



FEATURE ARTICLE

Date: 26th July 2010

Issued by: Andrew Gadd, Head of Research - Lighthouse Group

Pension Shake Up

In this Feature Article I thought I would look at three announcements that the Coalition Government have made in the area of pensions in a little more detail, namely the change from RPI to CPI, proposed changes to the annual allowance and finally the treatment of persons at age 75.

RPI to CPI

As I am sure you are all aware Pensions Minister Steve Webb confirmed in a written ministerial statement the Coalition Government's proposal to replace the Retail Prices Index RPI (RPI) with the Consumer Price Index (CPI) as the basis for calculating inflation linked statutory revaluation and pension increases for all occupational pensions, not just public sector pensions as announced in the Emergency Budget. This change will apply to revaluation in deferment as well as increases to pensions in payment and PPF and FAS compensation.

The change will not affect benefits until the next increase is made, which in most cases will be in 2011.

The Government has said that the change is being proposed because the CPI is a better measure of pensioners' cost of living than the RPI. But for me the obvious purpose is to reduce pension liabilities in both the public and private sectors. For employers this is a rare piece of good news while scheme members are likely to take a different view because in the long term, CPI, which does not include mortgage interest repayments, is likely to be a lower rate than RPI, resulting in lower benefits for scheme members and pensioners.

The actual impact on any particular scheme will depend on the wording of its specific rules. Some scheme rules simply link increases to the statutory requirements (e.g. statutory revaluation and pension increase orders), in which case members will be directly affected if the statutory measure changes. Other scheme rules "hard code" a link to the RPI measure of inflation in which case a change can only affect future accrual if a rule amendment is made.



Ultimately this is an important change and for individuals each scheme will have to be looked at on a case by case basis.

Changes to the Annual Allowance

Although the Emergency Budget was fairly light on detail at just 246 words, it made it clear that the Coalition Government will scrap the current plans for a tapering of higher rate tax relief for those earning £130,000 or more due to the complexity of implementing these rules. It also promised a consultation on what level a restricted annual allowance should be pitched at, indicating that this looks set to be between £30,000 and £45,000. This is markedly below the current annual limit of £255,000, but for many investors, most notably those making single premium or annual contributions, this high level had already been made unattainable by the introduction of the anti-forestalling measures in the 22 April 2009 Budget.

For many, this proposed change is broadly positive and infinitely preferable to the previous Government's plans, which would have been incredibly expensive to implement at both the provider and employer level. In effect under the Coalition Government's proposals individuals are losing some of the tax relief they got under A-Day but it is also still a considerable improvement on what we had pre A-Day, where the contribution limit was quite a low percentage of your earnings.

It is worth noting that even if the annual allowance were eventually to come in below the proposed range, at say £25,000 a year, then anybody saving into their pension at this level for 35 years would, assuming a modest 6% annualised growth rate, accrue some £1.7 million for their retirement!

Ultimately reducing the annual allowance puts the emphasis back on making regular pension contributions, which is in many cases a more prudent way of building your retirement income rather than paying in large single contributions in the last few years.

Although in many ways the reversion to an annual allowance will simplify the advice process, as usual the devil will be in the detail. Additional areas to be finalised include, for example, how defined benefit pension entitlements will be calculated for this purpose.

The Coalition Government is expected to take advice from all concerned stakeholders and come back with the revised rules in the autumn, which will then be put before Parliament again as the Finance Act 2010 (mark 2) in 2011. The one caveat to this is that all measures will be retrospective, so anyone trying to front-run the annual allowance is likely to be caught either by the anti-forestalling measures or the new legislation.



Age 75 Treatment

On the 22nd June the Coalition Government announced that it would “end the existing rules that create an effective obligation to purchase an annuity by age 75 from April 2011 to enable individuals to make more flexible use of their pension savings.”

As an interim measure, provision was made in the Finance Bill 2010 so that the tax rules will not make members of registered pension schemes who reach the age of 75 on or after 22 June 2010 buy an annuity or otherwise secure a pension income until they reach the age of 77. This enables all such members to defer their decision on what to do with their pension savings until the new rules are finalised next year.

For those of you that are interested HMRC have produced very good Technical Guidance on this which is available at: <http://www.hmrc.gov.uk/pensionschemes/technical-note.pdf>

In addition the Coalition Government has entered a period of consultation regarding the new rules that they may introduce and this is available at:

http://www.hm-treasury.gov.uk/d/consult_age_75_annuity.pdf

I urge you to take a look at this document which proposes some sweeping changes.

For me the highlights are:

- The Coalition Government proposes to create more flexibility for people who do not wish to buy an annuity. USP currently allows individuals to take a tax-free lump sum at the beginning of their retirement if they wish (minimum age 55), keeping funds invested in a tax-exempt environment while drawing down an income from their remaining pension pot in line with their needs, subject to a prudent drawdown limit. The Government will allow capped drawdown - equivalent to USP extended beyond age 75 - for the whole of an individual's retirement. This means that individuals will be able to choose how much to draw down annually from their pension pot throughout their retirement (subject to a capped limit), or whether to draw any income at all.
- The Coalition Government will go further than capped drawdown by creating additional flexibility for individuals who wish to draw down more than the capped annual limit. Under this flexible drawdown model, individuals will be able to draw down unlimited amounts from their pension pot, provided that they can demonstrate that they have secured a sufficient minimum income (MIR) to prevent them from exhausting their savings prematurely and falling back on the state. The requirement to demonstrate a minimum income will apply at the point at which an individual wants to exceed the annual capped drawdown limit. The Government will set the



level of the MIR and will review this level periodically. (The Level of MIR has yet to be fixed and fully defined.)

- Both capped and flexible drawdown will increase flexibility for private pension savers before and after age 75. This will make it unnecessary to continue to offer ASP as an option after age 75. ASP will therefore cease to exist when new rules come into effect. The new capped and flexible drawdown limits and rules, when finalised, will apply to existing members of ASP from April 2011.
- The annual USP limit (120% of the value of an equivalent annuity) was set in the context of the existing rules. The risk of running out of funds during drawdown increases with advancing age. The coalition Government therefore intends to review whether the existing annual limit remains appropriate.
- Pension commencement lump sums, trivial commutation lump sums and value protection lump sums are currently not available after age 75. The Coalition Government proposes to remove the age 75 limit on value protection lump sums, pension commencement lump sums and trivial commutation lump sums.

It is vital to remember that all of this is currently in the consultation stage and therefore we will have to wait to see what is eventually put before Parliament but from an individuals point of view change means potential uncertainty and even confusion - which can only really be solved through good financial planning and advice, which of course is where Lighthouse advisers come in.

Whilst LighthouseXpress Ltd has taken every effort to ensure that the above research is accurate, we cannot accept liability for any errors or omissions. In addition, it should be noted that the research does not constitute advice to invest, or not invest, in any product referred to above. This research is provided in order to assist you to provide your clients with sufficient information on which to make an informed investment decision. The past performance of an investment provides no guarantee as to the future performance of the new funds. The value of unit prices can fall as well as rise and the return of your capital is not guarantee.

LighthouseXpress Ltd is a wholly owned subsidiary of Lighthouse Group Plc, the AIM listed largest autonomous IFA and wealth management group in the UK. Full details of the group, including regulatory authorisations, can be found at <http://www.lighthousegroup.plc.uk>, or by contacting:

General enquiries phone number: 08000 85 85 90

General enquiries email address: enquiries@lighthousegroup.plc.uk