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REMOVING THE AGE 75 CLIFF-EDGE FOR PENSION SAVING

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The Coalition Government is consulting on proposals to change pensions tax law by "scrapping the age 75 annuity requirement" from April 2011. If they proceed, the change may give defined contribution (DC) pension schemes a new unique selling point.

Removing the age 75 barrier

Strictly, it is not currently compulsory to buy an annuity by age 75. But the alternative, "alternatively secured pension" (ASP), is a severely restricted form of income draw-down (see box – Current options for DC pension savings). It is unattractive to most people in the normal course of events. ASP was only intended to be a minor concession for those with religious objections to the risk pooling inherent in annuity purchase, not a general alternative to buying an annuity at age 75.

The Government proposals - capped drawdown

One Government proposal is to extend the more flexible unsecured pension (USP) income drawdown facility to cover everyone and remove ASP entirely. The government calls this "capped drawdown".

Its consultation sought views on whether the more generous USP annual drawdown limit will remain appropriate for capped drawdown after 75, where there is a concern that individuals may entirely exhaust their pension savings during their lifetime. The Government also expects to increase the tax charge on unused USP funds to around 55%.

At the same time, the Government wants to allow annuity value protection lump sums to be paid on death after age 75.

As an interim step, the Government has already changed the rules so the current requirements apply at age 77, not age 75.

It is hardly surprising the Government have taken this step. Back in 2004, George Osborne tried to remove the age 75 cliff-edge. Since then the impact of falling markets on DC pots showed that making people buy annuities at any fixed point could force people to sell investments at the worst possible time.

The radical part – flexible drawdown

But the proposals would not just affect those over 75. Under a more radical proposal, where anyone aged 55 or more has secured an inflation-linked income for the rest of their lives exceeding some minimum, they will be allowed to withdraw as much or as little of their remaining DC pot as they wish in any year (subject to marginal income tax).

Under this "flexible drawdown" arrangement, individuals will be allowed to meet the minimum income requirement through any mixture of state pension (which could itself be up to around £250 per week), increasing occupational pension scheme pension and increasing lifetime annuities. The Government is consulting on where to set the minimum. But to judge by the illustrative figures in the report, it looks unlikely to exceed £300 a week in today's prices. If that is so, "flexible drawdown" might be available to individuals with relatively modest DC pension pots.

Implications for DC pension saving

Although DC is increasingly the normal form of pension saving, it has its issues. Annuity prices have been high over the last few years, and are likely to get higher when the Solvency II directive is implemented in 2012 (as it will require insurance companies to be more conservative in the way they back their annuity liabilities). It is widely recognised that current DC contribution levels are insufficient, against the background of high annuity rates.

DC schemes already offer the advantage that an individual can control the investments, with self-invested pension plans becoming increasingly popular for those who want hands-on control. However, this isn't necessarily an attraction; some people just don't feel comfortable making those decisions.

With the flexible drawdown model, the DC approach to pension saving may have found another unique selling point: full control for individuals as to when they draw their pension savings and, after securing a minimum income, the ability to bypass annuitisation and its increasing regulatory costs.

The advantages of this flexibility in principle are clear; access to pension savings as and when, and at whatever pace, feels right for an individual.

The dangers, even with the minimum income requirement, are equally clear; ranging from investment performance during the "drawdown" phase not meeting expectations (or illustrations), with the result that individuals face a poorer retirement than they could have secured through an annuity, through to the risk of mis-selling to individuals who should be annuitising.

In principle, risk during the drawdown phase should be manageable, either by individuals investing in low risk (but low growth) asset classes or by further developing the range of products already offered in the context of USP, such as term investment bonds which combine the ability to drawdown income up to an agreed amount with a guaranteed investment return at the end of the term.

The mis-selling risk should not be underestimated; it will be for the regulatory authorities to ensure that there are processes in place to avoid the worst potential abuses. That may not be straightforward; many IFAs are already reluctant to advise members on the choices they face under pension schemes.

Wider implications

The introduction of flexible drawdown may have advantages for defined benefit occupational pension schemes too. Many such schemes are struggling to manage historic liabilities. Members who transfer out reduce the liabilities and risk these schemes bear. However, generally members are reluctant to transfer out into DC schemes: annuity prices mean that the transfer payment they receive from their old DB scheme will seldom be enough to replicate their original benefits. If members now see a real advantage to a DC scheme transfer over staying put, that may be good for DB schemes (and their sponsors).

More generally, some have commented that the flexible drawdown approach feels inconsistent with the regulatory approach taken for many years that pension saving (and the associated tax breaks) are there to provide pensions in retirement.

It is fair to say that in part this seems to be another step along the path of treating DC pension saving as just another savings option (within limits). Income drawdown was first made available for personal pension schemes in 1995, extended to DC occupational pension scheme saving in 1999 and further enhanced in 2006 (by the Finance Act 2004).

Where flexible drawdown does start to look very different though is in the principle that, provided the minimum income requirement is covered, the residual savings can be taken in one go at any time. This would allow pension savings to be used to help out family, or to cover medical or care needs. It could even be the first step towards tax efficient "welfare savings accounts".

Clearly, capped or flexible drawdown won't be for everyone. Not all DC pots will be big enough to secure the minimum income requirement, and some people will not feel comfortable taking the risks and costs that come with delaying, or avoiding, annuitisation. But at this stage it looks like flexible drawdown just might be seen in retrospect as the starting point for a new era in retirement savings.

Current options for DC pension savings

Before age 75	After age 75
Do nothing • Funds paid out tax free on death **Purchase a lifetime annuity** • Dependants pensions may be bought as part of the annuity • A value protection lump sum may be paid on death before 75 if payments made are less than the annuity purchase cost **Unsecured pension** (**USP**): • Funds designated as available for USP • 25% may be taken as tax free cash at the point of designation • Up to 120% of what would be provided by an "equivalent annuity" can be drawn down each year. • Fixed term annuities can also be purchased. • Unused funds can be used to provide dependent pensions. • Unused funds paid out as a lump sum taxed at 35%	**Purchase a lifetime annuity** • Dependants pensions may be bought as part of the annuity • No value protection lump sum can be paid **Alternatively secured pension** (**ASP**): • All funds not used to purchase a lifetime annuity by age 75 must be treated as designated as available for ASP • No tax free cash available. • A minimum of 55% of the value of an equivalent annuity must be taken each year, up to a maximum of 90%. • Fixed term annuities can also be purchased. • Unused funds can be used to provide dependent pensions or paid to charity. • Unused funds paid out as a lump sum taxed at 70% with additional inheritance tax on the remainder, making a potential tax charge of about 82%

The amount that would have been provided by an "equivalent annuity" is calculated using tables provided by the Government Actuary's Department.

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