FREEDOM AND CHOICE IN PENSIONS

Budget 2014 – A Pensions Revolution?

March 2014

Following the surprise announcements in the Budget, the implications for UK pensions and savings are far reaching. The Chancellor announced a fundamental reform, principally in the way people access their Defined Contribution ("DC") pension, to provide more freedom and choice. That reform has significant implications for all types of pension arrangement and for personal financial planning.

In this briefing we highlight the key changes announced, outline the action that should now be considered, and comment on some bigger picture social policy issues in what is becoming a new and different retirement era.

Immediate Flexibility

From 27 March 2014, the Treasury has announced some immediate changes, outlining more flexible rules around flexible drawdown and trivial commutation:

- **Relaxed drawdown limits** – The minimum amount of guaranteed pension income individuals need in order to access their pension savings flexibly is reducing from £20,000 to £12,000 and the capped drawdown limit is increased from 120% to 150%. This implicitly recognises the value of other non-pension assets for total retirement saving and partly answers criticism of the current rigid drawdown limits.
- **Small pension sums** – Trivial commutation limits are relaxed for Defined Benefit ("DB") and DC plans. A trivial commutation lump sum can now be taken where a member has under £30,000 of pension savings in registered pension schemes (up from £18,000). In addition, the size of a small pension pot that can be taken as a lump sum has been increased from £2,000 to £10,000 and, for personal pension plans, the limit on the number of such pots that can be taken as a lump sum has increased from 2 to 3.

Immediate Action

- Trustees, employers and providers to decide whether and when members may take advantage of the new flexibility on DC drawdown limits and DB and DC small pension sums.
- Review and amend plan rules and member communication.
- Update retirement and early leaver processes.

Take Care

The Government's intention is to introduce the revised legislation via the Finance Act 2014 in or around August 2014 and to backdate it to 27 March 2014. Many plan rules refer directly to the current limits and if a payment is made that is greater than the current limits, it risks being an unauthorised payment unless this backdating flaw is addressed. Advice should be sought.

Defined Contribution Flexibility from April 2015

The tax rules are to be altered so that individuals can decide how to access their DC pension, whether as a lump sum, an annuity or through a drawdown product, accessible from age 55. This will cement the right to flexible retirement in a way that up until now has been a matter of the contract between employer and employee. The Treasury is consulting on a range of implementation issues, including whether this flexibility will be overriding, or whether it will still be subject to individual plan design.

- **Tax free lump sum** – Individuals may continue to take a lump sum usually of 25% of their DC assets as tax free cash (although there is developing speculation as to whether this is sustainable for the Treasury in the medium term).
- **Full taxable commutation** – Assets above the tax free lump sum may also be taken as cash, taxed at the individual's marginal rate (rather than at the current rate of 55%).
- **Full drawdown** – There will be no cap on the amount that can be withdrawn as drawdown income and no minimum income requirement.
- **Impartial guidance** – The Government is to introduce a new "guarantee" (to head off the risk of mis-selling) for all DC savers of "free and impartial face-to-face guidance on their choices", and a new duty on pension providers and trustees of trust-based pension plans to offer this.

Defined Contribution Action Before April 2015

- Consider responding to consultation (which closes on 11 June).
- Before April 2015, trustees, employers and providers to decide whether and when members may take advantage of the new flexibility.
- Consider whether changes are overriding, and/or the extent to which rules will need amendment.
- Consider member communication – to inform them of any new plan policy.
- Update retirement and leaver processes.
- Consider current transfer policy and any impact of a potential increase in transfers.
- Review investment strategy and lifestyle default fund design – current funds may be incompatible with ongoing risk in retirement and/or cash exit.
- Address guidance duty – how, when, who? Note that many trustees will be unable to provide this without a relaxation to financial services legislation.

Implications for Defined Benefit plans

The key changes have been heralded as providing much-needed flexibility for DC savers. There are implications for DB plans too; some of which are deliberate but others are more indirect or even unintended.

- **Public service transfers** – The Government has announced its intention to ban transfers out to DC plans from public service pension plans, to avoid the consequential burden to the taxpayer of early access to more flexible benefits (other than in limited circumstances). The real cash flow issues here affect unfunded public sector schemes (where capital outflows would be crystallised in a pay as you go scheme) but, as ever, the Government seems unable to distinguish between these arrangements and the funded schemes such as the Local Government Pension Scheme.
- **Private sector DB transfers** – The Government is consulting on whether there should be similar or other restrictions on transfers from private sector DB plans, because of concerns around the impact on capital markets and potential damage to the wider economy. While the arguments are plausible – that the demand for corporate credit from DB pension plans will fall if transfers are funded by selling bonds – this is a bold foray into micro-management of asset allocation which will provoke righteous reactions from employers and trustees alike who have borne the cost of quantitative easing in gilt prices over the last few years.
- **Defined Contribution benefits in Defined Benefit plans** – DB plans which provide DC benefits (whether as hybrid plans or Additional Voluntary Contribution arrangements) are also affected by the DC changes outlined above. The Treasury makes no mention of the complexities of partial transfers from hybrid plans which would be affected by such changes. Trustees need to take particular care of the effect on members who have rights to enhanced lump sums on pre A Day service.
- **Triviality** – The triviality commutation limits outlined above also apply to DB plans from 27 March 2014.

Defined Benefit Action

- Consider implementing for DC benefits within your plan
- Accelerate any consideration of transfer out incentive exercises for liability management – this option may be closed soon.
- Consider transfer experience, actuarial factors, and the likely impact of potentially increasing transfer-out requests, including administration resourcing.
- Consider communication messages, and the duty of trustees to act in members' best interests. How far does this duty extend in any debate around security v. flexibility for members?
- Review liability driven investment strategy and implications for investment returns – there is a growing concern that the wider implications of reducing annuity purchases and the impact on the capital markets will materially affect liquidity and return, and indirectly increase the cost of DB liabilities.
- Consider the impact of the removal of compulsory DC annuitisation on the wider annuity market, including the pricing of bulk annuities and the knock-on effect on the calculation of section 75 liabilities.
- Accordingly, consider responding to consultation (which closes on 11 June).

Social Issues – a new approach to retirement?

Whose money is it anyway?

These changes will have a significant impact on the retirement market. In recent years, in part due to the auto-enrolment reforms, the UK has experienced an inexorable march to DC benefit provision but the underlying trust law and financial services regime which regulates DC has simply not kept pace – hence all of the Pensions Regulator's attention to the question of DC governance. The current regime insufficiently recognises the investment risks borne by individual members. The changes herald a new understanding that pension savings represent an individual's own money, so that greater flexibility as to how the individual accesses that money should follow. This may disturb a legal fiction that DC money is "owned" either by trustees or pension providers such as insurance companies.

Flexible retirement – a right not an option?

Another major challenge to the status quo, by giving DC members greater access to their savings at age 55, will also bring major challenges to retirement patterns, reinforcing the abolition of the default retirement age. Whether the automatic enrolment rules keep pace with this radical change remains to be seen.

Social care – finally some joined up thinking…

We have advocated for some time the need for greater integration between the pensions and social care regimes. In our 2013 white paper, "*In Sickness and in Health: Reforming Pensions and Social Care*" we made a number of recommendations designed to introduce more flexibility as to when and how an individual should access pension benefits to support social care needs. The Government's changes go a long way, and arguably for some, too far, towards addressing the need for flexibility. Even so, the UK still needs properly integrated state retirement and welfare benefits and we consider there is still need for improvement in the integration of differing social care and pension policies for retirement and long term care, whether driven by treasury, welfare or health-related Government policy.

We welcome the recognition of the need for greater support for individuals in making retirement choices and first advocated an easement on this in our 2012 white paper, "*Pensions in the Age of Austerity*".

A new duty of care?

In practice, trustees and pensions managers will not be authorised, and in many cases competent, to give "guidance" at the point of decumulation. We await detail on how this new duty will be implemented and whether the duty will form part of the exercise of trustees' investment functions (liability for which cannot be excluded or limited by virtue of section 33 of the Pensions Act 1995). Trustee protection of members' interests is a long established concept, but one of the consequences of the new proposed duty may be to encourage yet another shift away from trust based retirement plans towards contract based vehicles to avoid this new duty of care.

Long term impact plus immediate action

Overall, there is much to welcome in the radicalism of the Government's proposals and changes as too many pension savers with low sums of money have been deprived of a meaningful use of their own savings by the current regime. However, it remains to be seen whether the new regime will in reality support long term increased retirement provision or will have potentially unforeseen consequences for the DB regime. In the meantime, much action is needed (as outlined above) to address the changes now announced.

If you wish to discuss the implications of the Budget changes for your pension plans, please contact any of the individuals below, or your usual contact in the Squire Sanders pensions team.

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