ABI CONSULTATION RESPONSE: HM TREASURY'S FREEDOM AND CHOICE IN PENSIONS

June 2014

INTRODUCTION

The ABI welcomes the opportunity to respond to HM Treasury's consultation, *Freedom and choice in pensions* ("the consultation paper"). This submission sets out the industry's view of the proposals. We remain committed to exploring ways to improve outcomes for customers at and throughout retirement and welcome engagement with Government and the regulators as the details of the reforms are developed.

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has almost 350 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

EXECUTIVE SUMMARY

Developing a retirement income framework that will meet the vastly different requirements of current and future workforces is one of the most important policy challenges of our generation. The UK's population is ageing as a whole – from 1950 to 2010 the proportion of people aged 65+ increased from 11% to 17% and the proportion of people aged 80+ increased from 1% to 5%. The next two decades are particularly crucial, as a large cohort of people (those born 1945 – 1965) come up to retirement.

While living longer is a trend to be celebrated, an ageing population puts pressure on an unfunded State Pension and increases costs for other public services such as the NHS and social care (healthy life expectancy is not increasing as quickly as life expectancy). Rising life expectancy also means that increasingly people may be drawing pensions for longer than they have spent paying off their mortgage. Historically low interest rates compound this challenge. While longer working lives and other forms of wealth generation and transfer can help, it is important that the UK has a strong long-term savings culture.

We need a framework that drives this culture, with clear State provision based on principles of entitlement that command public support and a regulatory and political

environment that allows products to meet retirement income needs.

A number of major public policy initiatives are underway to encourage greater private saving during people's working lives. The key initiative is automatic enrolment, and should see at least nine million people newly saving or saving more into their pension.[1] Customers with greater long-term savings are better able to respond to the various financial shocks that can occur in later life, without the need to rely on additional State support. This is positive for the individual, as well as for the State. There has also been a major leap forward in the form of the single-tier State Pension.

However, it is clear that we need as fundamental an approach to meeting the in-retirement needs as the Turner Commission took towards workplace pension saving ten years ago. The changes in the Budget 2014 are such a change, with a move towards more control and responsibility for the individual over how to use their pension savings through later life. The proposals have wider social implications for how people save and spend in their later life, and will need monitoring over the long term to understand their impact.

The Guidance Guarantee

One of the key proposals in the consultation paper is the Government's "guarantee that individuals approaching retirement will receive free and impartial face-to-face guidance to help them make the choices that best suit their needs," to be delivered by April 2015.

Pension providers have a crucial role in preparing people for retirement. ABI members are committed to helping customers understand their options and enabling them to make good decisions. They are well placed to deliver guidance which is objective, product-neutral and sales-free, as they do now, and will continue to do.

However, the Government has set an extremely ambitious timetable: the guidance guarantee must be in place in April 2015. We believe this means it must make use of the existing guidance infrastructure. Therefore, for April 2015 the guidance guarantee should be delivered through existing guidance services such as MAS, TPAS and Citizens Advice. This should make use of the £20m seed funding and will establish content and standards specific to the guidance guarantee and secure capacity.

As the scope of the guidance guarantee is established, and the content and standards become clear, Government and FCA should continue to review the role of providers and utilities, and whether providers and others with a commercial interest can deliver the guidance guarantee themselves in a genuinely impartial way. This should also take into account what emerges on related policy areas: the FCA's work on access to advice and the advice boundary, the Retirement Income Market Study and the wider tax changes to implement pension flexibility. This ongoing review could happen in parallel with development of the utility/ies.

The impartiality of any organisation with a commercial interest in the outcome of guidance will be questioned by some parties; and standards may not be sufficient to ensure that it is *perceived* as impartial by customers, media and stakeholders. Customers' behavioural biases can also inhibit shopping around: people are more likely

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[1] DWP, https://www.gov.uk/government/news/pensions-savings-9-million-newly-saving-or-saving-more-says-pensions-minister

to buy a product from the service that gives them guidance, however impartial the information given to them may be.

Delivering the guidance guarantee through existing guidance services means that no additional outsourcing arrangements will be required – central services, to which providers and schemes already signpost, will be in place but with a more prominent role in the customer journey. These services will able to give an alternative perspective, if the customer needs it, in addition to any information and guidance given by the provider or scheme or commercial services that they use.

The new tax framework and wider environment

The Budget proposals also offer the opportunity to create simple rules for how people can access their pension. This could provide the framework for further innovation to help people cover the varied risks that they face in later life. Government therefore needs to be mindful of the overriding principle of freedom and choice when revising the tax rules to underpin the new system. Government's role is to decide the tax treatment of pension savings on the way in, whilst invested, and on the way out. The tax rules should be permissive and not constrain providers' flexibility in product design.

We want to ensure that the rules in place after April 2015 strike the right balance of creating a simple and flexible framework while also providing the right protections to customers. Creating the new rules should start with the customer – how to ensure greater flexibility in a world where there will be no such thing as a single retirement point. We have a number of suggestions for how Government can encourage innovation within the retirement income market which are set out below. Annuities will continue to form part of the solution; to this end, consumers should not be able unilaterally to unpick existing annuity contracts seeking to surrender for cash.

The new rules must uphold the current tax relief framework for consumers, including the 25% tax-free pension commencement lump sum. While we would like to see a debate about the best way to incentivise pension saving, we do not think that the new tax rules for April 2015 should incorporate further fundamental changes to the system.

We support increasing the age at which an individual can take their private pension savings, and specifically the proposal to increase the age from 55 to 57 in 2028. We believe that 2028 is sufficiently far away that people for whom this applies will have enough time to consider how the new age limit affects their options.

We understand that the introduction of new freedoms for DC may encourage transfer out of DB schemes. Members of DB schemes currently have the right to transfer their benefits to a DC scheme, and this right must be retained. It is only fair that all pension savers have the full range of options open to them.

Our main concern is to ensure that people in private DB pension schemes carefully consider their decision to transfer out. We also recognise that this poses a risk to employer-sponsors as well as having implications for the wider economy. We therefore recommend that conditions should be placed on the right to transfer, including a requirement on the potential transferor to take regulated financial advice.

Finally, consumers can derive significant benefits from being in DB schemes, particularly those with generous terms and guarantees. When including the tax free cash option, DB

schemes can provide flexibility as well as an income for life. There has been a decline in the number of DB schemes over time and to keep those remaining schemes running, the Budget proposals must not prevent trustees from being able to use insurance tools to manage risks and assets.

It is still too early to determine the full impact of the Government's proposed reforms on DB and DC schemes' investments. We do however envisage that there will be a change in what investments are made and for how long, and the change in assets that is likely to occur may result in a more diversified mix. The industry and Government need to work collaboratively to ensure that efficient markets are in place to adapt to new flows of money in and from pensions.

There are at least three sets of rules governing consumers' pension savings – legislation (tax rules and DWP rules on governance, administration, scheme quality etc), prudential and conduct regulatory rules, and contractual and trust-based scheme rules – and we must all work together to ensure that a coherent framework is in place to meet consumer needs. The scale of change and the need to avoid customer uncertainty means that Government, particularly HMT, must take a lead role in coordinating and ensuring pace so that changes can be implemented in time for April 2015. Clarity on all key legislative and regulatory changes will need to be received at least six months prior to the effective date of April 2015.

Insurance is a sector which delivers a huge and complex range of services to citizens and business. The industry manages significant investments and is a major contributor to the Exchequer in taxes.[2] The proposals have the potential to have a transformative effect on the industry; however they must be managed carefully through robust cost benefit assessment and with the practical impact on consumers in mind. The Government, along with the regulators, must be coordinated, move at pace and work together with the industry.

RESPONSES TO CONSULTATION QUESTIONS

1.1 A new tax framework for retirement (chapter 3)

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

While the ABI agrees with the statement that current tax rules stifle innovation in the retirement income space, innovation has occurred in the retirement income market despite the limitations imposed by tax rules.[3] The ABI is encouraged by the possibility of a simple and flexible framework that allows for a greater range of financial products to help people cover the varied risks that they face in later life.

[2] The industry managing investments amounting to £1.8 trillion, employing around 320,000 people and contributing £10.4 billion in taxes (in 2010/11 – equivalent to 1.9% of total Government tax receipts). ONS, The Blue Book, 2013 edition. TheCityUK. ABI Research Paper No. 29, 2011 – Total tax contribution, conducted by PwC for the ABI. Of this, £3.2 billion relates to income tax on employment income and annuities, £2.7 billion of Corporation Tax and £1.6 billion of Insurance Premium Tax.

[3] HMT consultation document, p 15.

We note that the consultation paper states that the new system will see no changes to pensions tax relief during the accumulation phase of pension saving.[4] We agree that the rules should uphold the current tax relief framework for consumers, including the 25% tax-free pension commencement lump sum. People are encouraged into automatic enrolment by the tax relief, and also base their retirement plans on the tax-free cash, and incentives should not be removed without a coherent alternative and appropriate notice to allow individuals and the pensions industry significant time to adjust. While there should be wider consideration about how to incentivise pension savers through tax incentives across the pension's lifecycle, we believe that this is such a major issue that it should not be conflated with the Budget changes for April 2015 which in themselves are a major development.

We also strongly encourage Government to maintain its stance that under new rules those who have already purchased an annuity remain bound by the contract they have entered into.[5] This means that customers cannot unilaterally break the annuity contract and surrender it for cash. This is important: it prevents the proposals from having retrospective effect; it maintains the long-term investments underpinning the annuity; and it would be an expensive and disruptive process to unwind the contracts.

As well as the pension tax changes required, consideration should be given to the broader regulatory and legislative landscape. As noted in our response to Question 2, a degree of alignment is needed between the new tax rules and the FCA regulatory regime, particularly in the perception of risk to the customer from certain products. Other rules, including court rulings, impact on pensions including bankruptcy law and divorce/separation law. For instance, earmarking orders can sometimes refer to the ex-spouse being entitled to 50% of any annuity payments/scheme pension – this may not capture the new range of options.

We are also mindful of the impact of taking pension savings as lump sums on welfare entitlement. Our starting principle is that people should not be penalised for taking personal responsibility and providing for their future. We would like to see work by DWP's welfare team and DH's social care team to look at the impact of the Budget measures on consumers.

Key aspects of the new system need to be clarified as soon as possible. Time is needed to amend systems, which makes it preferable that providers have the opportunity to feed in early about what works and also have clear insight about what will be implemented.

Question 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?

In principle, if there is to be full flexibility, then it should be available to all pension savers so that they have the full range of options from which to choose a good outcome. A statutory override to bring pension scheme rules in line with new legislation would allow customers to benefit from the new freedoms. An override would also avoid a lengthy and costly process, as providers of contract schemes can be required to seek each customer's permission before being able to make a change to the contract.

However, some schemes (such as legacy schemes) may not be designed to accommodate access to the full range of options. While the statutory override would

[4] HMT consultation paper, paragraph 3.23, p 24.
[5] HMT consultation paper, paragraph 3.22, p 24.

reduce the efforts to change scheme rules, it would also create significant and costly changes to bring administrative systems in line with new rules. This change would be particularly major if the intention is that the pension can be used like a current account for partial withdrawals.

Therefore, we recommend that the statutory override allow (but not require) schemes whose rules would otherwise preclude it to offer the new flexible income options if they wish to (i.e. the override should not force providers to provide the new flexibilities). Where the individual would like to take up other options on the market, be it an annuity, drawdown or something else, then the provider should facilitate a transfer to another provider or different scheme.

If a statutory override is established, providers should be able to treat full withdrawal payments in the same way as under current triviality rules – that is, using a standard approach to tax rather than an individual specific one. A standard approach would see the provider apply a single tax rate to all withdrawals, with the individual responsible for completing a tax return if a different tax rate should apply. We note that there are payroll implications.

Because the statutory override will directly interact with scheme rules, it is important that providers have the opportunity to review and provide input on the technical application of the override mechanism. This will ensure that the mechanism works effectively. We urge HMT to work with industry on this.

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

The retirement income market was already evolving pre-Budget as pension pots grow and consumers' expectations of later life, and how to pay for it, change. Innovation and market entry has yielded more choice and more competition, with annuities remaining a good option for many people who need a secure income. There are 14 providers who offer annuities on the open market, and 12 providers of enhanced annuities based on health or lifestyle factors. The proportion of enhanced annuities continues to rise and was at 28% in Q4 2013, with more people with the smallest pots buying enhanced annuities. Guaranteed Annuity Options may also be available under existing contracts, a benefit that has existed for many years, and in the current low interest rate environment, can provide an increased income from a pension pot.

There is also a comparatively small, but growing, market for investment-linked annuities (7% of annuities were investment-linked in 2013) and there are about 21,000 new drawdown customers every year. Overall the existing market offers customers security with some flexibility within the rules set by the Government and regulators.

However, with the introduction of the new flexibilities, Government has a responsibility to design a new system that provides both good outcomes for consumers, with the right protections, and enables the retirement income market to innovate further. We believe the Government has three important duties:

- Recognise that innovation is driven by consumer demand, and take a lead in creating an engaged consumer base who are equipped to make choices about how to fund later life;
- Develop simple rules so that new, flexible and engaging products are possible, while

also maintaining the right level of consumer protections; and

- Coordinate and steer policy that affects the development of the market, so that Government and regulators' objectives align and the industry is incentivised to innovate.

Innovation driven by consumer needs – engaged consumer base

We emphasise that consumers do make choices about their retirement income, which in turn drives provider supply of products. Our 2013 customer research found that, while levels of understanding of type of annuity vary, 84% of people who had bought an annuity were aware of the option to buy a joint life annuity, and married customers who did not purchase a joint annuity more commonly made a conscious decision not to. Our statistics also show that most people do choose some form of death benefit – either a joint life annuity or a guarantee period.

Financial services providers have a responsibility to ensure that products meet consumer needs, but providers are also acutely aware that products must be what consumers want and can afford. In the Department of Health's rapid review of the role of financial services products for social care, the industry explored the potential for greater use of retirement income products to help pay for care.[6] While the review found that there could be new social care products, lack of consumer demand was the major inhibitor.

The DH rapid review also demonstrated the difficulty of predicting consumer behaviour when a major reform takes effect. In social care, part of the rationale for the introduction of a cap on eligible care costs was that it would encourage people to plan ahead by creating a known amount to plan for. However, it remains unclear whether and how people will plan ahead, and providers will have this in mind when thinking about committing capital for product development. We believe that the reforms to the retirement income market will have an even greater impact on consumer behaviours, and therefore it will take time to understand what consumers want and need once these new choices are available.

Innovation within the retirement income market must be driven first and foremost by consumer demand. We need engaged consumers with the capability to consider options based on their circumstances and what the market can offer to meet their aspirations. It is necessary to create a savings culture where people progress through life actively building and adapting their personalised income solution so that it covers their needs and risks in later life. We know that consumers can be helped further to make good decisions about their retirement income, and have introduced a number of initiatives (including a compulsory Retirement Choice Code of Conduct) to achieve this change. The guidance guarantee will also help with this, as will the ongoing communications between customers and providers, but we need a strategy that creates engagement.

This will need Government leadership, and joint work to develop engagement and holistic planning. This applies at the savings end, where savings levels need to be further increased, and at the spending down end. An example of an area that requires Government support is the public awareness campaign on social care, which we would like to see at least on the scale of automatic enrolment. The Government's commitment

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[6] https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Social%20care/Developing%20Products%20for%20Social%20Care%20Report.ashx

to delivering an awareness campaign will be crucial in communicating the message to consumers that, even with the cap, they may bear significant costs arising from social care in retirement and should plan ahead and anticipate how to manage these costs.

Of course, consumer demand and appetite for products will be influenced by the size of their pot. Currently we see a significant proportion of pension pots that are relatively small, thereby making options like taking cash more attractive. We would expect that over time, as pots grow, more choice and innovation will occur to cater to a larger market of people with bigger pots.

Simple rules for flexible products

The tax rules act as limits on the shape of retirement income products and this is rightly recognised in the consultation paper. For instance, a lifetime annuity must be payable for the member's life or up to a term of 10 years after death if a guarantee is purchased.[7] The annual amount of the lifetime annuity payable is also limited in that it must not go down except in the specific circumstances prescribed by HMRC regulations. There are many possibilities for new retirement income products, such as an annuity that provides varying payments according to customer needs – these are currently not possible because current tax rules do not allow the annuity amount to decrease except in narrowly defined circumstances.

New rules should meet certain principles of design, so that they fit within a modern tax code and meet changing consumer trends. The principles that we would apply are:

- *Proportionate and effective tax rules.* In March 2011, the House of Commons Treasury Committee set out six principles with which tax policy should comply. These are: basic fairness; supporting growth and encouraging competition; certainty, including simplicity; stability; practicality; and, coherence. Overall, rules should achieve the desired objective.
- *Supporting flexibility and the intention of Budget measures.* We want to ensure that the new rules do not undermine the principle of flexibility or unnecessarily frustrate consumers' understanding of how the new rules will work. To maintain flexibility as far as possible, any new restrictions should be targeted at avoidance behaviours.
- *Protecting the interests of consumers.* This has a number of aspects – rules should:
    - Be simple and easy to understand. We are thinking about how the rules will be explained to customers, and particularly those who might inadvertently 'trip' into the scope of avoidance rules.
    - Allow people to build up a reasonable pension pot for retirement through tax relieved contributions.
    - Recognise that phased retirement is the new normal, and that people increasingly work while also drawing on savings.
    - Recognise that not all people have access to other savings to help them during hard times (such as ill-health or when facing unmanageable debts), meaning that a pension can be the only source of financial support. Rules should allow people to access their pension pot (once eligible, i.e. over 55), but return to pension saving at a later time when not under financial pressure.
- *Working with, not against, other Government policy*, particularly automatic-enrolment and the fact that consumers must opt out to stop contributing to their pension scheme. Other policies where there may be a conflict include longer working lives,

[7] HMRC, http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM09101710.htm

automatic transfers ("pot follows member") and the application of the guidance guarantee.
- *Making this work for April 2015.* The new rules for tax planning/avoidance are just one set of measures that need to be in place for April 2015, and we must think practically about how to ensure the whole package can be implemented smoothly in time.

The ABI is participating in HM Treasury's technical working group on the changes to the tax framework and will feed in our detailed comments through that forum. On the specific tax avoidance issue, measures should be targeted at those who seek to abuse the system and should not impact on those needing to access their pension savings whilst continuing to work and build up further provision for their later life.

Overall, we need simple rules with the right consumer protections, which are proportionate and limit regulatory costs as these are ultimately passed on to the customer. Where rules do not make sense in the new post-April 2015 environment, they should be scrapped.

Coordinated policy creating the conditions for innovation

It is important that the Government works with all key stakeholders to coordinate and, where possible, align policy initiatives so that the conditions are in place for innovation. There are two particular areas which need attention:

- The relationship between Government policy initiatives, EU rules and regulatory rules, which can create limits on provider innovation; and
- The indirect impact of other Government policies and factors on the market.

The following three examples demonstrate how government and regulatory initiatives can create limits on provider innovation. We do, however, acknowledge the importance of independent regulators and the crucial role they play in supporting consumer confidence in the financial system. We are encouraged by recent statements by the FCA about the need for innovation.

The first example is in the application of conduct rules. There is a perception in the industry that the FCA's view of the risks to consumers from different retirement income products is at odds with Government's view. This may limit the availability of products deemed "risky" by the FCA. For instance, as recently as March 2014, the FCA stated on its website that: "A drawdown pension, using income withdrawal or using short-term annuities, is complex and is not suitable for everyone. It is riskier than an annuity as the income received is not guaranteed and will vary depending on the value and performance of underlying assets."[8] In the same month, the limits for drawdown were lowered with the Government direction that "these changes will allow those with some form of defined contribution pension wealth much greater choice and flexibility over how and when they access their savings. The government estimates that an extra 85,000 people will be eligible to access flexible drawdown, or to take their pension wealth as a lump sum this year if they so wish".

Similarly, many of the features that have found favour with DWP in the Defined Ambition and Collective Defined Contribution (CDC) policy space have been separately

[8] FCA, http://www.fca.org.uk/firms/financial-services-products/investments/drawdown-pensions

questioned by the PRA as they apply to with-profits. For example, in February 2013, Andrew Bailey said of with-profits: "There is of course a logic to pooling returns, but for the policyholder the return can be complicated, and sometimes made opaque, by the practice of pooling different generations of policyholders who may have different expectations on their returns (conditioned, for instance, on changes in the external environment); and by the practices of smoothing returns and of charging differentially for the economic value of the guarantees..."

The second example is of regulatory developments (such as the European Union's impending Solvency II regime) raising the possibility of insurers having to set aside higher levels of capital against the business that they write. Although partially mitigated by recent agreements in the Omnibus II Directive, there are still high costs of capital associated with long-term insurance business. There are also regulatory start-up costs and risks, such as authorisation and permissions and developing literature.

The final example is of the burden of policy development on the industry. This is a pivotal year for automatic enrolment, but the industry is also addressing the implementation work for a pension charge cap, an audit of older and higher charging legacy schemes, new governance and quality standards rules, as well as a retirement income market study. An unstable policy and regulatory environment, with frequent changes to rules, creates uncertainty that is not conducive to innovation and competition, particularly for long-term products.

As to the indirect impact of other Government policies and factors on the market, the retirement income market is not just a matter for financial services regulation. Sufficiency and flexibility of retirement income in future will be a major challenge for the nation. People face many financial needs and risks in retirement, and the degree to which retirement income products can address those needs and risks are influenced by the State as well as the market. Where Government seeks certain behaviour, such as planning ahead for social care costs, it needs to be clear about what incentives it is willing to introduce to drive change.

The Government and independent bodies such as the Bank of England also determine structural factors and influence macro-economic factors, e.g. Quantitative Easing has clearly had an impact on long-term interest rates. The risk associated with external factors – interest rates, longevity and the future cost of administering the product – is likely to affect how attractive it is to enter these markets.

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

The UK has an ageing population and private savings have to extend over longer periods, and therefore we are in favour of increasing the age at which DC savings are accessible from 55 to 57 in 2028. Again, in coming to this conclusion, we have weighed up the impact on the consumer. People need to be able to plan out their later life, including when they phase down from work. It is therefore encouraging that the rise in minimum pension age from 55 to 57 will not happen until 2028, which should provide sufficient notice to pension savers.

We also agree to some alignment of rules, so that access is available in all circumstances from a certain age, which greatly reduces complexity. We expect that access for exceptional circumstances, such as ill-health, as well as existing protected

pension ages, will continue to be allowed. We think it is sensible for the new minimum pension age to apply to those who have not attained age 55 before, say, 6 April 2028. This means that an individual who had the ability to take benefits before this date would not lose it after this date if they had not attained age 57.

We are however concerned about consumers having their trust abused through 'scams', and worry that a standardised minimum pension age could heighten this because there will be a known point when people can take their savings; the risk is exacerbated by the new ability to access pension savings as cash without the tax penalty of 55%. On-going monitoring of how the pension liberation sector develops is necessary, and particularly where scams extend beyond 'products' or 'schemes' regulated by HMRC and/or the FCA and TPR. It also underlines the importance of providers and other market participants such as the regulators and consumer organisations providing good information, guidance and advice. This includes the guidance guarantee.

Finally, we have considered the merits of pegging the minimum pension age to rise alongside the State Pension Age. We believe this is worth exploring, as it would provide an independent mechanism for increasing the age, and would ensure that the gap between the accessibility of the private pension and the State Pension did not grow further. We question whether it should be pegged against the State Pension Age, or whether the reviews of the State Pension Age established by the Pensions Act 2004 should also incorporate review of the minimum pension age.

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

We support a single minimum pension age on the grounds of simplicity and fairness.

Maintaining consistency between pension schemes seems appropriate, but the practicalities of implementation would need to be examined for some older style arrangements. We recognise that consumers can transfer between arrangements to access additional flexibility should they wish.

We think that there may be a bigger impact on DB than DC schemes, however further analysis is needed on this.

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

On balance, we believe this is unnecessarily restrictive. Private insurance and savings are there to fill the gaps where there is no State support, and having access to their private pension savings could provide a lifeline for people who are not yet eligible for the State Pension. A five year gap would mean that over the long term, the minimum pension age could rise to well over 60 as the SPA could move up further and many people may not be able to work for that long.

1.2 Supporting choice (chapter 4)

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

Question 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?

The Annex sets out key points from our work with KPMG on development of models for the guidance guarantee. This emphasises that impartiality is an important consideration, but far from the only consideration in the choice of delivery channel. It also sets out:

- Design principles
- How it is promoted
- What it covers
- Which types of customer might use it
- How it fits into the overall customer journey
- Delivery options – whether by a process or experts
- Success measures
- Costs
- Demand
- Funding mechanisms, including who should pay
- Considerations for launch
- Next steps

These considerations are set out in more detail in the Annex which draws on modelling work we have undertaken with KPMG and our members. We would be keen to continue to discuss the development of the guidance guarantee with the Government, FCA and other stakeholders.

Pension providers have a crucial role in preparing people for retirement. ABI members are committed to helping customers understand their options and enabling them to make good decisions. They are well placed to deliver guidance which is objective, product-neutral and sales-free, as they do now, and will continue to do.

However, the Government has set an extremely ambitious timetable: the guidance guarantee must be in place in April 2015. We believe this means it must make use of the existing guidance infrastructure. Therefore, for April 2015 the guidance guarantee should be delivered through existing guidance services such as MAS, TPAS and Citizens Advice. This should make use of the £20m seed funding and will establish content and standards specific to the guidance guarantee and secure capacity.

As the scope of the guidance guarantee is established, and the content and standards become clear, Government and FCA should continue to review the role of providers and utilities, and whether providers and others with a commercial interest can deliver the guidance guarantee themselves in a genuinely impartial way. This should also take into account what emerges on related policy areas: the FCA's work on access to advice and the advice boundary, the Retirement Income Market Study and the wider tax changes to implement pension flexibility. This ongoing review could happen in parallel with development of the utility/ies.

The impartiality of any organisation with a commercial interest in the outcome of guidance will be questioned by some parties; and standards may not be sufficient to ensure that it is *perceived* as impartial by customers, media and stakeholders.

Customers' behavioural biases can also inhibit shopping around: people are more likely to buy a product from the service that gives them guidance, however impartial the information given to them may be.

Delivering the guidance guarantee through existing guidance services means that no additional outsourcing arrangements will be required – central services, to which providers and schemes already signpost, will be in place but with a more prominent role in the customer journey. These services will able to give an alternative perspective, if the customer needs it, in addition to any information and guidance given by the provider or scheme or commercial services that they use.

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

There should be no difference between treatment of trust-based schemes and contract-based schemes, and the Government and regulators should avoid assumptions about differences between these. It makes no sense to customers, and adds cost and complexity to providers, to treat these differently. Many people will have pension savings in both types of scheme, and many ABI members run both trust-based and contract-based schemes. Regulators have made efforts to ensure the experience of taking benefits from both types of scheme is logical and consistent, and this should not be undermined.

Trust-based schemes will also face impartiality challenges. For example, guidance from the Pensions Regulator strongly encourages schemes to appoint an adviser or annuity broker, and these types of firm will have a financial interest in the outcome of the guidance guarantee, and therefore their impartiality will be questioned. Extending this argument further, a trust-based scheme may have a financial incentive (and it may be in other members' best interests) either to keep retiring members in the scheme, or for them to leave.

Many trust-based schemes and contract-based schemes offer outsourced or in-house information, advice and guidance services to their members at retirement. These are valuable to those who use them, and should be retained but viewed separately to the guidance guarantee.

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

The Annex sets out further some of the considerations in provision of guidance about retirement more widely. The guidance guarantee should not seek to meet all guidance needs, but the Government, regulators and the wider industry should work together to ensure people have access to other forms of guidance to help them make decisions about retirement, which will be more complex following the Budget.

Regulated financial advice clearly has a role in helping people to understand and make choices throughout retirement, and it will be important to have early clarity from the FCA on its work on the advice boundary, which has implications for retirement guidance and access to advice more generally. For customers without an adviser, there are certain subjects that the provider or scheme is best placed to discuss with the customer: the assets they are invested in, charges, any guarantees they have and how they want to take retirement benefits. Other guidance services are better placed to discuss subjects

such as options for long-term care, debt, state benefits, work, tax and information about other providers' products. The key will be for these different types of service to work together effectively in a way that makes sense to customers.

1.3 Defined benefit schemes (chapter 5)

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.

It is only fair that pension savers have the full range of options open to them, and therefore the right to transfer to DC should remain. Our main concern is to ensure that people with private DB schemes carefully consider their decision to transfer out of the scheme. In deciding to transfer, members will need to consider the transfer value. We therefore make suggestions about how to manage the risk to the consumer, as well as to schemes.

Trustees of DB schemes currently have the ability to manage their risks through insurance solutions, such as buy-outs, buy-ins and longevity swaps. Solutions towards the buy-out end of the spectrum mean that some or all members are transferred out of the scheme and have their pension rights secured through insurance such as a deferred annuity. We are especially concerned to ensure that the proposals do not prevent trustees from being able to access insurance tools to manage the risks and assets of scheme members and the employer-sponsor. The ability for consumers to opt out of the buy-out plan and take a transfer before the scheme winds up should continue.

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

For most savers in DB schemes, it will make sense to remain in the scheme and receive a scheme pension. People with DB pensions will have a guaranteed income for life, with inflation protection, guarantees and dependent benefits. There is also some flexibility, as cash can be accessed through the pension commencement lump sum.

However, DB pensions are not the right solution for everyone, and the options available in DC decumulation are more flexible and provide a broader range of options especially from April 2015. For example:

- The fixed shape of a DB pension will not be appropriate for all members. Some members' needs will be better met by having more flexibility over how much income to take and when to withdraw it. Similarly, some may require a short-term income rather than an income for life.
- Those who are unmarried or with a reduced life expectancy may be able to obtain a higher, more appropriate income from DC.
- The DB framework does not generally support the phasing-in of pension income to allow a gradual withdrawal of working hours, as it is usually a requirement to stop working for the employer when drawing pension benefits. With the trend away from a retirement "cliff-edge", towards a gradual reduction of work, this will increasingly become an issue that stifles employment opportunities. This, in turn, could be bad for the economy.

Members of DB schemes currently have the right to transfer their benefits to a DC

scheme, with or without trustee consent and with no requirement to take advice, at any time until 12 months before their normal retirement date.[9] Each individual's circumstances are unique and it is therefore important to retain and provide flexibility for income choices at retirement. We believe that it is only fair that pension savers have the full range of options open to them, and therefore the right to transfer to DC should remain.

Members with DC rights in the same scheme as their DB rights (hybrid schemes) should also have the same access to options as if their rights were only in a DC scheme. Consideration and appropriate protection is also needed for people with, for instance, section 32 policies.

There are existing controls to manage the risks from transfers:

- Funded liabilities – unlike most public sector schemes, the funded nature of private sector DB schemes means that the money to make transfers to DC arrangements should be more readily available.
- Employer benefits – while transfers can be beneficial to the individual (in the circumstances noted above), transfers can also be beneficial to both the sponsoring employer's balance sheet and the scheme's funding position, improving security for those members remaining in the DB environment.
- Regulatory safeguards – the existing framework also provides safeguards where schemes are underfunded, by allowing transfer values to be reduced to reflect the underfunding. This protects the position of remaining members and the employer's balance sheet. In these circumstances, it may be best for the individual not to transfer. This highlights the importance of receiving regulated financial advice.

Further controls could be introduced to manage concerns about member outcomes and the impact on the economy:

- A requirement to take regulated financial advice about the transfer.
- The right to transfer would not apply to members with a scheme pension in payment.
- There would be a mechanism that trustees can activate if allowing the transfers would cause significant instability within the scheme.

Advice and guidance

Our main concern is to ensure that people with DB benefits carefully consider their decision to transfer out of the scheme. They need to be fully cognisant of the benefits and risks of their choices:

- Members should be aware of the transfer value set by their scheme sponsor.
- In transferring out of a DB scheme, the member will be taking on the longevity risk (and potentially other risks) previously managed in the scheme.
- In DB there are basically only two options – to trivially commute if within limits, or to take a scheme pension (an individual can also take tax free cash). However, in transferring to a DC scheme, there is a greater range of options.

[9] See Pensions Scheme Act 1993, Chapter IV Transfer Values.

There is a strict Code of Conduct governing group incentivised transfer exercises where all pre-retired members of DB schemes are offered the opportunity to take a transfer value. The Code requires the opportunity to take paid-for independent financial advice where the scheme instigates the transfer.

We think that people considering a transfer should be required to take professional financial advice about the transfer. If it is member initiated, we believe it only fair that it should be at their expense. Otherwise, there is a risk of a large number of speculative enquiries and the aggregate costs could damage the interests of scheme members as a whole. Full regulated financial advice should be supported by information and guidance provided by the scheme.

Treatment of pensioner members

We understand that the introduction of new freedoms for DC may encourage transfer out of DB schemes, and that this poses a risk to employer-sponsors as well as having implications for the wider economy. We therefore propose that people with a DB pension in payment should not be able to transfer out. This aligns the approach with that for DC, as it would be the same as where an individual has an annuity contract where they are not able to unilaterally terminate the contract.

Separately, given the benefits that accrue from a DB benefit, we would not expect significant numbers of active members to transfer out. This means that the proportion of people likely to transfer is reduced further.

If pensioner members of DB schemes are unable to transfer out, this would reduce the potentially affected group by nearly 40% (see below table, PPF *Purple Book 2013*).

Table 3.5 | Membership by membership type and status, as at 31 March 2013*

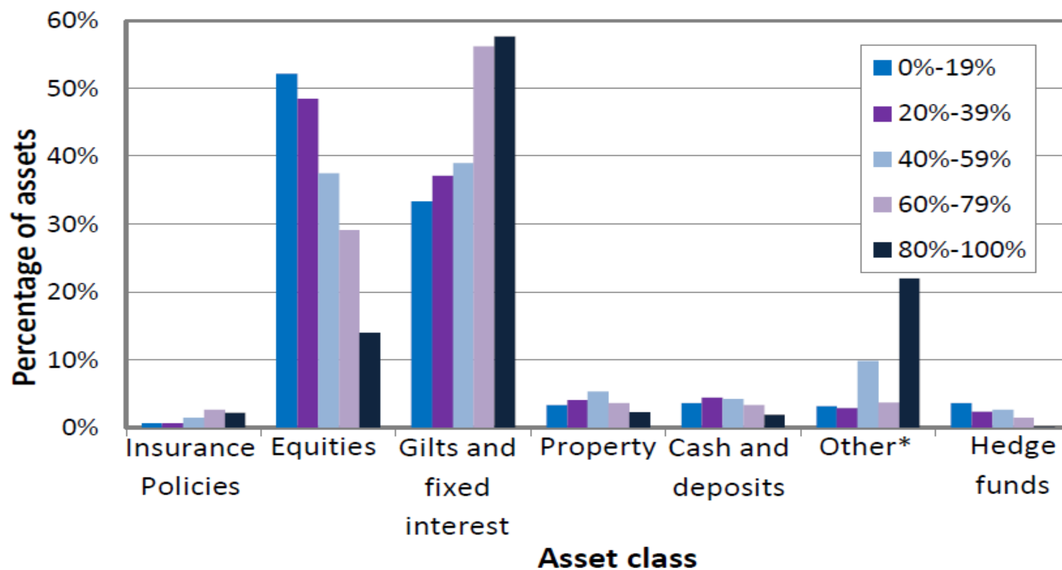
	Open	Closed to new members	Closed to future accrual	Winding Up	**Total**
Active members (millions)	0.82	1.10	n/a	n/a	**1.91**
Deferred members (millions)	0.95	3.35	0.84	0.01	**5.15**
Pensioner members (millions)	0.85	2.94	0.56	0.01	**4.36**
Total	**2.62**	**7.38**	**1.40**	**0.03**	**11.43**

Not allowing transfers when the pension is in payment also makes sense in terms of the investment approach. The DB schemes most heavily invested in fixed interest and hedge fund assets are those which have the highest average age profiles, with predominance of members already retired and drawing pensions, or close to retirement (see chart below, PPF *Purple Book 2013*).[10] This is confirmed by the NAPF study, which indicates fixed interest holdings of 40% of assets for schemes closed to both new members and future accrual, but only 17% for schemes open to both new members and

[10] Please see the PPF's *Purple Book 2013* for background on Chart 7.4, including what assets fit within the 'other' category.

future accrual.

Chart 7.4 | Weighted-average asset allocation of schemes by current pensioner liabilities as a percentage of total liabilities



Schemes most heavily invested in equities have a lower age profile (because they are still open to new younger entrants) and therefore have a longer investment horizon before liabilities fall due.

<u>Trustee mechanism</u>

We suggest that there could be a mechanism which trustees could apply if, by allowing transfers, the scheme would become unstable. This would be similar to the current rules which allow trustees to provide individuals with a lower transfer value if the scheme is under pressure. In considering this, we note the following points:

- If a member of a private DB scheme loses confidence in the scheme's sponsor, he or she may seek to transfer out of that private DB scheme.
- The Pension Protection Fund (PPF) was established to pay compensation to members of eligible DB pension schemes when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the DB scheme to cover the PPF levels of compensation. However, the PPF is limited and does not protect the affected consumers' entire pension amount.

The mechanism could be established within trust deeds, and could allow trustees to provide lower transfer values or to extend the time period between receiving the request and making the transfer.

Question 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?

As highlighted in our response to Question 9, there are a number of risks associated

with allowing members of private sector DB schemes to transfer to DC schemes. These risks can be described as follows:

- Risks to consumers: Consumers who choose to transfer from a private sector DB to DC scheme should be aware they are taking on the longevity risk previously held by the DB scheme sponsor.
- Risks to DB scheme sponsors: Risk managers are best placed to set an appropriate transfer value to manage the effect on the remaining scheme members. It is important that DB scheme trustees continue to have the flexibility to set the level of transfer value and so appropriately manage this risk. We note that this can mean a lower transfer value for the individual seeking to transfer, and thus highlight the need for regulated financial advice.
- Risks to the wider financial system: there may be other unintended consequences due to the inter-connectedness of the financial system.

The Pensions Regulator will need to consider how employers should assess contribution requirements to DB schemes in future. This is because of the uncertainty over take-up of future transfer values (which are paid on a best estimate basis) versus members remaining in the scheme (which must be assessed on a prudent basis). If not managed, this could lead to underfunding of schemes.

1.4 Financial markets and investment (chapter 6)

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

Impact on investment by allowing transfers from private DB schemes to DC schemes

As noted above, we support the proposal to leave in place the existing flexibility for members of private sector DB schemes to switch to DC schemes, thereby effectively extending to these consumers the flexibilities of the government's proposed reforms.

We are unable to comment at this early stage whether the proposed reforms, if extended to members of private DB schemes, are likely to result in an increased rate of transfer of these members to DC schemes. Further, the market is in its early stages of responding to the government's proposed reforms. We assume alternative products are likely to have 'annuity-like' characteristics to address the longevity risk, whilst also being more flexible. As a result, the impact of allowing transfers on investment for both DB and DC schemes is unlikely to be known for a few years.

Impact of proposed reforms on DC schemes' investments

As noted earlier, it is still too early to determine the full impact on DC schemes' investments by the Government's proposed reforms.

According to the consultation paper, approximately 75% of members of DC schemes opt to purchase an annuity on retirement. Most assets purchased to back annuities are fixed interest securities, the majority of which are corporate bonds. Other assets held by major annuity writers include infrastructure, mortgages, equity release, property and social housing.

We believe it is important that, once a consumer purchases an annuity product, they

should not be allowed to *unilaterally* break the contract and seek to surrender their annuity. If people can unilaterally break the contract, it creates a retrospective element to the Budget measures. There is also an investment aspect to this, as annuity providers will invest in assets at a portfolio level that deliver returns that match the expected payments from the annuities for many years into the future. Where illiquid assets have been purchased, the provider is unlikely to be able to liquidate the assets to provide the funds to pay the surrender value, meaning that the provider would in practice have to fund the surrender from free reserves and then hold the asset to maturity. This would be reflected in the surrender value.

An ability to break the contract unilaterally would also carry an adverse selection risk for providers, as individuals may seek to revise their decision due to a previously unknown health condition. As annuity contracts are a form of insurance, providers rely on having safeguards against selection in and out of the risk pool.

Development of alternative products

It is likely that the new products that will emerge to serve consumers will have 'annuity-like' characteristics, as they need to continue to address longevity risk and the long-term needs of society. The change in assets that is likely to occur may result in a more diversified mix and higher proportion of risk assets such as equities. For example, in the United States, there are a range of different products available to consumers and these are invested in a 'blended' range of assets, including long-term fixed income and risk capital assets, such as equities.

It is important that Government recognises that more innovative products and investment approaches can result in additional costs. For example, investing in infrastructure assets requires the resourcing of an expert team of analysts to determine the risks associated with these assets and the appropriate product structure to address both investor and consumer needs. This team of analysts will come at a cost to the firm, which must be assessed against the overall viability of the product.

Effect on DB bulk annuity schemes

The Government's proposed reforms to allow greater flexibility have had an effect on the individual annuity market, and could lead to developments and greater competition in the bulk annuity market. Growth in the bulk annuity market could fill any potential investment shortfall created by the reforms to the individual annuity market.

Consideration of the proposals on prohibiting transfers from DB to DC schemes also needs to take account of the effect on the DB bulk annuity market. Trustees need the full range of de-risking tools available to them to best manage scheme risks and assets over the long term.

Impact on infrastructure assets

Investment in infrastructure assets is small, compared with other fixed income assets, such as corporate bonds. The Government's proposed reforms are unlikely to reduce overall demand for infrastructure assets as they offer stable returns over a long period. However, to meet consumer demands for products that are more flexible and have easy access, some infrastructure assets may need to be packaged differently.

More cash in the financial system

The greater flexibility offered to consumers could lead to pension money flowing out of annuities or similar types of alternative products into cash or direct consumption. It is likely that the average cash balances in the financial system will increase as a result of the Government's reforms. These increased cash balances could be invested into money market funds or bank deposit accounts.

For further information contact:

Yvonne Braun
Head of Savings, Retirement and Social Care
0207 216 7414
Yvonne.braun@abi.org.uk