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Stephen Timms
Work & Pensions Committee Chair
House of Commons

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BY EMAIL ONLY

Dear Stephen,

Thank you for inviting me to give evidence to the Work & Pensions Committee as part of your inquiry into accessing pension savings. It is very important that the impact of the pensions freedoms are examined at this point after their implementation, to ensure they are working effectively for customers. I am writing to expand on some of the points I made at the evidence session, and to update the Committee on the ABI's recent report on pension withdrawals.

Pension freedoms - Annuities and Solvency II

The freedoms have opened up greater choice for people at retirement, and the retirement market has developed products to meet these needs. As I mentioned at the Committee, guaranteed income products (annuities) can be the most appropriate choice, particularly in later life, offering the lifelong financial certainty many retirees desire. However, the current costs of lifelong guarantees are high and have made this product less attractive to consumers, as well as providers.

The Government's current review of Solvency II presents the opportunity to make changes to key elements of this framework, in particular the Risk Margin, potentially contributing to making a guaranteed income more affordable, while maintaining high levels of customer protection.

The Risk Margin is an additional buffer insurers are required to hold over and above what they need to meet their obligations to customers and their extensive capital requirement buffers. The current calculation results in a Risk Margin which is too large, too sensitive to interest rates, and wholly inappropriate for long-term products such as annuities. Its flaws are universally accepted; even the PRA has described the current framework as "simply wrong" [1]. The sub-optimal allocation of capital caused by the current Risk Margin design places upward pressure on the price charged to policyholders, reducing value and product choice for them in exchange for unnecessarily high levels of protection. This makes selling annuities and other long-term guarantee-based products less attractive to firms, and the products less affordable for customers.

The ABI proposes modifying the framework to fundamentally reduce the amount of funds required for the Risk Margin element of Solvency II by at least 75%, which alongside some reforms to the regulator's supervisory approach to the Solvency Capital Requirement

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[1] Speaking recently at the Treasury Committee, Sam Woods, Chief Executive of the PRA stated: "The idea of the risk margin is a good one; it is actually common sense, but the way it is calibrated is problematic and, indeed, I would say wrong."***– 23 June 2021***
https://committees.parliament.uk/oralevidence/2433/pdf/

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(SCR), could help redeploy £35bn[2] to increase investment in the sector, help to improve the affordability and availability of guaranteed income products or support the writing of future capital-intensive annuity contracts. High levels of customer protection will continue to be upheld following reforms, with UK insurers holding in excess of £138bn[3] of solvency risk capital, in excess of technical provisions.

Pension freedoms - Supporting customers with decisions

To coincide with the Committee's evidence session, the ABI published the attached report, Supporting customer decisions about pension withdrawals. The report sets out the challenges customers face in making decisions about withdrawing from a pension, how providers and schemes currently support them, and what more could be done if different rules were in place. The report's key findings are:

- **Many current retirees are making full use of pension freedoms.** There are valid concerns about unsustainable withdrawals but right now they are mitigated by most retirees having other sources of income, particularly guaranteed income from defined benefit pensions: the Pensions Policy Institute found in 2018 "less than 10% of today's retirees reach retirement with only DC savings and no DB entitlement."[4] Future retirees will be much less likely to have other income to rely on and many will be relying solely on a DC pension.
- **Most people are not getting the support they need to make decisions about withdrawals**. The industry has an important role to play in providing this help, in addition to regulated financial advice and greater, earlier uptake of impartial guidance from Pension Wise.
- **Pensions providers have improved the support they offer by more tailored communication and greater use of digital channels**. The industry could go further still, by improving how pension options are presented to customers and defining boundaries to shape decisions, so customer decision making is simpler and safer. A change in the rules about guidance and advice would enable providers to do more.

The key policy recommendation from the report is to change the guidance and advice rules so that the majority of customers get support with pension withdrawals. Providers are currently limited in how much support they can offer without giving a personal recommendation, and therefore giving financial advice (which would require them to undertake a full fact find). Rule changes would enable providers to support customers by, for example:

- Telling customers about the income tax implications of taking a lump sum
- Talking customers through what a sustainable income could look like, taking account of their circumstances but without a full fact find
- Providing more details on risk in investment pathways

[2] https://www.abi.org.uk/globalassets/files/publications/public/regulation/kpmg-report-on-macro-economic-impacts-of-potential-regulatory-changes-from-solvency-ii.pdf
[3] https://www.abi.org.uk/globalassets/files/publications/public/regulation/kpmg-report-on-macro-economic-impacts-of-potential-regulatory-changes-from-solvency-ii.pdf
[4] PPI *The evolving retirement landscape*

- Prompting customers to consider that people in their situation often secure a guaranteed income at a particular age.

Pension freedoms - Investment Pathways

The report also includes the first ABI data on the implementation of investment pathways (see also Annex). It is very early data from the first three month of pathways being implemented, and only covers part of the market. However, the data suggests that the pathways are being used as intended and validate an approach based on choice, as customers are choosing different options. As I said at the Committee, similar numbers chose the options "I have no plans to touch my money in the next 5 years" and "I plan to take out all my money within the next 5 years"; demonstrating that a single default investment would have been the wrong choice for one or other of those groups. It will be important to evaluate how investment pathways work in practice over time, and the FCA's post-implementation review should assess the customer experience. Providers will also monitor how compatible customer behaviour is with their stated intentions.

However, the Department for Work & Pensions (DWP) has not yet introduced equivalent investment pathways regulations for trust-based schemes, nor one-page retirement communications. There are also data gaps in the use of pension freedoms by trust-based scheme members. Conversely, on other policies DWP have taken the lead with FCA following. DWP is now consulting on the 'stronger nudge to pensions guidance', but with critical differences to the consultation just completed by the FCA, for example whether customers receiving advice are in scope. Regulations need not necessarily be simultaneous or identical, but we would like to see DWP and FCA (and where appropriate TPR and HMRC) do more to ensure their regulations are aligned and sequenced in order to prevent gaps between trust-based and contract-based schemes emerging.

Pension freedoms - Money Purchase Annual Allowance

At the Committee, I mentioned that the Money Purchase Annual Allowance (MPAA) is a reason why people choose to take a tax-free lump sum and no income – doing this by itself does not trigger the MPAA and therefore restrict tax relief to the first £4000 contributed per year. Subsequent withdrawals do then trigger the MPAA. This is unnecessarily complicated, drives illogical decisions, and more widely the MPAA penalises ordinary savers who needed to access their pension at an early age but also needed to continue saving. It can be solved by scrapping the MPAA altogether and replacing it with enforcement of existing rules on recycling cash.

Pensions Dashboards – Estimated Retirement Income

Finally, the Pensions Dashboard Programme is now developing apace, and we are on track to see the first dashboards go live in 2023. However, a key outstanding question for the Programme is about estimated retirement income – what to communicate to dashboard users about the retirement income their pension pots are likely to generate. It is important that dashboards are able to help customers understand how different their retirement income might look if they access pensions at different ages or in different

ways. But it must be delivered in a way that works for users and simple enough to be achievable by pension schemes. This is a critical step in delivering dashboards to the Programme's timeframes. An urgent decision is needed from Government and regulators on the requirements for data providers and dashboards in relation to estimated retirement income – without it, it may not be possible to include this information in initial dashboards. For our part, we will be putting forward our proposals on how best to present this information to users.

I hope this is able to assist the committee in its inquiry, and please do let me know if you would like any further information on this or any other points I made at the committee.

Best wishes,

Yvonne Braun
Director of Policy, Long Term Savings & Protection