The Trustee toolkit downloadable

How a DC scheme works 2014

Tutorial five: Decisions at pension age

By the end of this tutorial you will better understand the:

- ways in which members can access their benefits at pension age
- legal requirement to information to the member regarding their options at pension age
- implications of poor decisions by members at pension age
- importance of an effective communications process in mitigating risks to good member outcomes
- steps trustees can take to improve their scheme's pension age, or retirement, process

This tutorial is part of **Scenario two**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Introduction

The Tutorial: 'Good member outcomes' earlier in this module introduced you to the risks that might affect the outcomes for a DC member. There is one risk applicable to this tutorial: when members make poor decisions at pension age.

Why does this risk occur?

This risk occurs because individuals are responsible for making the decisions about how to convert their pot into a pension. This phase is sometimes referred to as 'decumulation' as the member starts to access their benefits.

As members are not always well-equipped to make these decisions, there is a significant risk that they will make inappropriate decisions for their own personal circumstances or fail to obtain the most competitive rates for the product that they are purchasing.

What can trustees do?

There are a variety of options open to members for accessing their benefits which may or may not be available to them directly from their scheme.

Trustees are expected to make members aware of their right to transfer their benefits to another scheme at any age in order to take advantage of the different options, whether or not the scheme itself offers them.

Whilst trustees are not responsible for the decisions made by members and cannot offer investment advice, trustees are responsible for providing communications on members' options and telling them about the government's 'Pension Wise' guidance service.

> Visit the Pension Wise website at **www.pensionwise.gov.uk**.

Trustees must also provide certain warnings about the risks attached to the various retirement options that members may have.

These can be either generic risk warnings about the risks associated with each option or personalised risk warnings where trustees ask members questions to identify any attributes, characteristics, external factors or other variables that increase the risk associated with an individual's decision to take benefits in a certain way.

It is helpful if trustees can monitor the decisions that members are making when they reach pension age. If the decisions that they are making do not fit their member profile (perhaps nearly all of them are choosing higher risk options), this might indicate that the communications to members should be reviewed.

Disclosure regulations

Trustees need to ensure that information and communications provided to members comply with the Disclosure of Information Regulations 2013. In this tutorial, you will learn more about the wide variety of options available to members of DC schemes when they reach pension age and how trustees can develop the scheme's processes and communications to minimise the risk that they will make poor decisions.

You will find more information in the Tutorial: 'Member communications' and the Module: 'Pensions law'. You can read the guide to communicating and reporting at **www.tpr.gov.uk/communicate**.

The right retirement decision for an individual

If you consider a group of individuals of approximately the same age who are members in the same scheme, you may find that they have very different circumstances.

Member A: Greg	**Member B: Flavia**
Greg is 52 and a deferred member of the scheme but he is in poor health and is currently receiving some state benefits. Greg has two children and hopes to take his retirement early.	Flavia, aged 53, is a deferred member of the scheme with a large pension pot. She is now running her own business and expects to continue earning whilst drawing her pension. She understands investments well and likes to take a higher risk with some of the value of her pot.
Member C: Graeme Graeme, aged 62, is an active member of the scheme. He has been investing in property over the years and now has a large rental portfolio which will pay him an income when he retires in three years. He hasn't invested much into his pension as he built up his property empire, but plans to stop working at age 65. His wife has recently retired and is now receiving a pension from a defined benefit pension scheme.	**Member D: Helen** Helen, aged 64, has been an active member of the scheme since age 60. She expects to continue working until her mortgage is paid off when she is aged 68. She was automatically enrolled into the scheme at the lowest contribution rate possible and admits that she finds pensions difficult to understand.

Summary

Individual circumstances for members may vary. They could be:

- planning to start accessing their benefits at different ages
- in poor or good health
- active or deferred members
- either working or not working currently
- expecting to continue in paid work while drawing a pension
- holding different assets and liabilities (eg other pensions, property, mortgage or other debts)
- receiving state benefits
- in a partner relationship with someone with a large pension
- either single or with dependants

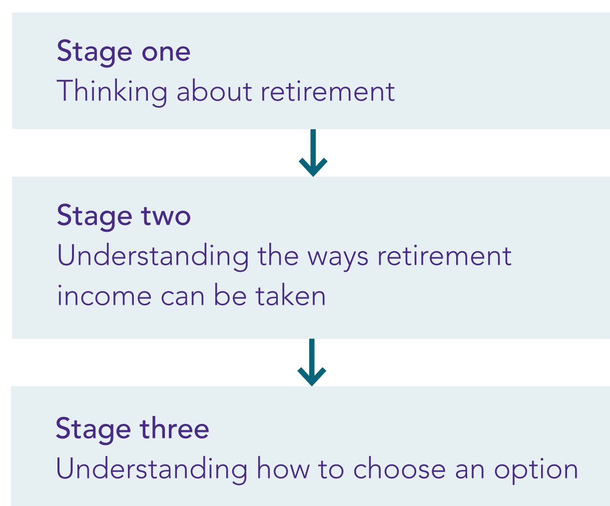
The member could have:

- small or large retirement accounts
- different levels of financial literacy
- different attitudes to risk

These differences are very important when members choose their option. The solution chosen by one member may not suit someone else. Keep these four different members in mind whilst working through this tutorial. What decisions are they likely to make? What support might they need?

Member timeline

There are three stages of understanding that the members will need to pass through before they are likely to be ready to make the decision about their pot. Let's look at stage one first.



Stage one: Thinking about retirement

Some members will only start thinking about the decisions that they need to make when they are close to reaching pension age. Generally, members will benefit if trustees prompt them to consider the issues below well in advance of their target pension date.

- When they want to retire.
- Whether they might wish to stagger their retirement.
- The impact of timing of retirement on the income that they would receive.
- Whether their scheme has any special rules.
- What other income they can expect (eg from the state pension).
- Whether they have any other pension benefits in other pension arrangements.
- Whether these pension benefits can be combined or split.

Stage two: Understanding the ways retirement income can be taken

Traditionally, at retirement members of DC schemes would convert their accumulated fund or value of their pot into a retirement income (a pension). This is known as the crystallisation of their benefits or decumulation.

In many cases, the member leaves the scheme (and ceases to be a member) when they take their retirement income. However, in some cases, scheme pensions or other retirement products are offered. From 6 April 2015, the options available for a member's accumulated fund in a DC scheme widened. Broadly, from age 55, members of DC schemes have the right to:

- get a guaranteed income for life - this is known as a lifetime annuity and the income it provides will be taxed as earned income at the member's marginal rate of tax
- get a flexible retirement income (flexi-access drawdown) - this allows members to leave their money in their pension pot and take a taxable income at intervals and times to suit them
- take their whole pot as cash in one go - a quarter of the value can be taken free of tax but the rest will be taxable at the member's marginal rate of tax
- take their pot as a number of lump sums - the member can decide when and how much to take out and each time they take a lump sum a quarter of it is free of tax with the excess taxed at the member's marginal rate of tax

Members may also take any combination of the above and/or delay taking anything from their pot until a later date. Trustees of DC schemes are not obliged to offer all of these options from their scheme. However, they must allow members to access them. This access can be achieved by either offering these options from the scheme or by allowing members to transfer to a provider that does offer their chosen option.

The information provided to members at pension age should cover the full range of options available, both within and outside the scheme, and must tell members about the government's 'Pension Wise' guidance service. This enables members to choose the option best suited to their own particular circumstances.

Trustees will find it helpful to consider the information provided on each option when drafting text for the risk warnings they are required to send out to members in relation to the different options.

Taking an income: Lifetime annuity

Most members, historically, have received a retirement income by means of a lifetime annuity.

How do they work?

In exchange for the value of the member's pot, the annuity provider promises to pay the individual a regular income for the remainder of their life.

If the individual, who has taken out an annuity, lives for a long time then they will receive much more income than if they die soon after they start receiving their benefits. Therefore one of the key factors used to determine the size of an annuity is the individual's life expectancy. In order to spread their risk, the insurance company sells lifetime annuities to many people. This is called pooling. Some people will live less time than expected so they will, in simple terms, be subsidising others who live longer than expected.

Insurance companies also take on the investment risk for this type of annuity. Annuity rates may therefore vary over time according to the insurance company's expectations of the returns that they will achieve on the money that they invest. Trustees must inform members that they have a right to purchase an annuity on the open market.

Common options

There are a range of options available. These are the most common.

- Single/joint life: A single life annuity pays an income to the individual for the rest of their life. A joint life annuity pays an income to the individual for the rest of their life and continues to pay an income (often at a lower rate) to the surviving spouse or dependant on the death of the member.
- With or without guarantee: If a guarantee is chosen then, even if the member dies within the guarantee period, typically five or 10 years, the annuity will continue to be paid, either to a named individual or to the estate.
- Level or increasing/index-linked: A level pension remains the same throughout the individual's life. Increasing/index-linked payments increase each year, either by a fixed percentage or by the increase in the retail price index (RPI) or consumer price index (CPI), possibly subject to a cap on the rate of increase. This option is intended to ensure that the pension keeps up, at least to some extent, with inflation in retirement.

What impact will the options have on the income level?

Each option within an annuity has a price and this price is reflected in the level of income that the member will receive. Some options have a small impact and are inexpensive, while other options can be expensive. Usually, the most costly option is the increasing annuity because this is the most costly option for the insurer to provide. The cost of a joint life pension will depend on the age of the spouse/partner. Guarantee periods do not generally have a great impact on price, but the cost will increase with the length of guarantee. If a decision to buy an annuity is taken, the decision as to which annuity to buy will be a judgement for the member to make that balances the cost of the product with the features it provides.

Other annuity types

There are three other types of annuity.

Enhanced and impaired life annuities

One of the key factors affecting the size of an annuity is the life expectancy of the individual. Insurance companies may pay a larger annual annuity if the individual is not expected to live as long as other people. Individuals are often unaware that they may be eligible for these types of annuities.

Enhanced annuity

The enhanced annuity is available to individuals who have a lifestyle which may shorten their life. This could be because they are overweight, smoke, have done certain manual jobs or live in a particular part of the UK. They can sometimes be purchased without further medical evidence since the terms often depend on lifestyle rather than illness.

Impaired life annuity

The impaired life annuity is available to individuals who have a health condition/illness which threatens to shorten their life. The provider has some certainty that the pension income will cease earlier than a standard annuity. The rates offered can be significantly increased and are always subject to underwriting and further medical evidence.

Investment-linked annuity

For the types of annuity already covered in this tutorial, the insurance company carries the investment risk as well as the individual's longevity risk.

With investment-linked annuities, the individual takes on some of the investment risk. This means that members can take advantage of investment growth but there is a risk that the value of the investment and the income could fall, although a minimum level of income is normally guaranteed. These types of annuities are often more costly for providers to run so the charges may be higher than for conventional annuities. Since the income cannot be fully guaranteed, investment-linked annuities may only be suitable for members who are prepared to accept a degree of risk with their pension income.

Taking an income: Other options

Here are two examples of other options members might choose to take.

Flexi-access drawdown

A flexi-access drawdown pension (also called income withdrawal) lets a member draw an income from their pension pot while leaving it invested. There are no limits on the income that an individual can take, subject to tax. A quarter of the pot can be taken tax-free and any other withdrawals are taxable. As with any investment, there's the risk that the value of the pot can go up and down.

Members considering this option need to think about how much they are likely to withdraw each year and how long their money needs to last. It's important that members check the impact of any charges on lump sums withdrawn as well as on undrawn funds.

Different schemes and providers offer different types of flexi-access drawdown and members should consider shopping around to find the best option to suit their circumstances.

Fixed term annuities

Under a drawdown arrangement a member can also use the value of their pot to buy a fixed-term annuity. This provides the individual with an agreed income for a specified term (say three or five years). It also promises to pay a set lump sum at the end of the term which the individual can use to buy a further fixed term annuity or a lifetime annuity if they wish. These arrangements are sometimes known as short-term or temporary annuities.

Taking the whole pot as cash or as a number of lump sums

Members considering these options need to think carefully how they will provide an income when they stop working. It's important that they do not underestimate their own life expectancy.

There are also tax implications when the whole or part of a pension pot is taken as cash. Although a quarter of the pot can usually be taken tax-free, the rest is taxable. Members need to consider their personal tax circumstances and whether they might have to pay a higher rate tax than normal if they choose one of these options.

Some providers and schemes may also charge members for taking lump sums or leaving part of the pot invested so it's important that members check whether charges will apply.

Stage three: Understanding how to choose an option

Trustees must communicate with members as they approach pension age. This can help members understand more about their options and how they can buy decumulation products.

What must be communicated?

Trustees must tell such members about the government's 'Pension Wise' service and must also provide a 'wake-up' pack to members.

What must be in the 'wake-up' pack?

The wake-up pack must include:

- a statement of the options available to the member under the scheme rules
- a statement that they have the opportunity to transfer flexible benefits to one or more different pension providers
- a statement that different pension providers offer different options in relation to what the member can do with the flexible benefits, including the option to select an annuity
- a statement that different options have different features, different rates of payment, different charges and different tax implications
- a copy of the revised Money Advice Service leaflet 'Your pension: It's time to choose' which has been approved by The Pensions Regulator (TPR), or a statement that gives materially the same information
- an estimate of the value (or CETV if relevant) of the affected member's flexible benefits (if the benefits are 'transferrable rights' in accordance with the disclosure regulations), the date that this was calculated, an explanation that this is not guaranteed and information about any guarantees or features, restrictions or conditions that could affect the value
- a statement that there may be tax implications associated with accessing flexible benefits, that income from a pension is taxable and that the rate at which income from a pension is taxable depends on the amount of income that the member receives from their pension and other sources

When must the wake-up pack be provided?

Trustees must provide a wake-up pack to members at least four months before they reach their selected pension date. However, trustees should consider communicating earlier than the legal deadlines where this makes sense.

Does this information have to be provided at any other time?

Yes, the same information must be given where a member:

- asks the trustees about taking benefits
- informs the trustees they are considering or have made a decision in relation to what to do with flexible benefits
- is over or within four months of normal minimum pension age (currently 55), or they meet the ill-health condition

This doesn't need to be sent if the same information has been provided to the member within the last 12 months except for where a member is approaching their pension date. The trustees still need to provide the estimate of the value of their flexible benefits information (even if you the information has been provided within the last 12 months) and provide a statement that the member has been given information about the:

- flexible benefits that may be provided to the member
- member's opportunity to transfer those benefits
- options available under the scheme rules

When does this information need to be sent?

The timeframes for providing this information are broadly:

- where an affected member is approaching their pension date, at least four months before that date, or if the pension date is specified less than four months before the date the benefits become payable, within 20 days of the date the pension date is specified
- where an affected member requests information (or informs the trustees they are considering or have made a decision in relation to what to do with flexible benefits), within two months of the member making the request or informing the trustees
- where there is contact between trustees and affected members about what they can do with flexible benefits, within 20 days of the initial contact

Other information

The amended Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 outlines the information that must be provided to affected members and when it must be provided. Separately, trustees are encouraged to provide additional information to assist affected members.

You can learn more about this by reading the guide to communicating and reporting at **www.tpr.gov.uk/communicate**.

Focus on the risk

The decisions that members make about their pension benefits are complex, often irreversible and can have a significant effect on the quality of their life after retirement.

Risks at pension age: Member information

In the run up to a member accessing their pension benefits, trustees should ensure that members have information about:

- the options available to them
- the types of products available to them
- the differing features of each option including tax implications and other generic risk warnings
- the government's 'Pension Wise' guidance service

Even if members have gained a good understanding and made an informed decision about the retirement product that they want to take out, trustees should make sure that members are made aware that their retirement income could be affected by:

- the value of their fund falling just before they access their benefits due to investment risk if they are in volatile funds
- annuity rates falling before they buy an annuity either because mortality rates are improving or because long-term interest rates are declining

Risks at pension age: Impact to members

If members are not in possession of all the information they wish to access their benefits, they may:

- choose an option that doesn't suit their needs when another option may be more appropriate, for example deferring drawing their pension if they do not need the income, for example, they are continuing to work
- not realise that they are eligible for an enhanced or impaired annuity, which many people qualify for due to their lifestyle or medical condition
- not have understood the different tax implications of different options
- have to pay other costs that they had not accounted for (eg they may not have realised that the costs involved in certain retirement products increase with extra complexity)

Risks during retirement

If a member chooses an unsuitable option when accessing their benefits there is a risk that they may not have enough income to last the rest of their life or provide for dependents.

If a member chooses to take an annuity but selects the wrong type of annuity then there is a risk that it proves to be unsuitable (eg fails to keep pace with inflation, doesn't provide for spouse/dependant/civil partner).

There is also the risk that members will choose complex products they do not fully understand or that are not suited to their needs in retirement.

Mitigating the risks: Designing a process

The pension age, or retirement, process is the end-to-end set of scheme communication materials, additional support provided to members in the lead-up to retirement and the implementation of members' decisions.

The process

Processes vary between schemes but they often offer:

- a scheduled series of communications which inform the individual about their options as they approach (and pass) their target pension date
- online resources such as annuity calculation tools and other information
- pre-retirement training courses
- access to independent financial advice
- telling members about the government's 'Pension Wise' guidance service
- annuity broking services

The objective of the process should be to guide the member to make the most appropriate decisions based on their individual circumstances. There are two broad types of support that trustees may wish to offer.

An intermediated process

In this process the trustees and/or the employer facilitate member decision making by appointing an adviser or annuity broker.

An information process

In this process, members make decisions for themselves and are supported in this decision making process by information from the scheme trustees and others involved with the administration of the scheme. The government's 'Pension Wise' guidance service is designed to help members understand the options they have.

Deciding on the process

The decision on what level of support to provide to members is a scheme design issue which will often be a decision for the employer. Wherever possible, trustees should follow an intermediated process by providing members with access to independent financial advice or an annuity broking service.

Many schemes already provide this kind of additional support to members and TPR is happy for trustees to continue to do so. This increases the likelihood that members make the optimal decision, based on their individual needs and circumstances.

> You can learn more about this by reading the guide to communicating and reporting at **www.tpr.gov.uk/communicate**.

The ABI code

The Association of British Insurers (ABI) code of conduct on retirement choices is a mandatory code which ABI members are required to follow.

What is it?

The code sets a baseline standard for the retirement communications issued by ABI member organisations to pension scheme members.

TPR expects all occupational trust-based DC schemes, including those where there is no insurer, to meet the standards set out in the ABI code in respect of their retirement processes and communications with scheme members.

What do trustees need to do?

The ABI code only covers communications with members, and in practice many schemes already go much further in the support that they provide to members. TPR wishes trustees to continue to do this and to maximise the support they can provide to members at pension age, given the complexity of the decisions that need to be made at this point.

Where the scheme insurer provides pension age literature for trustees to issue, they should obtain assurance from their insurer that it is compliant with the ABI's code. Trustees should also satisfy themselves that the retirement process and literature meets the specific legal requirements in respect of the disclosure regulations.

You can view the ABI code at **http://bit.ly/ABIcode.**

or view the The ABI's work on pension language: Making Retirement Choices Clear at **http://bit.ly/ABIguide**

Case example: Four members

Remember Greg, Flavia, Graeme and Helen who we met earlier in this module? They are all members of a scheme with:

- a normal retirement age of 65
- warm-up letters sent to members when they reach 62
- a further letter sent six months before age 65 with information about the pension options available to them
- support tools such as planners and information about other options are available on the employer's intranet only

A key issue for consideration when designing a pension age, or retirement, process is whether it works for all types of members. Which of these four members does the scheme retirement process above best support in making informed decisions?

Greg, aged 52, is a deferred member of the scheme but he is in poor health and is currently receiving some state benefits. He recently wrote to the scheme, telling them about his situation and that he wishes to draw his benefits next year, and they have sent him the standard letter normally sent at age 62.

Flavia, aged 63, is a deferred member of the scheme with a large pot. She is now running her own business and expects to continue earning whilst drawing her pension. She understands investments well and likes to take a higher risk with some of her pension pot.

Graeme, aged 62, is an active member of the scheme. He has been investing in property over the years and now has a large rental portfolio which will pay him an income when he retires in three years. He hasn't invested much into his pension as he built up his property empire, but plans to stop working at age 65. He is concerned about the low level of annuity rates currently. His wife has recently retired from a defined benefit pension scheme.

Helen, aged 64, has been an active member of the scheme since age 60. She expects to continue working until her mortgage is paid off when she is aged 68. She was automatically enrolled into the scheme at the lowest contribution rate possible and admits that she finds pensions difficult to understand.

Feedback is at the back

Improving the process

If schemes provide members with high quality scheme communications and additional support when making decisions, the members are more likely to understand the options available, to shop around for a competitive deal and to choose the right option given their particular circumstances. Below are four actions trustees could take now.

Types of process

For most schemes, as members' personal circumstances are so diverse, a range of pension products are likely to be appropriate, in addition to lifetime annuities.

Trustees should consider whether an information-based process is providing the optimal support for members and whether to provide an intermediated process, to assist members in identifying the right product with the right features.

Information for members

Information on the options at pension age should be provided to members prior to their pension age. Trustees can address this by providing a copy of the Money Advice Service guide 'It's time to choose'. This explains the range of retirement products available to members and how they can shop around to get the best deal.

> You can download the Money Advice Service 'It's time to choose' guide at **http://bit.ly/timechoose**.

Ensuring data quality

Trustees need to be able to send the right information to the right member at the right time.

- To send letters to members, trustees need their addresses.
- To send scheduled letters at the right time with appropriate projections, trustees need correct dates of birth and expected retirement dates.

Trustees can take steps to improve data quality by actively tracing missing members and by encouraging members to ensure that the information held about them is correct. If a member does not keep their intended pension date up to date then they will not receive scheme communications at the most appropriate times.

Communications timeline

Trustees should plan their communications with members in the years leading up to their expected pension date so that members are prepared for the decision they need to make.

> You can learn more about this by reading the guide to communicating and reporting at **www.tpr.gov.uk/communicate**.

Feedback

Case example: Four members

This process does not support Greg's situation. Greg is likely to benefit from other options, such as a serious ill health lump sum payment or an impaired life annuity. As a deferred member of the scheme, no longer working for the employer, he will not have access to the employer's intranet to find out about options which may be more suitable for him than a conventional annuity. The process therefore is at risk of Greg making a poorly informed decision.

This process does not support Flavia's situation. Flavia is a deferred member of the scheme, no longer working for the employer so she will not have access to the employer's intranet to find out about options which may be more suitable for her than a conventional annuity. For example, a drawdown pension may be appropriate and she may not realise this. The process therefore is at risk of Flavia making a poorly informed decision.

This process best supports Graeme's situation. The process is likely to work better for Graeme as he is engaged in the topic and already has some understanding of pensions. He may want to take advantage of taking a lump sum (or sums), a fixed term annuity or deferring drawing his benefits and as he has access to the intranet, he can find out more about these options.

This process does not suit Helen's situation. Helen is likely to benefit from options other than a conventional annuity. She is not financially sophisticated and may not realise that she qualifies to receive the whole of her pension fund as a lump sum (subject to tax on the excess over 25%) as she does not have the confidence or understanding to take advantage of the information on the scheme's intranet. The process therefore is at risk of Helen making a poorly informed decision.

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