explanation of how with-profit funds operate in recent years. With-profits fund providers now produce a Principles and Practices of Financial Management (PPFM) document for each of their with-profits funds. PPFMs explain in detail how the funds are managed including the application of discretion (which extends to MVRs and terminal bonus). Customer-friendly PPFMs are a more recent development, and focus on key aspects of with-profit fund operation.

Question 6: The government would welcome views on the pros and cons of each of the 3 approaches above. In particular, the government would be interested in views on particular components of an exit fee or other charges that should be considered to be in scope of any limit, and evidence on what might be the right level for any cap.

24. We agree that there would likely be significant legal concerns if the Government attempted to impose a cap on early exit fees or other contract terms on a retrospective basis. This would represent a change to existing contracts and . changing terms many years after the contracts were written may also set a legal precedent which could have wider implications.

    *A cap on early exit fees on **new** contract terms would have limited effect on pension scheme arrangements, given the general absence of such terms on contracts written nowadays.*

25. Aside of the legal issues noted above, imposing a cap on early exit fees and charges is likely to have administrative consequences for the pension scheme providers affected:
    a. providers would need to update administration systems and processes to reflect the new charging structure imposed and this task will not be straightforward where older schemes are administered on now-obsolete systems;
    b. updating contract terms, and associated disclosure on contracts which are largely decades old, is also likely to be complicated; and
    c. in policies designed with exit penalties, if these are removed, then whilst those leaving early might do better, those who keep their policy to maturity will do less well on average, unless cross- subsidised by the providers' other policyholders or shareholders.

26. An imposed cap on early exit charges will have a wider financial impact on the scheme providers, to the extent they were not now able to apply charges they were expecting to make. The actual financial impact of this will depend on the:
    a. size of the cap relative to charges;
    b. extent of early exits in practice (including how 'early' they are); and
    c. level of remaining exposure providers have to charging structures with 'back-ended' exit charges.

27. We agree that a voluntary approach to restricting exit fees and charges would avoid some of the legal issues if a cap were imposed retrospectively. However, this may be ineffective as there may be a lack of incentive for providers to introduce such voluntary arrangements given the costs of doing so.

28. If a cap were to be imposed, doing so on a flexible basis – with a focus on fees and charges which were harder to justify – could avoid some of the issues arising from a simple but 'blunt' fixed monetary or percentage cap. This is likely to best balance the interests of consumers and providers; albeit potentially being more complicated to identify which fees and charges to apply the cap and more difficult to understand.

Pensions Transfers (Chapter 3)

General comments

29. As mentioned earlier, the IFoA believes that individuals should not face unnecessary barriers when trying to access the new pension freedoms. If individuals are in a scheme that is not able to offer pension flexibility, then they should be able to transfer to a scheme that does. The process for transferring between pension providers should then be as smooth and efficient as possible.

Question 7: How is the current statutory process working in your opinion, and what more could be done to make the statutory process quicker and smoother?

30. It is important to remember that there are distinct parts of the statutory process. A customer will request a quote and the provider will supply it. However, that is a separate process from the customer obtaining advice about providers to whom payment could be made, which in turn is separate from the actual payment mechanism. A number of industry initiatives have simplified the overall process and significantly improved the time taken to transfer. However, there are no requirements to follow any of these, while some providers have only implemented them in part. Any requirement on providers to sign up to a certain initiative or standard to enable easier transfer would improve the speed of transfer more uniformly, rather than it being subject to a provider's choice.

Question 8: What are your views on adopting a separate process for transfers out where benefits are flexible? What might this process look like, and what, in your opinion, might be the risks of doing so?

31. Taking a transfer of flexible benefits could also lead to poorer outcomes for scheme members. Therefore, adopting a separate process for transferring flexible benefits should be subject to careful thought. There are currently a number of significant differences between defined benefit (DB) pensions and money purchase (MP) pensions. Many insurers already apply different conditions of transfer from DB schemes compared to MP, so formalising the different approaches between these two may actually only be recognising current practice across the market. One key difference is the need for individuals to recognise the implication of moving from a known pension to an uncertain one. This may prevent individuals from transferring between the two types of pension, which might result in a worse outcome for those members, if a MP environment would have been more suitable for their individual circumstances.

Question 9: Do you have any evidence of circumstances where receiving schemes are not accepting pension transfers in under the new freedoms, or are putting in place procedural barriers to doing so?

32. Our members' experience suggests that in some circumstances transfers to insurers may not be accepted, or the decision to transfer may be more difficult to implement. Some examples of this are:
    a. For small amounts, for example less than £1,000, which fall below a providers' minimum transfer in level.
    b. Transfers of money already crystallised where a more specialist transfer and reporting service is required. Many existing providers are unable to support this.
    c. Transfers from a product that would create the risk of the member being worse off (such as transferring defined benefits, including underpin benefits). In these circumstances, members must take advice before the transfer proceeds. This can be

frustrating for individuals if they are clear on what they want to do, given the extra cost of getting advice.

Question 10: In your opinion, what more could be done to make the process for receiving firms accepting pension transfers in quicker or smoother?

33. The process for transferring must recognise the balance between individuals having access to the pension freedoms and the protection for individuals making, in some cases, complex financial decisions. It is important that the regulations are clear about what steps should be taken to reduce conduct risk by receiving insurers. The current regulations do contain some clarity, which is reflected in provider practices. However, there are areas, such as in the case of insistent clients, where firms may consider the conduct risk too great to accept transfers where an individual wants to proceed contrary to advice.

34. Implementation of a common standard, in line with one of the existing industry initiatives, would help ensure the receiving providers can quickly access the information required from the existing provider, and will result in a quicker transfer.

Question 11: What, in your view, is the scope for making the process for transfers more efficient through a standard that works for the majority of pension savers? Should this process focus on transfers in relation to flexible benefits? How might this work in practice?

35. A number of standards already exist in the industry (e.g. Origo transfer standards). Adopting one of these standards more uniformly across firms involved in pension transfers would be a solution. Implementing such a process for flexible benefits seems the most appropriate approach and in line with existing industry practice. This would require firms to operate to a set of agreements and data formats that reduce hand-off times, with agreed service level agreements for responses to requests from other firms.

Financial Advice (Chapter 4)

General comments

36. In our response to earlier consultations on the new pension flexibilities, the IFoA noted that adequate financial advice / guidance would be crucial to individuals in understanding the pros, cons and inherent risks relating to the wider choice they face. We also noted that robust consumer protection was essential to avoid the potential risk of mis-selling or consequences of poor advice.

37. The IFoA also supports a proportionate approach to financial advice. We recognise that the cost of full independent advice could be material in respect of smaller pension pots. However, individuals with pension wealth of less than £30,000 may have a greater need for financial advice, particularly if they have limited alternative retirement benefits. Therefore, tailored guidance should be offered in lieu of full independent financial advice.

Question 12: What has been the impact of the legal requirement to receive independent advice on the process for transferring safeguarded benefits?

38. It is probably too early to assess the impact. Certainly, there has been an increase in the volume of requests for transfer value quotations from occupational schemes since the announcement of the April 2015 changes but, as yet, little increase in the volume of actual transfers. This may suggest either that members are reluctant to take the requisite advice, or

that advisers do not generally view the transfer values offered as high enough to justify a recommendation to transfer. However, it is too early to draw any firm conclusions.

Question 13: How could the process for seeking advice in relation to safeguarded benefits be made quicker and smoother, and clearer for individuals, firms, and advisers?

38. There is a limited supply of those willing and qualified to provide such advice. While this gap in the advice market remains, there will be inevitable delays in the process. The cost of advice also remains a barrier, particularly for those who would not previously have considered taking financial advice.

Next Steps (Chapter 5)

General comments

39. This consultation focuses on the extent of potential barriers facing individuals who are looking to access the new pension freedoms from age 55. If a compulsory or voluntary cap on early exit charges is introduced, then there is an argument that individuals aged under 55 should not be discriminated against if they also wish to transfer to another pension provider. However, widening the scope of any cap on charges would widen pension providers' corresponding exposure, with an increased financial impact. We also note that removing the cap on early exit fees from those aged below 55 would go beyond the policy intent of the consultation (with its focus on access to pension freedoms).

40. The initial pension freedoms have only been available for a short period thus far. It will take time for pension providers to modify their systems and processes to cope with the still new flexibilities. Therefore actual experience of the pensions transfer process under the new pension landscape is still developing.

41. As we mention earlier, the results of the FCA / tPR and wider data gathering exercises as part of this consultations will be useful in gaining clarity on the extent of barriers on early exit. We recommend that HMT reflects on these inputs, but also on developing pension transfer experience as the implemented pension freedoms start to bed-in, before reaching an informed view.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely,

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