Policy briefing

March 2014

The Chancellor's Savings Agenda: Freedom of Choice in Pensions and the "Right to Guidance"

The Chancellor announced in his Budget statement major reforms to the decumulation market aimed at enhancing customer choices at the point of retirement, and assisting customers in making those choices. It comes as part of a wider package encouraging savings. His speech and a detailed Treasury consultation sets out:

- reforms to the pensions rules so that all consumers are offered the full range of options at the point of retirement (lump sum, drawdown or annuity) regardless of the size of their accumulated pension;
- an interim step of easing the trivial commutation and other limits to improve flexibility; and
- the right to guidance: offering to all consumers retiring with DC a pension at-retirement guidance that impartial, face-to-face and free at point of use.

This announcement was part of a package of measures around the Chancellor's savings agenda, which included reforms to Individual Savings Accounts limits and changes to national savings and pension bonds.

Next Steps: the Treasury has published a consultation alongside the Budget statement setting out more detail on the Government's thinking in this area. Responses are due on 11 June.

Overview

On 19 March 2014, the Chancellor of the Exchequer announced as part of his annual Budget statement major changes to the pensions and retirement income market aimed at enhancing customer choices at the point of retirement, and assisting customers in making those choices. The Treasury has published a consultation alongside the Budget statement setting out more detail on the Government's thinking in this area.[1]

Background

Encouraging the public to save into a pension to improve quality of life in retirement has been a major public policy objective spanning both the Labour and current Coalition Governments, and both have long had concerns about options available to consumers at the point of retirement.

- Declining state support and employers rolling back final salary Defined Benefit (DB) pension schemes has resulted in more people having to resort to money-purchase Defined Contribution (DC) schemes;
- Auto-enrolment came into force last Autumn, in an effort to bring another 11 million people into DC pension schemes. Early results among already staged employers suggest this has been a success; however

[1] HM Treasury, *Freedom of Choice in Pensions*, 19 March 2014 https://www.gov.uk/government/consultations/freedom-and-choice-in-pensions For information on the wider Budget 2014 announcements, see our Policy Briefing on Budget 2014, 20 March 2014.

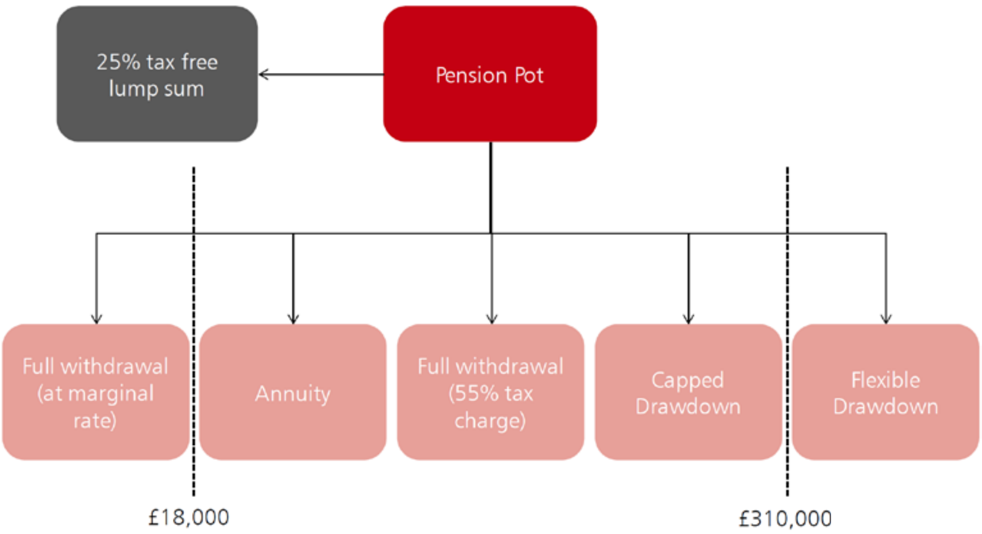
- The process of deciding these pension choices is highly complex, even to those consumers who are inclined to think about it. This decision will have a huge impact on the customer's overall financial wealth over the rest of retirement, and the decision also may not be reversible without effort, financial loss and stress.
- The FCA's annuities thematic investigation suggests that the market does not sufficiently encourage shopping around: 80% of consumers could be getting a better deal elsewhere, resulting in detriment of £114-£230m.
- Meanwhile, the Financial Services Consumer Panel observes that many of consumers who do shop around are being enticed down [unknowingly to the customer] non-advised routes leading to unsuitable products.

Treasury thinking about the proposals

Overall the Treasury wants to simplify and improve choices for consumers at point of retirement. Currently the tax system for pensions operates on the "exempt-exempt-taxed model": pension contributions exempt from National Insurance Contributions subject to an annual and lifetime allowance; investment growth on pension contributions are exempt from Capital Gains Tax; finally, but after the first 25% tax-free commencement lump sum, pension payments are taxed as other income at about 55% at current rates [HM Treasury pensions consultation, March 2014, pp.17-18]. The Treasury was concerned that this system has three broad issues given the current realities:

Figure 1: Illustration of the current tax treatment of DC pensions (p.21, Diagram 3A):

Under the current system, people's choices are constrained by the size of their defined contribution pension pot. There is some flexibility for those with small and very large pension pots, but around three-quarters of those retiring each year purchase an annuity.



The tax system is very complex and confusing:

Retirement options depend on a complex interplay between the amount of DC pension accumulated, minimum and state pension ages, and the rules of that particular pension scheme. Only very small proportions of situations have full retirement flexibility. After the tax-free commencement lump sum, to avoid paying the full tax rate on additional amounts (currently 55%), only the following individuals can only enjoy the marginal rate of income tax:

- those with less than £18,000 total pension savings; or
- those with a guaranteed annual retirement income of over £20,000, equivalent to an accumulated pension of about £310,000 at today's annuity rates (as calculated by the Treasury).

In so doing, the system "rewards those who have only saved a small amount or very large amount [...] while restricting choices for those who have saved a moderate amount" [p.18, para.3.9].

The tax system favours products such as annuities

For individuals with accumulated savings of between £18,000 and £310,000, the only way to avoid a 55% tax rate after the 25% tax-free amount is to purchase either an annuity or capped drawdown [p.18, para.3.10]. Aside from the view that annuities might not be suitable for everyone, the Government is concerned following the FCA thematic investigation about the integrity of that market, declaring that it "is currently not working in the best interests of all consumers. It is neither competitive nor innovative and some consumers are getting a poor deal" [p.3, fifth para].

That said, the Treasury does acknowledge that a better performing annuities market could play a role. It argues that "for many people, purchasing an annuity will remain the best way to secure an income, at least at point of retirement" [p.29, para.4.4].

The tax system favours the traditional notion of a fixed retirement point

Finally, the tax system seems to favour people making a one-off decision on their income for the rest of their lives. In reality, the retirement options need to be more flexible, given increasing blurred transitions to retirement, lifestyles and the proportion of life spent in retirement [p.29, para.4.1].

Main proposals

Offering to all the full range of decumulation options:

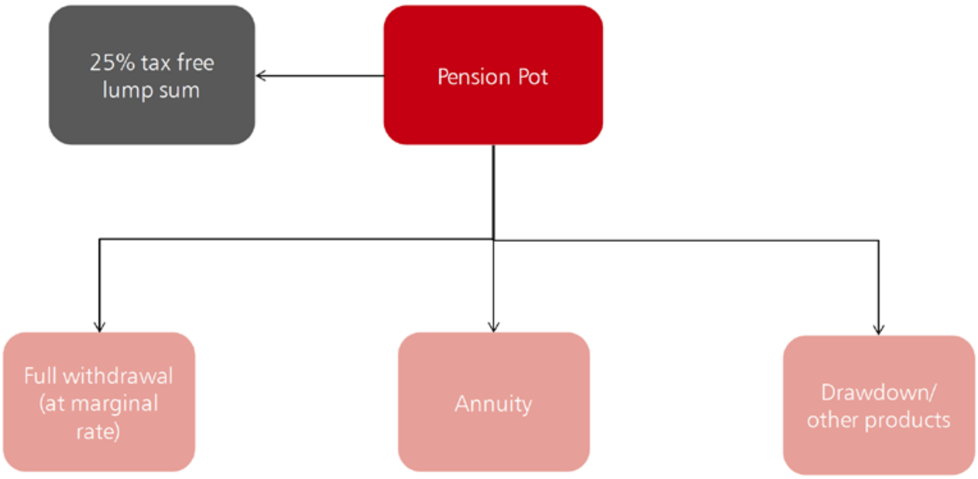
With effect from April 2015, changing the tax rules to allow everyone the flexibility to access their DC savings regardless of their accumulated pension savings [pp.19-20, para.3.13-3.14]:

- Individuals would be able to draw down whenever and however they wish, whether by annuity, lump sum or draw down. There will be no limit on the amount one can withdraw, and no minimum income requirement which people have to satisfy to withdraw from their pension.
- It will apply to all individuals over the Minimum Pension Age of 55, rising to 57 in 2018.
- The 25% tax-free commencement lump sum will continue.
- However the 55% rate for full withdrawals will be scrapped, and any extra amount drawn down "will be treated as income and therefore subject to the marginal rate of income tax". So customers will be taxed depending on how much the drawdown in a particular year exceeds the individual's basic personal and higher rate amounts.

These rule changes would effectively remove the tax incentive to purchase an annuity, which has invited a market reaction (see below).

Figure 2: Illustration of the future tax system for accessing DC pensions at retirement (p.21, Diagram 3A):

Under the new system, regardless of the size of their defined contribution pension pot, everyone will be able to choose any of these options. This will mean that everyone has access to full withdrawal, an annuity or drawdown, and potentially other products created by providers.



Interim steps of improving flexibility:

With effect from 27 March 2014, a set of measures will take effect that introduce greater flexibility on an interim basis [pp.23-24, para.3.20-3.23]:

- reducing the Minimum Income Requirement from £20,000 to £12,000;
- increasing the amount of pension wealth that can be taken as a lump sum from £18,000 to £30,000;
- increasing the capped drawdown withdrawal limit from 120% to 150%; and
- increasing the small pot limit (the amount of pension wealth that can be taken as a lump sum, regardless of total pension wealth) from £2,000 to £10,000, and increasing the number of personal pots that can be taken under these rules from two to three.

Free at-retirement guidance for all:

The Treasury understands that "an informed, active customer base is critical to ensuring an effective market" [p.29, para.4.2]. To help people make choices at retirement, a new "Right to Guidance" for people retiring with Defined Contribution pensions is to be made available by April 2015. The Government has pledged a £20m development fund to get this initiative up and running.

Proposed criteria for this "right to guidance"

The Treasury wants a new guarantee that all individuals with a DC pension in the UK approaching retirement be offered "guidance" that meets the following criteria [pp.30–31, para. 4.11]. The offering must be:

- impartial and be considered of good quality;
- covers the individuals range of options to help them make sound decisions to equip them to take action, whether that is seeking further advice or purchasing a product;
- free to the consumer (at point of use); and
- offered face-to-face.

Importance of impartiality: while the Government "welcomes the statements by the ABI committing pension providers to provide a conversation for customers," they want to ensure the service offered is "focused on [the customer's] best interests and not those of the provider" [p.30, para.4.10–4.11].

"Guidance" versus "advice": the Treasury makes clear in their consultation that they mean this service to be guidance or signposting in the first instance rather than professional regulated advice. So we think they have in mind something like the service offered by the Money Advice Service, The Pensions Advisory Service, Citizens Advice, or what the consumer group Which? now offers to its members. In some cases, this guidance might lead to regulated advice as one of the suggested paths a customer might take.

Note that even though the Chancellor's speech and the Budget Red Book use the term "advice" in this context, that is clearly intended for a public audience that does not understand the regulatory nuances. However, the consultation that was written for regulatory audiences is careful to make the distinction and describe the guarantee as "guidance".

Quality and standards: the guidance must meet a set of robust standards to ensure that it focuses on helping customers understand the choices open to them, how to engage with products and providers confidently and knowledgably, and how to access professional independent financial advice. The Treasury consultation states that "the FCA will work in close partnership with consumer groups, TPAS and the MAS" and be "developed using insights from behavioural economics as well as the expertise of consumer groups and others" [p.31, para.4.13].

After the guidance – improving professional advice: the Treasury consultation discusses the further assistance consumers might want after their "guidance session" to help them purchase a product. The government "will consider ways to ensure individuals are equipped with the skills and information to choose the adviser, broker or comparison site that suits their needs and that they understand the nature of the advice or service they will be offering" [p.31, para.4.16–4.17]. Again, the fact that the Treasury sees professional advice as a possible next step from a guidance session indicates their thinking of the distinction between the guidance guarantee and the regulated professional advice sector.

Consultation questions on the "right to guidance"

The Treasury consultation paper sets out eleven questions on the pension reforms in general, of which three relate to the "right to guidance" [p.32]:

- 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?
- Should there be any difference between the requirements to offer guidance placed on contract-based pension providers and trust-based pension schemes?
- What more can be done to ensure that guidance is available at key decision points during retirement?

Proposals around Defined Benefits schemes

The policy changes announced in the Budget were focused on DC pensions, mainly because the Government believes "the risks related to securing an income in retirement for those with DC pensions sit with the individual, rather than the scheme or employer" [p.33, para 5.1]. However they recognise the implications the changes have on those with Defined Benefit (DB) schemes.

People in private sector DB schemes do not face the same set of DC scheme-related decumulation issues because by definition, these are generally dealt with by the employer who bears the risk of market volatility from short-to-medium term market conditions.

The Government nevertheless "believes in maximising freedom of investment options for retirement savings, wherever it is potentially feasible to do so" [p.34, para.5.10]. However they are not clear how this should be done, without risking a large-scale transfer of members to DC schemes which would be detrimental to the wider economy.

Clearly they are seeking a course of action that affords choice to people while not endangering the wider economy. Some options under consideration include:

- legislating to remove the right of all members of DB schemes to transfer to a DC scheme, except in exceptional circumstances;
- continuing to allow members of DB schemes to transfer to DC, as now, but requiring that any funds which have been transferred are ring-fenced by the receiving pension scheme and subject to the existing DC tax framework;
- placing a cap on the amount that people in DB schemes can transfer to DC schemes each year;
- continuing to allow transfers, but requiring that any transfer to a DC scheme must be approved by the DB scheme trustees before it can be made; or
- leaving in place the existing flexibility for members of private sector DB pension schemes to switch to DC schemes, thereby effectively extending to them the full flexibilities described elsewhere in this document. The government is open to this option, given its attractions in principle, but only if it is clear that this would not create significant risks for the UK economy.

Stakeholder responses

Few stakeholders were expecting such radical changes from the Government just three weeks after the FCA annuities market study was started. While observers were almost certain that the FCA market study would culminate in some major changes, specific proposals were not expected until the study's completion next spring.

- Most sector commentators (the ABI, APFA, Legal & General) have released positive comments, welcoming the need for consumer choice. Legal & General Director of Stategy Tim Gosden explained in a press release on the FCA thematic review that they "do not believe any of the issues raised by the FCA are insurmountable, but they do require a proper understanding of the challenges that many consumers face with this often one-off important financial transaction."
- Consumer groups also supported the announcement. Which? said that it was "right to fix the broken annuities market." They cited their recent research that showed that 42% coming up to retirement trust their pension provider to act in their best interest, 38% approaching retirement who were contacted by their provider said they didn't get a clear explanation that they can potentially get a higher annuity if they shop around.
- The first few hours after the Chancellor's speech saw declines in pension provider share prices. Responding to these reactions, Partnership CEO Steve Groves told the PFS Financial Solutions magazine that he thought "people are reacting quite sensationally to the announcement which doesn't reflect the reality of the situation."[2] He explained that in fact his company "is broadly supportive of the proposed pension reforms as they are designed to provide increased choice and improved outcomes for people in retirement."
- Other pension providers such as the National Employment Savings Trust (NEST) announced that the pensions reforms will require a major overhaul of investment strategies. NEST Chief Executive Tim Jones told MoneyMarketing, "Changes to the ways in which consumers want to access their pension savings, and what they are allowed to do with them, are likely to influence how we manage their risks and invest their money."[3]

Next Steps

The Treasury consultation is due on 11 June, and the CII/PFS will be submitting a response.

Laurence Baxter
CII/PFS Policy & Public Affairs
March 2014

The Chartered Insurance Institute is the world's leading professional organisation for insurance and financial services, with over 112,000 members in 150 countries. We are committed to maintaining the highest standards of technical expertise and ethical conduct in the profession through research, education and accreditation.

The Personal Finance Society, part of the CII Group, is the UK's leading professional body for the financial advisory industry, with 34,000 members. Its mission is to lead the financial advice community towards higher levels of professionalism, exhibited through ethical and behavioural standards, interpersonal and business skills and technical knowledge, to the ultimate benefit of the profession and the consumer alike.

For more information on the CII and its policy and public affairs function, including examples of the range of issues in financial services and insurance that we cover, please see: www.cii.co.uk/policy.

[2] "Taking a Long-Term View," interview between Steve Groves, CEO of Partnership and Liz Booth, *Financial Solutions,* March/April 2014, pp.16-17.

[3] NEST reviews pensions strategy after Budget pensions bombshell, Tom Selby, *MoneyMarketing*, 24 March 2014.