Pensions.Consultation2014@hmtreasury.gsi.gov.uk

Pensions and Savings Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

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AFM Response to Freedom and Choice in Pensions consultation

1. I am writing in response to this discussion paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Register our support for the new pensions system; and
   - Comment on the practicality of some of the proposals in the consultation.

2. The Association of Financial Mutuals (AFM) represents 53 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, pensions, protection and healthcare needs of over 20 million people, and have total funds under management of £120 billion. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. A majority of our members are not ABI subscribers, so would not always be aware of initiatives developed there or which have input from large PLC insurers only.

3. The proposals launched in the Budget represent a bold and welcome statement on the future of retirement planning in the UK. We fully recognise the need for a radical overhaul of the current position, which is modelled on very different demographic, longevity and economic assumptions. Pensions legislation itself has become increasingly

complex and subject to change, whilst regulation has reduced the supply of advice for large parts of our society.

4. As a result, the gap in people's retirement needs and their current provision has been steadily growing- particularly for the less wealthy. Whilst auto-enrolment provides the nudge or stimulus to encourage or force people to start saving for retirement, there has been too much uncertainty and lack of clarity around options at retirement, and in our assessment this continues to contribute to low confidence in the pensions' industry, and inadequate provision.

5. And we accept that the sector has not done enough historically to address this: the review by the Financial Conduct Authority into the annuity market confirms that the market is failing to optimise the 'at retirement' position for many consumers, and AFM has raised in the past with the FCA a concern that too many people make inappropriate decisions.

6. We do not conclude though that the annuity market is dead. An annuity is still a very efficient way for most people to draw an income in retirement, on some or all of their savings. We do not expect that position to change as a result of the proposed reforms- though we do accept that, with people retiring with a myriad of pension pots, with differing needs, and with even the notion of ceasing work at a single age being outmoded, many people will need help to identify the solution(s) that best meet their needs.

7. We therefore applaud the planned overhaul, the determination to bring greater clarity and simplicity to retirement choices, and the recognition that people need more help to make the right decisions. We explore these points further in responses to the questions raised in the consultation.

8. We are also keen to stress the following key issues:

    a. We have approached the consultation from the perspective that as mutual organisations there is an interest commercially and ethically in helping consumers get to the right solution; though we recognise this means different things for each specific business, as well as for each individual consumer.
    b. A number of mutual providers have already demonstrated their capacity for imaginative and innovative solutions, and we believe the mutual model- and the diversity of approaches taken within our membership already- ideally lends itself to working productively with government and consumers.

c. The timetable for implementation of the changes is very tight: AFM members have been busy exploring the long-term consequences for their business as well as the immediate changes they need to address over the coming months; there is a risk though that finalising the detailed changes will come too late for the practical lead-time needed for implementation.
d. With around 400,000 people due to take retirement benefits this year, more work is needed quickly to remove some of the current uncertainty. For Treasury to realise their goal of people taking 'confident and informed decisions' there is still much to be done.

9. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Answers to specific questions

A new tax framework for retirement (Chapter 3)

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?*

The low-interest environment and rising longevity have led to a dramatic fall in annuity rates over the last ten or more years. There is no expectation that rates will recover significantly, and as a result people retiring now may find their (annuity) income is lower than expected.

We consider that there is significant merit in making the tax rules around accessing a pension consistent and straightforward. By necessity, rules are required to ensure the system is not exploited, but excessive rules will undermine the general direction; and complications, such as different minimum pension ages in different circumstances, will be likely to dampen demand. Similarly, scheme rules which prevent people taking advantage of the new flexibility in the tax rules undermine the policy initiative and create unfair barriers to individuals. Hence a statutory override, for defined contribution pensions, may be necessary.

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

The outline proposals do provide scope for innovation, however the new system would be further assisted by careful design of supporting features, including:

- A number of mutual providers retain a strong presence in the annuity market. They have demonstrated a distinctive commitment to treating policyholders fairly, both by helping them to find the right retirement option, but also in securing advantageous rates: AFM research shows a median uplift of 6% for an annuity provided by a mutual. A tighter market for annuities should increase competition, whilst the resilience and consistency of mutuals- for example during the financial crisis- should make them valuable partners to policymakers.
- In recent years we have since a significant increase in with-profits annuities, and we have seen new interest in fixed-term annuities since the budget. We have seen mutuals at the forefront of innovation to meet the needs of consumers, and would expect this to continue: for example in developing new forms of annuity, such as the U-shaped variant that is popular in the US.
- We consider below the nature of guidance/ advice and support for consumers, and facilitating simplified advice options will provide cost effect access for the mass market.
- The market for income drawdown has grown in recent years, but still has scope for further innovation, whilst the growing need for long-term care funding remains poorly served.
- More generally, the concept of lifetime savings accounts, as was being explored by government in the past, may remove some remaining obstacles to savings accumulation and retention.

- We also see greater capacity for alignment of pensions regulation as an important prerequisite to innovation: interventions from FCA, PRA, HMRC and The Pensions Regulator can be contradictory and unpredictable.

To encourage innovation there needs to be long-term stability on the regulation of pensions. Frequent changes to pensions' regulation and the uncertainty that results adds excessive costs to the industry, making it difficult for businesses to develop new products, as well as to make changes to existing products and systems. The resulting uncertainty also discourages consumers from planning for their pension.

As mutual organisations, there is a healthy appetite to challenge the traditional ways of doing things and to be more creative and innovative. This can be accelerated further were our legislation, which is often slow to adapt to changes to company law, more progressive. We have made this point to Treasury in separate correspondence recently.

3. *Do you agree that the age at which private pension wealth can be accessed should rise alongside the State Pension age?*
4. *Should the change in the minimum pension age be applied to all pension schemes which qualify for tax relief?*
5. *Should the minimum pension age be increased further, for example so that it is five years below State Pension age?*

We agree that the minimum pension age should be consistent, though we are not convinced that the case for raising it in line with an increasing state pension age is proven. Raising the minimum age would be likely to discourage savings via a pension and contradicts the notion of freedom and choice. We certainly feel that reducing the gap to five years would be harmful to the level of savings, as it reduces the incentive for personal provision.

Supporting choice (Chapter 4)

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

   As mutuals organisation, we consider there should be an interest commercially and ethically for providers in helping consumers get to the right solution.

   We therefore agree that effective guidance is essential, and that this is free, impartial and consistent. Consumers should be offered the option of taking face-to-face guidance, though not all people will need it. In many cases, a robust online tool would help a consumer understand either what the right solution is for them, or that they need further advice.

FCA is already doing work to clarify the differences between advice and guidance, and it should be very clear to consumers that free guidance is not the same as bespoke advice. A key question is whether the guidance should be approved by a third party, such as The Pensions Advisory Service or Money Advice Service, or also delivered by them too. We tend towards the former, so that there is consistent content in the guidance rather than delivery.

Behavioural economics will be helpful in demonstrating that for different consumers the buying process may vary: for example, many people are comfortable researching products online, but prefer to buy from a person; whilst others are happy to research products by visiting potential suppliers, but will have a preference to purchase online. Others make seek advice initially and can then manage future transactions themselves, where others will look for ongoing advice.

There is also growing evidence that consumers are potentially confused by some of the new options available to them, and research by one of our members has indicated there is a significant risk that people will inadvertently create significant taxation problems. This should therefore be an important component of the guidance guarantee.

It does not seem practical for a standard ‘at retirement guidance’ offering to cater for these varying needs. The advice regime is also key therefore, and in our view the new system presents a core opportunity to develop a mass market/ simplified advice solution that does not rely on the full advice process. We are pleased to see the FCA resurrect work on this: it will be key to making the provision of advice cost-effective, and focused on specific, at retirement needs.

Specifically this means exploring how to reinvent advice/ guidance that can be largely delivered via the internet, with face-to-face interventions that are cheaper than at present (but not free). Whilst there is agreement within AFM members that the system should be constructed to enable this, within our membership there are different business models, and as a result mixed views on whether face-to-face should be independent, restricted or capable of being provided by tied advisers. For example, Royal London and LV= have indicated that they consider guidance should be independent of the provider, whilst Wesleyan, which employs a skilled advisory force with specialist skills suited to the specialist audience it works with, believes it is well-placed to give the form of high quality guidance its policyholders will look for.

There is though no disagreement on the need for greater fairness and the potential for clearer guidance. We consider it is natural that many people will want to seek information initially from their provider, and our view is that if guidance is offered by providers, it is very important that the guidance is standardised and consistent: hence we see a role for TPAS or MAS along with the FCA in developing a clear guidance framework. Where an individual’s circumstances are more complex we would expect the framework to identify the need for evolved (independent) guidance: for example, where an individual has more than one pensions pot it becomes more difficult to justify a role for a single provider in giving guidance.

We would prefer to see the current wake-up pack replaced with a bespoke pensions passport. With greater certainty on state benefits, and the positive impact of auto-enrolment, now is the perfect time to provide a pension passport, available on demand. By comparison, the current wake-up pack appears inflexible and to ill-fit the future pensions landscape. We also think the pensions passport will be less expensive to produce, and will increase the consistency with the guidance provided in the guidance guarantee, and reduce a risk that a providers sells against the guidance provided in the guidance guarantee.

There are specific issues relating to small pots. At present the potential advantage of exercising an Open Market Option is unlikely to outweigh the cost of advice, and inefficiency is therefore built in. This is potentially unlikely to change under the new scheme.

To illustrate, if an annuitant is offered an annuity by their current provider of £1,000 pa, based on their small pot of £20,000, they might find that the cost of financial advice at, say £750, is not recoverable even in the very long-term even where they can improve their income by 5% or more by moving supplier, particularly if valuable benefits are lost as a result.

This illustrates the difficulty for small pots: we need to find a solution to the risk that at present people can be locked into low-income streams as a result of inertia and lack of access to advice. And indeed, if the pot value were £10,000 and the policyholder was thereby able to take all the proceeds as a lump-sum, the risk of detriment is significantly greater- as it would be if the policyholder had a number of small pots.

Under the proposed new system, 'free guidance' might encourage the policyholder to move to another annuity supplier to increase their income by £50 a year. However, they may lose additional benefits as a result, and the cost of the advice would be born by other policyholders in the original pension scheme- supressing efficiency in the system, and reducing value for all.

The solution may in part be more cost-effective, streamlined advice, and simpler access for people with small pots.

The government estimates around 320,000 people a year retire with defined contribution pensions, though PWC estimates there are 400,000 requiring advice this year.

However we think there could be many times this number who seek to explore in 2015 the opportunities presented by the new pensions system: in theory, anyone aged 55 or over who is not yet taking an annuity from a defined contribution pension might seek guidance. We believe the government or the FCA should undertake immediate research to seek to understand the potential demand.

There is also the practical challenge that we are now less than a year from the introduction of the guidance guarantee. With more work needed in Treasury and the FCA to finalise the scope and nature of the guidance this is an incredibly challenging deadline. We consider it is vital that the guidance is robust and credible from launch, but that also Treasury is realistic in what can be achieved by that time. From a practical perspective it may be best to build on the support already in place rather than reinvest the processes by which consumers access help, accepting that the nature and comprehensiveness of guidance might change over time. It is unlikely any one agency or advice route will be ready to launch significantly different guidance on time.

The government should therefore consider how best to limit the demand for guidance, so that those with the most pressing needs are first in the queue. An online tool, as we discussed above, might therefore be a helpful step in enabling people to better understand whether they need more detailed guidance now, depending on their current circumstances and future retirement plans.

We are concerned that the cost of the guidance guarantee will be high, and how this will be funded. Treasury has indicated that the cost will be raised from the industry, and we would suggest this is derived from an annual levy of the largest pensions providers, rather than a system based on individuals who receive free guidance. We would also argue for a de minimis threshold to be applied, as the impact of a new levy on smaller providers could be very damaging.

The government has pledged £20 million to help provide guidance, though the estimated annual cost is around £100 million. However, there is significant uncertainty over these figures at present, as it is unclear currently how many people will seek advice, and how costly this will be. Assuming face-to-face guidance focused purely on someone's retirement situation, the potential cost for a 30 to 45 minute guidance session and follow up recommendation from an intermediary could be in the order of, say, £300. It is expected that this cost will be borne by the insurer, and whilst PLCs may have recourse to their shareholders, in all likelihood the cost will be drawn from the provider's pension fund. In effect therefore, all people not retiring will be subsidising the cost of guidance to those that do retire: if 1 in 20 policyholders retire a year that would mean that the cost of guidance would equate to £15 per policy per year.

With the average annual pensions charge of around 0.75%, and the average pension value of less than £10,000 (across all policies), this extra cost could not be extracted from the current £75 charge (ie £10,000 x 0.75%) without significant changes to the nature of the service provided. If only 50% of the population of 320,000 retiring with a defined contribution pension received face-to-face guidance though, with the remainders' needs being met by online information, the costs would be more easily absorbed.

Defined benefit schemes (Chapter 5)

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

We have not considered the impact on defined benefit schemes as they are beyond our core scope.

Financial markets and investment (Chapter 6)

A.4 The government would welcome views on any potential impact of the government's proposals on investment and financial markets.

The annuity market before the budget was said to be worth around £11 billion, and this is expected to reduce significantly, with some estimates that it will reduce to a third of this value by 2015. If that is the case, there will inevitably be significant changes in the investment strategies of pensions providers. In particularly they will be forced to alter the balance of portfolios to make them less illiquid in order to allow for significantly greater withdrawals.

As a result, it is likely that the proportion of equities invested in pensions will reduce to support greater liquidity risk. This will accelerate a long-term trend in the sector, which has also seen a significant increase in the proportion of bonds held- though these are not generally a solution to the need for greater liquidity.

With more retirees likely to choose alternatives to annuities, it does not necessarily follow that they will be moving away from illiquid assets – those taking drawdown or other approaches are likely to go for assets with higher expected overall returns (as opposed to higher income return), such as equities. Hence the demand for gilts and corporate bonds will reduce. This is likely to provide bad news for Government (and corporate) funding, though it will be a much greater issue for Government if Defined Benefit scheme members are also permitted to switch out at retirement- as the size of pots are so much greater. The expected consequence is that the cost of Government borrowing (and corporate borrowing) will rise as they have to offer more attractive returns to investors.

There is likelihood that some people will take money out of pensions to invest in property, with the potential for a higher yield. For example, currently annuity rates of 5 to 6% can be matched by rental returns on property, where the latter also provides for growth on the capital invested and the ability to cash in the investment in the future. Whilst this is only likely to benefit wealthy retirees (the average pension pot of £17,000 not providing enough for property investment), it is likely to reinforce the demand for property and increase the risk of house price inflation, and therefore lead to earlier increases in interest rates.

In late 2013 a number of large annuity providers were able to pledge a £25 billion investment fund into the government's infrastructure programme, announced as part of the UK insurance growth action plan. This was as a result of clarity on the treatment of annuities within Solvency 2, given the providers greater long-term certainty on investment plans. The changes to the annuity market must cast doubt of their ability to maintain such investments.

The changes proposed to the annuity market have already had an impact on the shares of some of the leading insurers- particularly annuity specialists- which saw significant value wiped off their businesses immediately after the budget. For larger providers, prices have recovered due to the diversity of the businesses.

Annuity rates have been affected by the long-term decline of bond yields (partly as a consequence of Quantitative Easing), as well as the historically low-interest rates. Whilst the former have increased and the latter likely to in the near future, coupled with increasing longevity, it is understandable that annuity rates are now so low (though research shows an increase in rates from the lowest levels in 2012).

But it is also true that the rate provided may vary significantly between providers. As explored above, AFM undertook a review of annuity rates before the Budget, and found that on average, an annuity invested with a mutual enjoyed a six per cent uplift compared to a PLC provider. This potentially reinforces the concern that PLC insurers profits from annuities have remained robust despite the fall in the rates offered to annuitants. Obtaining a fair return on an annuity is more likely today with a mutual, irrespective of the nature of guidance and information received.

Whilst the question focuses on the impact on investment and financial markets, we also thought it would be useful to explore other implications of the proposals. These may include:

- We consider that the government's proposals will overall increase the size of the pre-retirement pensions market. More people are more likely to find the concept of saving for retirement via a pension more attractive as a result. Some of this growth is likely to be a result of substitution from saving via an ISA, though we firmly believe there will also be a greater propensity to save as a result of these proposals, in conjunction with other recent pensions reforms (especially automatic enrolment) and the broader savings announcements made in the Budget (ie the new ISA, 0% starting rate on savings income, new NS&I products).

  Consumers are likely to benefit by a better deal at retirement: both in a widened choice and a better fit to their needs, but also as we would expect new options to become available, and anticipate a reduction in transaction costs.

- Annuity providers have already seen a dramatic reduction in new business, and for specialist providers in particular, in their valuations. This is inevitable in the short-term. We would expect to see some failures in the sector, and that this could have a negative impact on some consumers, in terms of diminished choice.

  Providers are also concerned that the cost of guidance/ advice might be significantly greater than the costs predicted by Treasury. The costs of 'free advice' will be borne both by the providers and ALL their policyholders: the alternative of free guidance/ limited advice for all, and paid-for advice for a minority with complex needs will help ensure costs are more fairly targeted.

- Overall we see the supplier market benefit from increased pensions savings. We also anticipate more innovation will help offset some of the other at retirement costs and the contraction of traditional annuities.

- Where consumers make better financial decisions, the onus on the State should fall. Whilst some people may squander their savings, we consider most people will save more and will act responsibly and in their own best interests at retirement.

The Treasury should in the long-term see an increase in pensions savings result in an increase in tax relief paid. This should offset the short-term potential for higher tax take if more people commute more of their pension immediately. The contradictory and complex modelling are beyond the scope of our response, but we urge the government to carefully and fully project the exchequer implications.