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Reality or an illusion?

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Changes to pension drawdown rules might unlock more possibilities but still seem to affect only a few of the soon-to-be pensioners

The abolition of compulsory annuitisation – the rule forcing pensioners to take out an annuity by age 77 at the very latest – has added a further dimension to the choices available to pensioners in the UK. However, a closer look at the detail reveals that this may not be the holy grail it is being hyped up to be.

The alternative to an annuity is to draw income directly from the pension pot – a process known as pension drawdown. Under the drawdown route, individuals are entitled to leave their pension savings in the appropriate pension investment vehicle, allowing it to continue to grow and build the pension pot, and for an income to be taken directly from segments of the fund, encashed as needed.

Until this year, drawdown was only available for most pensioners up to a certain age – initially age 75 then rising to age 77 – although a form of unsecured pension arrangement (alternatively secured pension) was available beyond this age for those who had specific reasons for not taking out an annuity, such as religious beliefs.

From April 2011, full pension drawdown became possible for any pensioner at any age and, on the face of it, offers a wealth of possibilities for today's imminent pensioners. There are three basic routes that the pensioner can take: purchase an annuity, enter into one of the two distinct versions of the unsecured pension path – capped drawdown or flexible drawdown – or, importantly, mix and match solutions with a combination of annuity and drawdown, thus maximising the benefits of both routes.

An unsecured pension arrangement has two clear benefits. First, it may be useful to be able to retain specific investment vehicles into retirement. Business owners who have used their Sipp arrangements to finance their business premises, for example, may not wish to encash this investment, choosing to use the rental paid by the business back to the pension fund to finance their retirement income. Sipp arrangements may be particularly suitable for those keen to take advantage of the drawdown route, as they can hold a wide range of investments and can be adapted to meet encashment needs as they occur.

The second benefit of the drawdown route is the ability to pass on a portion of the residue of the pension fund to heirs on death. With an annuity contract, the value of the pension fund is lost to the pensioner's estate (although some

protection against early death can be introduced into the contract).

It has always been possible to pass on the residue of a drawdown contract to one's spouse with a tax-free lump-sum or income payable on death for pre-age 75 arrangements. Under the old ASP rules, any residue of post-age 75 pension pots not used for dependents' benefits was subject to a punitive tax charge of 82 per cent. With drawdown now possible for a wider range of individuals, some believe that a tax charge at this level would simply encourage pensioners to overspend in later years, risking the total depletion of the fund before death. Perhaps as a conscious effort to prevent this, this tax charge has been reduced to 55 per cent on death under the new rules, with no further inheritance tax payable.

The danger that pensioners will overspend during their retirement and empty the drawdown pot has been high on the government's radar when planning the new drawdown arrangement. The last thing it wanted to encourage was large numbers of pensioners falling back on state benefits in their later years – an ever more likely outcome as life expectancies rise. In order to prevent this, there are tight restrictions on how much of the pension fund can be spent through drawdown each year.

In the case of capped drawdown, this amount is based on the annuity income that the fund could buy and is determined by the Government Actuary's Department. The new drawdown limits are 100 per cent of the equivalent annuity figure. Of course, with every passing year in drawdown,

the fund size is likely to decrease (although this should be at least partly offset by investment growth), the equivalent annuity figure will drop accordingly, and the opportunity to purchase an annuity at the original level will have been lost.

As an alternative to capped drawdown, the government has introduced flexible drawdown. This removes the maximum income limit and its link to annuity levels, but obliges the individual to prove that they can reach a guaranteed minimum income requirement. This requirement has been set at £20,000 a year as at April 2011 and will be reviewed every five years.

The most important feature of the minimum income requirement rule is that qualifying income must be secure and guaranteed and cannot, therefore, take the form of investment income or another drawdown arrangement. Income from annuities, occupational schemes and the state pension are all qualifying income and if an individual has these in place, then a flexible drawdown arrangement could well be worth consideration. However, it would take a pension fund of about £250,000 to provide an annuity of £20,000 a year at today's rates; for the vast majority of people, there would be nothing left in the pot to take into a drawdown arrangement. For those with funds in excess of this level, drawdown could be worth consideration. Furthermore, those with high incomes who are lucky to belong to occupational schemes – public sector managers and senior employees in the NHS, for example – may well have the opportunity to both build a substantial private pension pot and meet

the minimum income requirement on retirement.

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Careful control of the dwindling of the underlying pension pot is key to a successful drawdown arrangement and the government recognises this; reviews are compulsory every three years up to age 75 and annually from age 75 onwards. At each review, the affordability and sustainability of the arrangement should be questioned and the benefits of drawdown reweighed against those of an annuity purchased at the current fund value.

Clearly, flexible drawdown can only be considered appropriate for those with substantial funds or multiple retirement income streams. However, even for those lucky few, there are pitfalls to avoid. From April 2012, the lifetime allowance for a pension fund will be £1.5m, with a 55 per cent tax charge levied on any funds in excess of this level. Where an individual has an existing pension fund of between £1.5m and £1.8m, it will be possible to protect it from the tax charge, but no further contributions to the fund will be allowed. Those with funds at this level who opt to follow the drawdown route in retirement (leaving the fund in investment) will need to make sure that growth does not take the fund over the lifetime allowance limit.

Despite the hype, the truth is that the changes to drawdown rules will affect only a very small percentage of those approaching retirement. Government figures suggest that in 2009 alone over 450,000 annuities were purchased, with a value of nearly £11bn, and most of

these would still have been purchased, even without compulsory annuitisation.

Annuities offer a secure regular income for life and continue to be the route most regularly advised for those with small to medium-sized pension funds. The vast majority of UK soon-to-be pensioners have less than £30,000 in their private pension pots, which is nowhere close to the amount that makes dispensing with an annuity an attractive proposition. For them the question is about where to find the best annuity products and rates in a difficult financial market, not whether or not to go down the annuity route.

However, there will be those who are in the fortunate position of having pension benefits far above the average. These will include those who have placed large sums into their private pension funds, perhaps through a Sipp arrangement. There will also be those in occupational schemes who have invested in their future through a parallel private pension scheme and have sufficient secure pension income from the defined benefit arrangement to allow them to take advantage of unsecured pension arrangements with their personal pension fund. For these few, affordability may be less important than the ability to pass on at least some of their pension savings to their heirs.

In many cases where drawdown is an option, the advice is likely to be to combine both secured and unsecured pension income to maximise both security and flexibility for the client.

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