

# 5 Stone Buildings

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**Pension flexibilities and default options  
- an impossible mismatch ?**

**Henry Legge QC**

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25 April, 2018

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## Pension flexibilities

- Introduced from April 2015
- Applicable to DC funds (but reports of transfers from DB to DC in order to take advantage of flexibilities)
- HMRC estimates: April 2015 to March 2017: £9 billion of savings accessed by 500,000 members
- Not yet a big issue for occupational schemes because most DC members have not yet reached retirement (according to tPR report)
- Six options

## The six options

- Leave pot untouched (ie continue to accumulate after NRD)
- Purchase an Annuity
- Adjustable income (ie income drawdown)
- Take cash in chunks (ie drawdown of capital)
- Take whole pot in one go (25% tax free, the rest subject to tax)
- “Mix your options”

## A few issues created by pension flexibilities - on and after retirement

- Right for members to choose to take their pensions under one of the options, but no obligation for occupational schemes to provide the flexibilities.
- If provided within the scheme could there be liability for the trustee/employer for providing advice ?
  - Provision of information required to enable member to make informed choice ?
  - Tax !!!
- Options for drawdown much more complex than DB scheme or annuity purchase.
  - New area for DC scheme: systems issue ?
  - Investment of fund after retirement

## Some issues on and after retirement

- If flexibilities not provided within the scheme, does scheme refer member to a different provider ?
  - Could this be culpable?
  - Regulated advice ?
  - Implies recommendation/due diligence ?

## Investment prior to retirement date

- “lifestyling”
- Reg 10A(5) of the Stakeholder Pension Schemes Regulations (2000/1403)

*“the process, applied from the relevant date and continuing until the member's retirement date, by which an investment strategy is adopted by the trustees or manager which aims progressively to reduce the potential for significant variation in the value of the member's rights caused by market conditions from time to time.”*

- The switch from return-seeking assets to bonds/cash in period prior to retirement date
- Must start from at least five years before retirement date (reg 10A(6))

## Lifestyling - when is the retirement date ?

- Manager needs to get the retirement date right
- Pension advisory service

*“If you decide to retire earlier or later than you originally stated and lifestyling is an option you wish to use, you should tell your pension provider. This means that they can make changes to the lifestyling schedule so that you don’t miss out.”*

- But nb that this may be a matter for the trustees’ discretion if lifestyling has already begun (reg 10E(2))

## “Lifestyling” and the default options

- Leave pot untouched (ie continue to accumulate after NRD) High return
- Purchase an Annuity Low return
- Adjustable income (ie income drawdown) High return
- Take cash in chunks (ie drawdown of capital) Some Cash + High return
- Take whole pot in one go (25% tax free, the rest subject to tax) Cash
- “Mix your options” ?

## Lifestyling, flexibilities and loss

- Pensions advisory service

*“Lifestyling may be suitable for you if you’re intending to purchase an [annuity](#) when you retire, to provide you with an income for the rest of your life. It’s unlikely to be suitable if you intend to keep your retirement pot invested and to use [income drawdown](#) to provide you with an income in retirement. This is because moving your pension fund to lower risk assets is likely to reduce the investment returns that you will receive”*

- tPR report

*“Schemes were aware that an inappropriate glide path constituted a risk to good member outcomes”*

## Scope for mistakes

- “Lifestyling” towards the wrong retirement date
- “Lifestyling” or failing to lifestyle in such a way that the member is worse off with their chosen pension flexibility
  
- Creates scope for arguable loss if there is a mistake
- How does the trustee/manager protect itself ?

## Lifestyling - opting out and opting in

- Lifestyling (except in certain situations) has to be the default option (*reg 10A(2) Stakeholder Regs*)
- More than 85 percent of UK DC members are in the default option
- Important that
  - trustees/managers give the members the opportunity and information required to opt out of the default option and
  - process instructions if given
- Even if most likely outcome is no response

## Notices required - reg 10D

- Lifestyling the default option for members joining after 6.4.05
  - Notice must be sent at least four months but less than two years before the start of lifestyling (ie 5-10 years before retirement date - (reg 10A(5)))
  - Must inform member that lifestyling will apply from a given date (reg 10D(7))
  - Member can then opt out and the trustee **must** comply- (reg 10E(1))
  - BUT if member opts out after lifestyling has begun, the trustee **may** comply (reg 10E(2))
- IE if member not given the chance to opt out of lifestyling and subsequently chooses income drawdown, scope for a claim:
  - fund is now in bonds but should have remained invested in return seeking assets.

## Pre 6.4.05 members - notices

- Lifestyling not the default option (reg 10A(3) and 10B(1))
- But notice needs to have been sent to these members
  - explaining lifestyling and
  - that they could opt in to lifestyling in this scheme (if available)
  - or transfer to another scheme (if not available) (reg10D(3) and 10D(6))
- If member's pot is not subject to lifestyling and ought to have been, also scope for a claim
  - Pot kept in return seeking assets when should have been in bonds

## What about a more subtle approach to investment ?

- tPR DC code - model statement of investment principles

*'We want members to be invested in a fund which:*

- *up to the age of 55 will seek to grow the members' assets with a medium level of risk*
- *from the age of 55 will seek to reduce the volatility to the members' benefits and will progressively switch the members' assets equally between three funds:*
  - *A cash fund: to preserve capital and to meet the members' need for cash at retirement*
  - *A bond-based fund: to invest in assets which are broadly expected to match those which an annuity would be based on*
  - *A lower-risk growth fund: to achieve a level of growth up until retirement which will then be used to fund the members' need for income drawdown.'*

BUT MERELY LIFESTYLING LIGHT ?

## Default glide paths ? Should they now be different ?

- What choice should you be assuming the non-communicative member will be making ?
- Might depend on size of pension pot - tax less of an issue in taking a lump sum?
- tPR says widely different investment responses to the issue: eg
  - 100% cash at retirement
  - 50% cash, 50% hedge of inflation
  - Offer choice of glide paths
- More communication with members ?

## Is this the answer ?

- Scheme mitigation strategies - response to tPR:
  - Greater flexibility in the glide path (ie more choice for members)
  - More communication with members towards retirement date
  - Different defaults depending on size of pots: ie greater %age of cash for smaller pots

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