Think piece

Personal Finance Society
Standards | Professionalism | Trust

PFS

Number 116 May 2015

Professional advisers should not fear the pension reforms

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(now appointed Minister of State for Pensions)

- A revolution is taking place for UK pensions. April 2015 ushered in a new era of freedom and choice. All aspects of private pensions are affected – whether personal or occupational pension scheme. Existing annuities could also be affected too if proposals for a secondary market are implemented.
- The freedoms were designed to ensure all pension savers, whether their funds are large or small, have the same freedoms and flexibility. But the new rules do mean there are new risks that pension savers will need to understand and consider. People could, inadvertently, fall into a tax trap. There is also the risk of new scams or frauds designed to part pension savers from their money. And understanding the nature of product options.
- The new range of risks and choices, underscores the importance of the other key element of the reforms: Pension Wise guidance. This aims to provide all consumers near or over age 55, who have a DC pension pot, with important information and "a conversation" about their options and the risks of the choices they might make.
- The Pension Wise service may have more potential than even the industry itself realises, providing consumers with an important insight into the complexity of the decisions they face – thus demonstrating the value of financial advice. The need for external help should become more apparent than ever to the public.
- The new freedoms do not apply to those who had already bought an annuity. Hence the proposal announced before the 2015 Budget to introduce a market for second-hand annuities.
- Most people will probably decide to hang on to their annuity, though some might want to consider selling it on. There are several reasons why they might want to consider this. Whereas now their annuitised funds are tied up forever, the proposals would provide some choice.
- The changes provide an opportunity for people to optimise their pension savings, though there are risks. Therefore the need for external help, including professional financial advice should help provide reassurance and provide informed choice.

PFS Introduction: amidst the debate around the relative merits of the pensions freedoms, one issue has kept recurring: the impact on the financial advice sector. That debate continues even a month on from the launch of those freedoms, further stoked by the follow-up announcement of a tradable annuities market currently under consultation for next year. What better time for one of the country's leading experts on pensions and later life issues – and now newly-appointed Pensions Minister – Dr Ros Altmann to offer a considered view, both of the current reforms as well as the new proposals. She is a distinguished returnee to our series, having penned the CII's inaugural Thinkpiece exactly seven years (and 116 articles) ago.[1]

A revolution is taking place for UK pensions. From April 2015, the old inflexible system gave way to a brand new era of freedom and choice. All aspects of pensions are affected – whether they are personal or occupational pension schemes, the pensions landscape is changing dramatically. Soon existing annuities could be affected too if the Government's proposals for a secondary market there take shape and are implemented.

Naysayers and the popular press warned of a breakdown of the new Pension Wise guidance under a torrent of calls from consumers looking to encash their savings; yet the contingency plans set up by the Government to handle high volumes in the first few weeks have not been needed. Despite doommongers' warning of thousands of pensioners whittling away their entire Defined Contribution (DC) pots on such wanton indulgences as foreign holidays and expensive sports cars; early evidence of activity since 6 April suggest that consumers are being more cautious than expected. Insurers did receive a higher than usual flux of calls in the first few days after Easter, and many of those have been inquires about encashing pots, but only some have actually gone ahead with encashment.

Considering the freedoms the reforms entailed, some positive messages can be derived from the fact that consumers are starting to inquire about their new rights and assess whether to take advantage of them.

Under the old rules, pensions were very inflexible for most people. Any money saved in a pension was locked in until later life. Then when people needed to take some money out, they were forced to buy an annuity, unless they had a very large fund. An annuity is an insurance policy in which an insurer takes someone's pension fund and then promises to pay them a specified amount of regular income until they die. One quarter of the fund could be taken tax free, but the income received on the remainder is taxed.

The vast majority of people had no choice and were forced to buy annuities. Only the wealthiest pension savers had freedom to choose what to do – they weren't forced to annuitise and could use drawdown funds, or leave their money invested, or even move it offshore and escape tax.

The freedoms launched last month were designed to ensure all pension savers, whether their funds are large or small, have the same freedoms and flexibility that only the wealthiest had before.

Despite doommongers' warning of thousands of pensioners whittling away their entire Defined Contribution (DC) pots, early evidence suggests that consumers are being more cautious than expected.

But the new rules do mean there are new risks that pension savers will need to understand and consider. In particular, any money taken out of their pension fund (apart from the 25% tax free lump sum) will be taxed as income each year. This means people could inadvertently fall into a tax trap.

There is also the risk of new scams or frauds designed to part pension savers from their money. The new range of risks and choices, underscores the importance of the other key element of the reforms: Pension Wise guidance. This aims to provide all consumers near or over age 55, who have a DC pension pot, with what can best be described as important information and "a conversation" about their options and the risks of the choices they might make. Pension Wise is available nationally across telephone, on-line and face-to-face channels, and is free at point of use. The conversations will be with someone who is specially trained and equipped to understand personal pension and decumulation issues and is completely impartial, with no interest in selling products.

[1] Dr Ros Altmann, "Money guidance and retirement savings advice: a critical view," CII *Thinkpiece* no.1 (May 2008) www.cii.co.uk/9963

The age-old "value of advice" question

This Pension Wise service may have more potential than even the industry itself realises. That "conversation" with a trained guider from either The Pensions Advisory Service or Citizens Advice may yield important insight into the complexity of the decisions people face. Just weeks before, George Osborne's famous Budget 2014 speech, the Personal Finance Society published a research report that found that:[2]

Nearly 14 million consumers who have never received advice before have the funds to invest, can afford an adviser and therefore are in a position to receive financial advice.

The research revealed the importance of demonstrating to its potential customers the actual value of advice. The public needs to see for itself just how complex decisions about investments, retirement and later life really are.

One of the major barriers to getting financial advice is a popular belief that consumers can do it themselves, relying on the internet or personal finance media. They do not understand the value of paying for financial advice as they think it is free, without realising the impact of commission they may pay when buying products on line and the lack of protection from 'non-advice' services.

On the back of the changes to regulated financial advice called the Retail Distribution Review, and well before the pensions freedoms announcements, the Personal Finance Society study concluded that advisers needed to be more flexible and look proactively at their clients' needs and experiences. Above all, the research revealed the importance of demonstrating to its potential customers the actual *value* of advice. The public needs to see for itself just how complex decisions about investments, retirement and later life really are.

As useful as sites like Moneysavingexpert.com may be on gaining insight into the latest investment and savings innovations; people need information that is personal and customised to their specific situation. Similarly those "Janet and John" case studies in the Sunday Money pages might be interesting on ideas about tax and decumulation, and readers might be able to loosely extrapolate the "people like me" examples to their own circumstances. But how can they really know that their tax and decumulation situation is exactly comparable? Just how "like me" are those people in the story?

This is a difficult message to get across using general marketing or education methods: consumers might need to have that spelled out to them directly.

Pension Wise can demonstrate value of advice

The pension freedoms provide precisely that message. The clear message is that while the reforms introduce greater freedom and choice in accessing DC pension savings, they also carry significant risk, hence the need for external help. I have grouped those risks into three:

- the nature of the product options themselves;
- the range of resulting choices; and
- the increased prevalence of scams.

Annuities are complex, not risk-free

Annuities were and continue to be a complex proposition for many people. The FCA market study into these products aptly showed just how difficult consumers find this to be: many in that market are unknowingly paying over the odds for their decumulation options. The products have become much worse value in recent years, as the amount of pension paid out in exchange for the pension fund is tied to long-term interest rates and the lower rates fall, the less pension income the customer will receive when buying an annuity.

Despite these complexities, most people received no help with their purchase: they were usually offered a standard annuity product that made no provision for their partner, no allowance for poor health, and no inflation protection. Unfortunately, many bought the wrong type of annuity but, uniquely in financial products, once an annuity is bought it can never be changed. This irreversibility has left many people stuck in products that do not suit their needs and put many people off pensions.

More (bewildering?) choice

While the new rules give people more choice and control over what to do with their pension, opening up exciting new opportunities, there are also new risks. Individuals have to make choices – and take far more responsibility

[2] The Personal Finance Society, *The RDR and consumers: the public's views towards the retail investment advice market*, Feb 2014. www.cii.co.uk/28904

for their decisions rather than being dictated to by Government rules. Unfortunately, however, in practice many pension firms seem to be intending to deny their customers the new freedoms or force them to move to another firm to benefit from them - and they may even have to pay a penalty to move as well. So the new freedoms may not be available to everyone and customers will need to check the terms of their pension.

Having access to external help that is legitimate, independent and trustworthy is vital; and as such the new Pensions Schemes Act 2015 makes it a crime to impersonate Pensions Wise. But such legislation cannot work in isolation.

There are several key risks customers should bear in mind. The first and probably most important is to understand the tax implications of any decisions made. Encashing the whole fund at once could lead to a large tax bill. For example having, say, £50,000 in their fund does not mean having £50,000 to spend, since such a withdrawal is counted as earned income and would attract a 40% tax rate on some of the withdrawal.

So just because consumers are allowed to draw their entire pension fund at marginal rates, does not mean they should. There are powerful reasons why they might want to simply do nothing when they reach age 55. If they don't actually need the money, it can stay invested and hopefully grow further over time. Many people will not have saved enough to see them through several decades of retirement and the longer they work and keep saving, the more they should have to live on in later life.

Freedom to be diddled

These freedoms may result in more choices for the public, but they have also opened the gates to a possible torrent of scam artists looking to exploit this unprecedented and ostensibly unregulated access to the public's hard-earned savings. While pensions scams are by no means new – as many an unfortunate customer can attest only too well – these have multiplied in the last year. In fact, just weeks after the Chancellor's March 2014 Budget speech, the scam artists were already out there trying to cheat customers on the back of all the publicity, and playing to peoples' lack of knowledge that the reforms had not even come into force yet!

The Government and FCA have tried to respond to this by warning consumers of the scam risk under the banner *Scamsmart*; and the industry itself has rolled out helpful initiatives such as the Association of British Insurers' C.H.O.I.C.E.S. campaign to underscore these warnings. As useful as those forewarnings may be, having access to external help that is legitimate, independent and trustworthy is vital; and as such the new *Pensions Schemes Act 2015* makes it a crime to impersonate Pensions Wise. But such legislation cannot work in isolation.

Advice as a next step from Pension Wise

So overall, the need for external help such as pensions guidance and (for many) actual professional financial advice should become more apparent than ever to the public. This is borne out in the evidence. In October 2014, the CII published a report outlining comprehensive focus group and survey research it had carried out into the public's views towards the pension reforms.[3] Its survey revealed that for nearly a quarter of consumers (see Figure 1 below), the *single most likely* follow up action after receiving pensions guidance would be to seek professional financial advice.[4]

Figure 1: Survey finding on consumers' single-most likely action following the receipt of the proposed pensions guidance

Q.25b: *Which one of [the various follow-up options] would you be most likely do after receiving the guidance?* Base: 956 respondents who would take any actions. Note: detailed descriptions were given for each option.

Among the possible follow-up options, respondents were presented with two for professional advice. One was described as detailed financial planning; and the other a more focused model specifically about at-retirement. This latter option has been discussed quite

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[3] The Chartered Insurance Institute, *Guaranteed Guidance for retirement: What consumers want*, Oct 2014. www.cii.co.uk/32081. Note that a technical appendix of all findings can be accessed from that page.

[4] *Ibid.*, p.16.

extensively in the advice sector, and many practitioners already offer such a proposition. The ranges for adviser charges given were based on analysis of the market at the time.

Cross-analysing this data against their responses to other questions reveals that those who will make their own decision feel more knowledgeable and are more confident making their own decisions, including those affecting retirement the following findings. However those selecting one of the professional advice options tend to:

- have higher pension values; and
- want to ensure they've carefully planned their income.

The CII reported that the focus group phase conducted as part of the research suggested an even greater interest in professional advice, with some interesting quotes:[5]

- "We don't mind paying £250-£500 and [the adviser] would be liable" (participant in the £10,000-£50,000 DC pot size group, London); and
- "I know it's a professional person. You are confident and the advice is guaranteed" (£51,000-£100,000 DC pot size group, Birmingham).

I think peoples' sentiments after a 30-40 minute Pension Wise discussion about their personal circumstances and their options would actually be much more supportive.

I thought these overall findings were hardly surprising, and in fact quite conservative. We must bear in mind that these customers were simply presented with some details of what the pensions guidance might look like (based on what relatively little was known on this in summer 2014 at the time the research was carried out), and how they might be inclined to use it. The respondents had not actually *gone through* a personalised guidance session. I think peoples' sentiments after a 30-40 minute Pension Wise discussion about their personal circumstances and their options would actually be much more supportive. It will be interesting to see what the early findings from Pension Wise will be.

[5] *Ibid.*, p.16.

Trying to offer freedoms to existing pensioners: tradable annuities

While the pensions reforms swept away the old rules about what people can do with their DC pots when they retire, the freedoms do not apply to those who had already bought an annuity. Cue the proposal announced just before Budget 2015 to introduce a market for second-hand annuities.

Why might people want to sell their annuities?

While most people will probably decide to hang on to their annuity, some might want to consider selling it on. There are several reasons why they might want to consider this:

- they may never have wanted to buy the annuity in the first place but had no other choice under previous rules;
- they may want to put some money back into a pension fund, rather than having it in an annuity and hope to benefit from future investment growth;
- they may have significant other pension income – this pension fund might have been an AVC (Additional Voluntary Contribution) fund that supplemented a guaranteed final salary pension. Someone receiving £20 a week from a £20,000 AVC, might prefer to have a cash lump sum, even if the amount is discounted for transaction costs;
- they may have large debts, or a mortgage that they want or need to repay;
- they may need money to pay for health or care needs or other urgent spending;
- they may want to know that their pension fund can pass on to loved ones if they pass away, especially after the removal of inheritance tax and 55% death tax charge;
- they may have purchased only a single life annuity, perhaps even with a guaranteed rate attached, but would rather have provision for a partner;
- they may be in good health at the moment but have particular fears of becoming ill;
- if someone has become very ill and is unlikely to live long, or needs to pay for care, they might find a lump sum more useful, even if it is much less than their original pension; finally

- people who had several pension pots and annuitised them might now prefer to take some as cash, or leave them invested in a new-style drawdown fund.

The amount they receive in exchange for their annuity income would be taken as a lump sum, taxable as income, or put into a pension drawdown product and any withdrawals would then be taxed as income. At least under these proposals they would have some choice, whereas now their annuitised funds are tied up forever.

Overall a choice not otherwise available

Many commentators and stakeholders have warned that this proposal could open the door to another mis-selling scandal. Of course there are risks. But risks existed under the old pension rules too. Allowing people the option to cash-in just addresses some of the unfairness between the past and the future.

Other commentators have criticised the proposals on the grounds that customers are likely to receive very poor value, and be charged unfairly high sums to cash-in their annuity. They note that people often received very poor value and paid high charges to buy the annuity in the first place and will now lose out a second time. It is certainly true that many people bought unsuitable annuities, but that is not a reason to deny them the chance to undo the deal.

Given the risks of customers receiving poor value, the Treasury needs to ensure that the FCA regulates the second-hand annuity market carefully. Customer protections must be put in place, since pricing an annuity is a complex transaction and, especially if there are few players in the market initially, it is important to have checks and controls on pricing structures to ensure customers are treated fairly. The Government is also planning to ensure that the Pension Wise service will offer people financial guidance so they understand the risks of selling their annuity and help them find a good rate – although ideally, they would take independent financial advice.

Nobody will have to sell their annuity, it will be their choice. Unlike when they purchased it, they will not be forced to cash it in and many will not wish to. However, giving them the option is only fair. Many who bought annuities understandably feel aggrieved that their money has gone to an insurer in exchange for a relatively low income with no inflation protection, whereas future pension savers can enjoy full freedom to choose what is best for themselves. This is a popular and sensible decision which I believe will be warmly welcomed by many.

In conclusion, while the reforms implemented last month and those being consulted on for next year are a fantastic opportunity for people to optimise their pension savings, this opportunity carries risks too. Therefore the need for external help, including professional financial advice should help provide reassurance that pension savers' money can work better for them, especially with greater tax incentives to keep the money for their advanced old age.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

Dr Ros Altmann CBE is an expert on pensions and later life issues; and has at time of publishing just been appointed Minister of State for Pensions following the 2015 General Election. She is an economist by training and worked in fund management in the City for fifteen years, and has advised Governments, regulators, industry bodies, corporates, finance firms, trustees and consumer groups and was Director-General of over 50s' specialist Saga Group from 2010 to 2013. Ros was consultant to HM Treasury on the Myners Review of Institutional Investment and worked on pensions policy with the Number 10 Policy Unit, was appointed at the UK Government's Business Champion for Older Workers from 2014 to 2015, and has recently been nominated as a Conservative Peer. She has received numerous industry awards and honours including Pensions Personality of the Year (twice), Industry Guru of the Year, Women in Public Life Award, and received a CBE for services to pensioners and pension provision.

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