Investment Management Association

# IMA RESPONSE TO HMT CONSULTATION

## "*Freedom and choice in pensions*"

**June 2014**

# IMA CONSULTATION RESPONSE:
## *FREEDOM AND CHOICE IN PENSIONS*


## SUMMARY

1. The IMA[1] is a long-standing supporter of greater flexibility in the provision of retirement income, allowing pension savers access to the right product at the right time in their lives. We therefore welcome the Budget announcement and look forward to working with Government, regulators and other stakeholders to secure its effective implementation.

2. Overall, we draw two main conclusions from the announcement. First, there needs now to be a full (and overdue) debate about how retirement choices are supported. Second, the notion of the annuity as the default option may no longer be acceptable. In our view, the following question is critical:

   *How to ensure access to appropriate retirement income products in an environment where individual circumstances will increasingly vary; where the accumulation phase is likely still to be focused on inertia not engagement; and where consumers may be heavily influenced by the way in which choices are framed, not by an informed assessment of options?*

3. A successful settlement will require clarity over scheme decision-maker responsibilities in default arrangements; a regulatory approach to the retirement market that allows diversity of product offering; clarity over the role and limitations of the 'guidance guarantee'; and a simple tax system.

4. One central observation here is that guidance is not a 'one off' process. For most individuals, guidance will be an implicit feature of investment through the accumulation phase, given a widespread dependence on auto-enrolment and default strategies. Those strategies also need to make some assumption about retirement options, which may entail engagement by individuals some time before they access pension savings. Finally, accessing retirement savings will not, for many, take the form of a one-off product purchase and ongoing support may be needed into retirement.

5. With respect to taxation specifically, we believe that the creation of a wrapper modelled on a SIPP and branded a 'Retirement Income Account' can help to ensure that taxation is focused where it should be: on the income stream rather than product purchase. We suggest specific measures that would allow investment funds better to serve the retirement market. At a broader level, we would encourage the Government to maintain a period of stability after the Budget 2014 reforms, and not move further to change the tax incentives around pension savings.

6. Our response is in two parts. The first provides general comments, the second more detailed answers to HMT questions.


[1] The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5 trillion of assets in the UK on behalf of domestic and overseas investors.

## PART ONE: General Comments

7. It has been apparent for some time that longstanding policy assumptions around annuitisation needed to be rethought.[2] Retirement provision and behaviours are becoming ever more diverse and flexibility within the system is required. At the same time, the annuity market has suffered particularly from low interest rates in recent years, and the advantages of mortality pooling have to be set against risks for consumers. These centre on 'one period' risk in terms of prevailing interest rates at moment of purchase; the inability to exit in the event that a product is no longer appropriate; and the lack of inflation protection in the most popular annuity products (level annuities).

8. The reforms implemented in April 2011 ended the requirement effectively to annuitise. Consumers henceforth could instead opt for capped drawdown or flexible drawdown. However, these reforms did not fundamentally change market dynamics, for a number of reasons:

   - Minimum income requirement for flexible drawdown was set at a relatively high £20,000 per annum.

   - The rules around capped drawdown, including stipulated review periods, did not favour the development of off-the-shelf income products. Furthermore, in the context of the low interest rates that made annuities increasingly unpopular, the 100% GAD limit (later relaxed to 120%) led to some frustration among those taking drawdown.

   - DC provision in the UK is still in a comparatively young phase, with the number of those retiring with primarily DC provision set to rise substantially in coming decades.

   - There still seemed to be an expectation among Government and regulators that annuitisation should be the default approach at retirement, with ambiguity about whether drawdown required regulated advice. Efforts to improve retirement income through 'shopping around' (Open Market Option), while positive, arguably focused on only part of the problem. An individual might only be getting a better rate for a product that was not optimal for their circumstances.

9. The inherent attraction of annuitisation for regulators and policymakers is understandable given the guarantee of pay out regardless of market conditions and an efficient means to pool mortality risk, a particularly important consideration later in retirement, both from an individual and public policy perspective. Allied to that was little official (or industry) expectation of active consumer engagement, evidenced by the need to introduce automatic enrolment to encourage individuals to save at all for their retirement, and the tendency of scheme members to remain in default arrangements once enrolled.

10. The combined effect of these considerations was to ensure that prior to Budget 2014, there had been only muted discussion as to how guidance or regulated advice mechanisms could be developed further to help individuals plan effectively for their retirement. It appeared that the tendency to buy a level annuity was seen as an acceptable default.

11. In that respect, one of the most significant immediate consequences of the Budget announcement has been to bring to the fore the question of how individuals get guidance or advice. This has happened not just because of the Chancellor's commitment to provide

[2] For earlier IMA positions, see in particular, Enabling Choice for Retirement (IMA, 2008): http://www.investmentuk.org/assets/files/research/20080325imapolicybriefing0308.pdf

free guidance, but because the boldness of the Budget liberalisation (total control over the pension pot) has forced a new option into the retirement market: exit in the form of cash rather than an obligation to purchase an income stream.

12. We have set out our interpretation of this history because we believe that the implications of the Budget are profound. To be clear, they are not at heart about the abolition of the effective requirement to take an annuity (which was the 2010/11 reform), but about the abolition of any requirement to secure an income. We draw two main conclusions from the announcement. First, there needs now to be a full (and overdue) debate about how retirement choices are supported. Second, the notion of the annuity as the default option may no longer be acceptable.

13. The IMA is neither an inherent advocate of drawdown nor a critic of annuity products. We have long set out our view that for many people, some form of annuitisation at some point in retirement is likely to be desirable. Equally, however, there is considerable scope for investment products, such as income funds, to support retirement income provision in a more widespread manner. Our objection to the pre-2011 policy environment stemmed from the assumption that the Government could or should define a universal approach. Our reservation about the post-2011 environment related to the way in which reform was implemented. Our practical concern about the 2014-15 reforms is how to ensure that the new environment allows a diverse product set, while not resulting in poor consumer outcomes.

14. In this respect, while greater flexibility is a positive development, it creates significant challenge – for regulators, schemes and their members, and the pensions industry in its widest sense. At the heart of this challenge is a question that is at once linked to behaviour, advice, distribution and product design: *How to ensure access to appropriate retirement income products in an environment where individual circumstances will increasingly vary; where the accumulation phase is likely still to be focused on inertia not engagement; and where consumers may be heavily influenced by the way in which choices are framed, not by an informed assessment of options?*

15. Four areas need to be addressed in particular, and we set out our views below in the response to specific questions:

    a. The governance of workplace DC default arrangements given the implication of decumulation choices for accumulation investment design.

    b. The timing and nature of guidance, including the 'guidance guarantee', and the distinction between guidance and regulated advice.

    c. The regulation and tax treatment of retirement income products.

    d. The ability of any decision-makers, including individuals themselves, to access information about their retirement provision in a joined up and complete manner.

16. We would also make a broader point about these reforms. The more permissive approach to retirement income is narrowing the difference between pensions and ISAs. While the simplification is welcome, constant change is not. We would encourage the Government to maintain a period of stability after the Budget 2014 reforms, and not move further to change the tax incentives around pension savings. In the absence of compulsion, the tax-free lump sum (TFLS) remains a significant incentive to lock away money for a long period of time. Removal or reduction in this benefit could make it harder to ensure that

individuals make dedicated retirement provision as opposed to saving in more liquid vehicles with the prospect that funds are used before retirement.[3]

## PART TWO: Answers to Specific Questions

### Q1. Should a statutory override be put in place to ensure that pension scheme rules do not prevent individuals from taking advantage of increased flexibility?

17. Yes.. For a variety of both practical and philosophical reasons, it is very hard to see why schemes should impose limitations. The practical reasons relate particularly to individual circumstances where scheme members may have a variety of sources of provision (e.g. deferred DB benefits or other DC pots). Individual scheme rules should not be allowed to complicate individual decision-making in a policy environment where greater freedom is available. The philosophical point relates to the nature of many DC arrangements, which are structured as individual contracts or accounts, and members have made their own payments. In such a context, why should schemes be allowed to intervene to determine precisely how benefits are taken?

### Q2. How could the Government design the new system such that it enables innovation in the retirement income market?

18. The future level of innovation depends upon a range of factors relating to the shape of default arrangements in workplace DC schemes, the shape of the guidance provision and the regulation and tax treatment of competing retirement income products.

### Default arrangements

19. Innovation will not take place if schemes and those providing guidance see a level annuity as a ‘safe’ default. The current governance overhaul of DC should be expanded to address the issue of how trustees and independent governance committees should think about both the accumulation and decumulation phases, since the two cannot now easily be separated.

20. The traditional approach to delivering DC default strategies has been to assume a de-risking process, typically over the last ten years, to protect the capital value of the individual pension pot against volatility. This de-risking process would also be designed to address issues such as annuity conversion risk in an environment where annuitisation was still expected. More sophisticated approaches in recent years are starting to accommodate the wider flexibility available to savers. However, the point here is that there are stage posts well before the pension pot is accessed that may have to be built into standards and guidance expectations. Alternatively, the expectation might become that all defaults should manage towards an assumption of crystallisation (and therefore maximum achievable pot size at that point in time). That is perhaps more straightforward for scheme decision-makers, but less optimal for scheme members for whom an income objective is likely to be central.

21. For those schemes that wish to extend their provision for individuals into the retirement phase, a series of potential tests for appropriate retirement income ‘defaults’ could be

[3] Prior to 2011, the TFLS could also be seen as providing an additional incentive (some flexibility of capital) in a system that effectively required an individual to lock away the rest of their capital irrevocably during retirement through annuitisation. All things being equal in terms of marginal rate liability for individuals, the other tax ‘benefits’ were simply a way of avoiding double taxation, in a form economically equivalent to an ISA (EET = TEE).

devised, such as inflation-protection and the issue of liquidity (i.e. whether a one-off irreversible product purchase is appropriate).

## Guidance guarantee and regulation of retirement income products

22. We comment in more detail on the issue of guidance in our answers to Q6 and Q8. Our overall position is that guidance is unlikely to be a one-off event, and that consumers and the product market need greater clarity from the regulator around the regulation of guided sales rather than advice (as defined by MiFID). A particular issue in this respect will be the regulatory treatment of competing retirement income products. Although we recognise that drawdown carries significant risks, so too do annuities in a different way. We do not believe that innovation would be well served in the product market if the bar is set unevenly.

## Taxation

23. The Government's consultation anticipates that pensioners should be chargeable to their marginal rate of tax on any withdrawal from their DC pension pot in excess of the tax-free lump sum. In order to achieve parity between tax treatment of the purchase of an annuity and the purchase of alternative retirement income products, any such tax charge should arise only at the point the individual receives money, and not when an individual uses funds from their pension pot to purchase the products.

24. In order to avoid a tax charge arising on the reinvestment of a DC pension into retirement income products (and thereafter on changes of investments in financial products), the IMA believes two proposals should be considered:

- Creating a clearly branded decumulation wrapper for retirement savings.

- Creating a system of roll-over reliefs that would enable an individual to defer tax liabilities when purchasing a financial product, or reinvesting funds from one financial product to another over the course of their retirement.

<u>Retirement Income Wrapper</u>

25. The first option, which could sit alongside the second, would provide simplicity for individuals and flexibility to meet the Government's aim of developing a market for retirement income products, especially for those of more modest means (the large majority).

26. Such a wrapper would take its inspiration from the Self Invested Personal Pension (SIPP), but could usefully be rebranded to emphasise the different nature of the product: e.g. Retirement Income Account (RIA). Individuals would have the choice to move some or all of their pension pot into an RIA or RIAs, without tax. The RIA could then be used to make investment in approved products over the full retirement period of the individual, designed to achieve the desired financial outcome. In most cases, this would be income generation for retirement, but other options might be made available to individuals to suit demand.

27. Product providers would develop RIA-eligible products that aimed to achieve different financial outcomes according to demand. We would expect there to be a significant focus on generating a stable level of income over retirement. This might be satisfied by income and capital gains generated within the RIA, or capital withdrawal.

28. Like the SIPP, the RIA would not itself have tax liability: income and capital gains would have no tax consequence while the funds are retained within the RIA.

29. The simplest administrative option, for individuals and RIA managers, would be for the individual to be subject to income tax at their marginal rate on any withdrawal from the RIA, whether this is funded from income, capital gains or capital drawdown. However, the flexibility to generate retirement income through a diverse range of financial products (either held in a wrapper or otherwise) complicates the operation of PAYE for retirement income. This demands a more flexible approach to operating tax deduction at source systems (including PAYE). The simplest approach would be not to mandate (but to permit) the operation of PAYE on retirement income products, and ensure that simplified access to gross income is available for those whose retirement income will not exceed the Personal Allowance threshold.

<u>Authorised Retirement Funds</u>

30. Authorised investment funds are an ideal vehicle for income provision and capital decumulation. The regulatory regime is long-established and provides extensive investor protection safeguards. However, authorised funds are currently required to distribute all income. This requirement sits in the FCA rules but its impetus stems from tax considerations. There is also a regulatory concern that investors should not believe they are receiving "income" when in fact their capital is being depleted. But for retirement products, capital decumulation is precisely what is needed.

31. Therefore, it should be possible to categorise a fund, sub-fund or share class as a retirement product and allow it to distribute a specific amount in each distribution period. Depending on the size of holding and amount required to be distributed, it may be that in any one period not all income or some capital must be distributed. To be treated on a par with annuities, this would require:

- transfer of monies from a pensions pot to be tax-free;
- distributions from the investment fund(s) to be able to include an element of capital drawdown;
- distributions to be taxed at the individual's marginal rate; and
- non-distributed income not to be taxed.

**Q3. Do you agree that the age at which private pension wealth can be accessed should rise alongside the State Pension age?**

32. This should probably be the case, but this issue is arguably better considered separately, and in the light of broader considerations, such as labour market behaviour and health later in life. Indeed, there may be a case for a Government review, or indeed independent commission, that develops a pre-determined formula. The danger of piecemeal change is that it may result in planning blight for individuals who find themselves chasing a moving target at a stage in their working lives where a number of vulnerabilities, relating both to position in the labour force and physical health, may leave them needing to access some part of their pension savings.

**Q4. Should the change in the minimum pension age be applied to all pension schemes which qualify for tax relief?**

33. The Government should aim for consistency of tax treatment and not encourage behaviours that may arbitrage between different forms of pension arrangement.

**Q5. Should the minimum pension age be increased further, for example so that it is five years below State Pension age?**

34. See answer to Q3.

**Q6. Is the prescription of standards enough to ensure the impartiality of guidance delivered by the pension provider?**

35. As regards the impartiality of the 'at retirement' guidance delivered by the pension provider, this question opens up the challenging area of what this guidance represents in regulatory terms, and what the responsibilities of the provider are, not just in terms of impartiality but for future outcomes where the guidance can be shown to have had a bearing on product selection. This in turn raises the question of how the Financial Conduct Authority (FCA) decides to regulate the distribution of retirement income products, which may be impacted by the wider European debates about 'complexity' under MiFID II and the new PRIIP KID. If drawdown can only be sold with regulated advice, for example, what are the implications for provider guidance and scheme member behaviour? Behavioural evidence would suggest that scheme members might not wish to pay for regulated advice, and choose instead from a range of immediate options. This clearly could result in a situation where little might change in terms of market patterns.

36. The concept of guidance, as opposed to the defined term "advising on investments", is problematic. It is not clear what the dividing line between guided sales and regulated advice might be and this has been a barrier to the development of guided solutions to help investors make better decisions in other areas. One of the reasons why more guided solutions have not emerged to fill the "advice gap" in the aftermath of the FCA's Retail Distribution Review is that potential providers are wary of inadvertently crossing the line, with adverse regulatory consequences. The FCA would need to clarify this situation in order to encourage appropriate persons to step up and offer guidance without feeling they would be taking on too much regulatory risk.

37. The question of guidance by the 'last provider' raises a fundamental question where individuals may have a variety of other provision, both DC, DB and perhaps non-pension assets that could be used for retirement income purposes. Should providers be responsible for taking a holistic view, and do the mechanisms exist for them and/or members to achieve this view in practical terms? The IMA has in the past argued for a Government initiative systemically to join up State pension forecasts with private records such that a virtual portal would bring together in one place individual entitlements.[4]

**Should pension providers be required to outsource delivery of independent guidance to a trusted third party?**

38. It is not clear what 'trusted third party' means in practice. In the context of guidance, this has the potential to be the worst of all worlds: an unregulated space where there is distance from the provider, but no connection to the world of regulated advice. We would

[4] http://www.investmentuk.org/assets/files/consultations/2012/20120323-dwpsmallpensionpotsconsultation.pdf

be concerned to see a semi-regulated 'cottage industry' emerging, with the risk that individuals could make life-changing and irreversible decisions with limited recourse. In order to provide confidence in such arrangements, and to exercise more control over quality, some form of kite mark (i.e. with minimum specified standards) approach for those permitted to provide guidance should be considered.

**Q7. Should there be any difference between the requirements to offer guidance placed on contract - based pension providers and trust - based pension schemes?**

39. To the extent that for the individual, DC pensions are effectively the same, whether offered under contract or trust, there should be no difference.

**Q8. What more can be done to ensure that guidance is available at key decision points during retirement?**

40. As we outline above, guidance may need to be available at key decision points both before and during retirement. One tool to deal with the 'during retirement' issue may be to require any provider offering a retirement income product, which is not an irreversible lifetime product such as an annuity, to issue some form of 'wake up' pack at 75. If the IMA suggestion of moving savings into a Retirement Income Account is implemented, this would be reasonably practical to achieve. Where money has moved outside the pension system, it would of course be very difficult.

**Q9. Should the government continue to allow private sector defined benefit to defined contribution transfers and if so, in which circumstances?**

41. It may be difficult to justify the imposition of a differential rule for DB schemes, particularly where it is certain in future that individuals will have an ever more fragmented set of pension entitlements as they move through working life. Forcing an individual who, for example, has eight years of DB entitlement early in their career, to remain a part of a scheme when they would rather have the option to consolidate their retirement provisions, appears unduly restrictive.

42. Against this have to be set three considerations. First, the experience of the late 1980s has well-illustrated the risks of individuals making the wrong decisions, which points once again to the absolute importance of ensuring that adequate support mechanisms are in place. This may have to be regulated advice as a minimum expectation as opposed to guidance. Second, as the consultation recognises, there may be market impacts of the Budget announcement – for example, on government and corporate debt purchase – as savers respond. However, the consequences of this are extremely difficult to predict. It is not certain either that mass transfers out of DB would take place or that demand for annuities or annuity-like products will fall significantly over the longer term as the DC market expands significantly. Third, there may be consequences (both positive and negative) for the funding positions of DB schemes, although again these are difficult to predict.

**Q10. 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?**

43. The risks fall into the three main areas set out in the paragraph above: risks to individuals transferring; risks to markets; and risks to schemes.